

ISLAMIC AND TRADITIONAL BANKING:
SOME AREAS OF CONVERGENCE AND
DIVERGENCE

INVESTMENT OPPORTUNITIES AND THE
CHALLENGE OF DERIVATIVES IN THE
MIDDLE EAST

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ISLAMIC AND TRADITIONAL BANKING: SOME AREAS OF CONVERGENCE AND DIVERGENCE

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Interest-free banking is no longer a mere theoretical proposition or an idealist's dream. Despite the fact that Islamic economics is a nascent discipline and Islamically-inspired banking and financial institutions are still in their early stages of evolution, last two decades have witnessed significant developments both in theoretical research and practical experimentation. Presently there are over seventy banking or financial institutions, with over two hundreds branches, and deposits exceeding \$80 billion, that are trying to mobilize and allocate financial resources on a riba-free basis. Compared to the quantum of the traditional banking business, this may look small, but from the Muslim perspective it represents a creative innovation with immense potential for the future. The fact that a conference like this is examining the relevance To each other of the two streams of Islamic and traditional banking and their tradeoffs, is a tribute to the attainments, and perhaps more important, the prospects, and potentials of the Islamic banking movement. Muslims constitutes one fifth-of the mankind, with fifty four independent states, occupying some of the most strategic areas of the world. There is a universal realization in the Muslim people to order their socio-economic life under the inspiration and guidance of their faith, moral values and principles, and seek the consolidation and integration of the Islamic ummah. That provides the raison d'etre of the Islamization movement. But the ummah cannot live in isolation, nor can the rest of the world afford to neglect the aspirations of over 1.2 billion people. It is in the best interests of all of us to understand each other more sympathetically and explore ways and means of healthy cooperation and fruitful competition.

2. Banking no longer a mere exercise in taking deposits and extending loans. Whatever be the beginning, the fact is in that the banking system today constitutes the very nerve-system of the world economy. Finance is the life-blood and banks control and manage this life-line. With the disintegration of the socialist politico-economic system, the opening up of the Third World countries and greater integration of the global economy the role of financial institutions in setting the pace of economy has increased manifold. Here we are faced with a fundamental problem: the institution of Banking has grown over the centuries in the context of a particular ethico-economic culture.

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Although riba (usury- interest) was forbidden by almost all great religions and ethical systems, and different cultures and civilizations had given rise to their own distinct financial institutions, including the medieval Christian and Islamic civilizations, modern banking grew in the lap of capitalism and around the pivot of riba (Interest). While banks perform a number of services, financial intermediation has become their major function. Modern banking system has successfully created a vast pool of assets which otherwise would have been in different places and forms, converted them into a huge force for financing private and public projects and in this historic process these financial agents were not only able to mobilize this vast financial pool but also develop the power to create credit on its basis, and as such wield enormous power and leverage, much in excess of the real asset base. Most of contemporary cultures have compromised on the question of interest — either as a necessary evil or as a convenient tool to benefit from the booty. The Muslims are resisting to succumb, despite the physical preponderance of the system. Their position is based on a set of religious and moral ideals, a value-system, and on their serious concerns about the ethico-economic consequences of interest-based economy and finance. The purpose of this paper is not to discuss the rationale of the Islamic position, as it has been fully articulated in the literature.¹ The point that deserves to be noted is the fact that the Muslim effort is to develop a financial and banking system on a totally different basis. This is a very fundamental departure from the present-day system. That there can be certain common features as well as areas of cooperation between the two systems is not denied, yet the fundamental differences in their basic approaches and ethos must be acknowledged. In the interest of clarity it would be helpful to spell out some of the basic differences.

3. In the eyes of the present writer there are at least four major differences between the two systems:

- a) The nature and structure of a modern capitalist economy can best be described as a debt-based economy. Whether we look into the consumption sector of the individual and the household, or the production sector, private or public, economic activity revolves round the pivot of credit based on interest. The strategy for growth pursued over the last few centuries has used credit as an instrument not only for physical growth but also for fiduciary expansion that is why the financial expansion via credit creation has become the premium mobile for economy, also the major headache for the system as far as stability is concerned.

