

ISLAMIC BANKING: AN OUTLINE OF SOME CONCEPTUAL AND EMPIRICAL ASPECTS

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1. Introduction

It may surprise some observers that this study addresses the banking system in Islam or, for that matter, the economic system in Islam. They inquire: what does Islam as a religion have to do with economics?

However, religion can be defined even in the western terminology — as stated by the French philosopher Michel Mayer — as «the set of beliefs and precepts which must guide our conduct toward God, toward other