¹ See: Mohsin S. Khan and Abbas Mirakhor (ed.), *Theoretical Studies in Islamic Banking and Finances*. The Institute for Research and Islamic Studies, Houston, Texas, 1987; Umar Chapra, *Towards a Just Monetary System*. The Islamic Foundation, Leicester, 1985; Ziauddin Ahmad et. al, (ed.) *Money and Banking in Islam*. International centre for Research in Islamic Economics, Jeddah, 1983; Abul A'la. Maududi. *Al-Riba. (Interest)*, Darul Fikr, Beirut, 1961; M.N. Siddiqui. *Issues in Islamic Banking*. The Islamic Foundation, Leicester, 1983; *Elimination of Riba from the Economy*. Institute of Policy Studies, Islamabad, 1994.

This has been the case in respect of domestic national economies for the last three centuries, if not more; and this is becoming the modus operandi for the world economy, at least since the Second World War.

Islamic economics, as it is being presently developed, is rooted in a different vision of the economy; one that is equity based as against a credit based one. Not that there would not be a possibility for loan transactions — Qard Hasan exists at a certain level to meet genuine individual or business needs. But the structure of the economy would be of a very different nature capital and entrepreneurship would be co-participants, sharing the risks as well as the rewards of the enterprise.

Islam is not opposed to a return on capital. It proposes that banking systems that operate on the basis of ex ante fixed rate of interest be replaced by profit-sharing systems in which the rate of return to the financial resources is not known in advance and is not fixed prior to the undertaking of transactions. Islam encourages trade and commerce and profit is not only permissible, it is encouraged. A variable rate of return based on actual profits is the basis on which Islam wants capital and entrepreneurship to cooperate and participate in the production process. Islamic societies were able to develop a number of financial instruments and institutions during the first one thousand two hundred years of Islamic history and although the economic system is much more complex today, Muslims are today engaged in an effort to develop an alternate system in the context of the contemporary economy.

- b) The abolition of interest is only one aspect of Islamic economics. Islam aims at establishing a just economic order, based on clearly spelled out economic rights and concepts of property, contracts, work and distribution of income and wealth. It stipulates a framework of values and disvalues, desirables and undesirable and hedges the market mechanism with a moral filter so as to ensure efficiency and equity in the process of allocation of resources. The role of state has also been clearly defined, neither being a neutral police state of the Laissez-faire type, nor a totalitarian state of the socialist order. There is limited scope for intervention for specific objectivities. Islam also emphasizes the need for stabilization of prices and protection of the value of money, which is a measure of value and a standard for deferred payments. In such an economy Banks are not mere financial intermediaries but also play an active role in developing and maintaining a certain pattern of economy, serving certain socio-moral objectives. Banks cannot be mere 'welfare institutions', but the welfare and equity dimensions are as relevant and as important in the Islamic scheme as the efficiency and the optimality dimensions. Definitely there would be tradeoffs. As such the objective is to achieve a balance between

efficiency and equity, and between profitability and welfare. Traditional banking is also tiding to discover the moral dimension in a limited sense. The whole movement towards ethical banking is an instance in point.² but that is something on the periphery — and not evens the whole periphery. Ethics and social objectives are central to Islamic banking— and that is why Islamic banking is not mere interest-free banking. It is much more than that. It represents a new and vastly different vision of the whole economy.

- c) Over and above the question of interest and ethical concerns traditional banking has two others aspects that cause fundamental concern amongst the Muslim economists. The history of the evolution of banking in capitalism bears witness to the fact that banks have mobilized the savings of tens of millions of people but the end-users, because of the cardinal principle of financial collateral among others, are limited. This leads to concentration of economic power and control in fewer hands. This is built into the system. Because of this, inequitable distribution of income and wealth takes place. This has led to permanent convergence of capital with capital and has resulted in denying laboring the possibility of a more equitable partnership with capital. This lies at the root of the great divide in a capitalist society. Islam wants to change this relationship. That is why the instruments of financial partnership that Islam has encouraged treat capital and labor and finance and entrepreneurship as partners, as co-shares of risk and reward. This produces a very different type of economy and society.
- d) The other aspect relates to the power of the banking system to create credit and as such enjoy part of power that is the privilege of the state — the Creation of money. Despite prudential rules and the role of the central banks the powers enjoyed by banks to create credit are immense and have a very important role in producing destabilization and cyclic movements. Economists and policy-makers in the western world have also been concerned about this situation and many schemes of banking reform have been put forth³. Islamic banking would resolve this problem by reducing fiduciary expansion and promoting a kind of a physical economy based on co-operation and co-participation of capital and entrepreneurship.

2 See James J. Lynch, *Ethical Banking: Surviving in an Age of Default*. McMillan, London 1991

3 See: Henry C. Simon, *Economic Policy for a Free Society*. University of Chicago press, 1948; John H Karechen, *Ensuring Financial Stability*. Federal Reserve Bank of San Francisco, June 1985; Mohsin S. Khan, "Islamic Interest-free Banking: A Theoretical Analysis." IMF Staff papers. Vol.33 no. 1. pp 1-27, Washington 1986.

4. After identifying some of the major areas of divergence between the Islamic and traditional banking, I deem it a demand of honesty and objectivity that I must note that the Islamic banking as it has developed over the last two decades, has a long way to go to be truly representative of the concept of Islamic banking. That efforts have been made with seriousness and dexterity to eliminate riba from financial dealings is something to be welcomed and encouraged.

Whatever mileage has been covered is appreciable. Moreover, this fact must not be ignored that these experiments are being made in a climate - both domestic and external - which is anything but congenial. The moral fibre of the society is weak. The legal framework is antagonistic. The tax system is partial towards the interest system and almost inimical to a profit-sharing system. The state of competition between the Islamic and traditional banking systems is such that most of the odds are against the Islamic system. In this context whatever progress has been made is path-breaking. Yet it deserves to be acknowledged that these efforts represent only first steps towards the direction of Islamic banking. Present day interest-free banks have relied rather too heavily on those permissible instruments of financing which are closest to the traditional system like Murabah (mark-up) and ijara (leasing). Almost 60 to 90 percent lending has been done through these instruments. The real alternate instruments of Mudaraba (Trustee-financing⁴) and Musharika (profit-sharing) have been used to a very limited extent. Other ethico-social objectives have also not received the importance they deserved. Greater success has been achieved in the field of deposit-mobilization; particularly many untapped sources have been drawn upon. But the socially beneficial and development and welfare oriented utilization of these resources has left much to be desired. Employment generation and flow of resources towards the lower and middle classes of the society, particularly in the rural sector, where great potential as well the challenge exists, has not taken place. That is why it would be unfair to judge the success or otherwise of the Islamic banking scheme mainly on the basis of the limited and partial experiment that is presently being made. The experiment is not even halfway through. The mileage yet to be covered is crucial. The distinctive character of the system is yet to appear. Then and then alone the scope and extent of the experiment could be fully and realistically appreciated ⁴.

While the present writer firmly believes that the Islamic banking can come of age only in an economy and society that is committed to total Islamization and where real transformation is produced as a result of comprehensive movement, consisting of Islamically oriented behavior of the individual and socio-economic economic based on Islamic values, he belongs to that group of economists who regard the contemporary.

4. As an example of such unfair comparison see: Elias G Kazarian, Islamic Financial Innovation in Egypt. West view pre.ss,' Oxford, 1993

Islamic-banking movement, despite all its weakness, as a positive development which bears great promise for the future. I also believe that despite fundamental differences with the traditional banking there is a vast area of cooperation between the two streams. After all venture capital has played a very important role in the development of the world economy. Investment banking has been an integral part of banking, more prominently in the German and French traditions of banking. Unit trusts and investment houses are operating as major financial institutions in the world today. IFC against IMF and World Bank has gone in equity financing in international development effort. I do not think western bankers would be averse to the idea of developing new modes of cooperation with the Islamic banks and financial institutions if they are presented with economically viable projects.

I do not think western bankers would be averse to the idea of developing new modes of cooperation with the Islamic banks and financial institutions if they are presented with economically viable projects. If Bosphores bridge — a billion dollar project — could be financed through venture capital, why not thousands of other projects. Once this new commonality of interest, based not traditional 'interest' but some form of equity-sharing — is built, I am sure new avenues of cooperation can be explored. Huge untapped resources exist in the Muslim world and one of the reasons why they remain untapped is Muslim reluctance to go for interest-based financial institutions. Recent surveys have shown at even in Saudi Arabia, between 40-60 per cent of the households that have a relatively high per capita income do not have a bank account. A large number of those who keep deposits have refused to take interest⁵ the situation are not different in other Muslim countries and even with the Muslim communities in many Western countries. There is no reason why this market should not be tapped. Islamic and traditional banks can play an important role in this respect.

A study-by the Development Centre of the OECD on Arab and Islamic Banks touches upon this aspect. Let me quote;

“If the South proposes now, with Islamic banking principles, a new concept of socio-economic interaction (profit-sharing systems, focus on small and medium-sized innovative entrepreneurs, with the major objective of economic asset creation, etc.), it could be a contribution to co-operation concepts so far mainly propounded by the countries of the industrialized world.

Islamic banking is trying to change the relationship between finance on one hand and industry and commerce on the other. This new relationship is the basis of the Islamic economic system being set up.

5. See R. Wilson. Banking and Finance in the Arab Middle East. McMillan. London, 1983; N.A. Sherbiny, Oil and the Internationalization of Arab Banks. Oxford Institute of Energy Studies, 1985

Though Islamic principles have yet to be put to the test in the competitive environment of international finance, the two systems are similar in that they both strive for closer ties between financial intermediation and economic-asset creation.

Islamic banks could make a useful contribution to economic growth and development, particularly in a situation of recession, Stagflation and low growth levels, because the core of their operations is oriented towards productive investments. All countries, both in the North and in the South, need more venture capital. Loan capital is available, particularly in industrialized economies, but at high interest rates. However, even medium-scale entrepreneurs there find it difficult to raise sufficient risk capital for expansion and innovation. This has acted as a brake on productivity and economic growth in the North. Thus, practical and immediate co-operation possibilities exist between Islamic banks and enterprises all over the world. The intermediation process remains to be full developed⁶."

Let me refer to a recent article by Prof John R.Presley and J G. Sessions of Loughborough University (UK) and published in a recent issue of the prestigious professional journal of the Royal Economic Society of Britain. The Economic Journal entitled: "Islamic Economics: The Emergence of a New Paradigm": The authors start with the lament:

"Western economists have been somewhat remiss in the last decade in failing to recognize what has the appearance of a new paradigm in economics - that of Islamic economics"

They conclude:

"A riba contract creates an explicit mapping between the compensation and the input of capital... The prevalent method of Mudarabah financing ties compensation to the outcome of the project. Mudarabah therefore allows the contract to control the manager's incentive to exert effort directly, since this effort affects the relationship between capital investment and the outcome of the project. Under a Mudarabah contract the manager is let free to chose the individually optimal level of investment in each state contingent on his contractually specified level of effort. Such a contract permits a mean-variance improvement in capital investment - average investment in increased whilst inefficiently large fluctuations around this level is reduced We have shown that the use of the prevalent alternative method of financier remuneration (i.e. Mudarabah) will, under certain conditions, lead to an enhanced level of capital

6. Traute Wohlers-Scharf, Arab and Islamic Banks, new business partners for developing countries; OECD, Paris 1983, P.95

investment on account of the ability of Mudarabah to act as an efficient revelation device”⁷.

I would like to conclude on a positive note by quoting a leading German economist Prof. Haus Alba'ah who says, about the Islamic banks:

“They supply equity in the form of venture capital to investors whose share ' is their ingenuity and their labor. Secondly, they supply equity in the form of equity capital as participants in the type of project which in general has majority shareholders. They may be ideally suited to meet the needs for equity capital in developing countries where the business risk is particularly high as well as in the industrialized countries where the development of new process and new projects involve high risk and requires large amount of venture capital”⁸.

These represent only some areas of cooperation and convergence. Let Islamic and Traditional Banking-not look upon each other as rivals, despite their differing perspectives. They can still be partners in building a brighter future for mankind — both in the Muslim and the Western worlds.

Journal, Vol. 104, No. 424, May 1994, p. 595.

7. J.R. Presley and J.G. Sessins, "Islamic Economics: The Emergence of a New Paradigm," *The Economic*

8. Hans Alba'ah, in *Islamic banking-'*. Proceedings of Baden-Beden Semmier, London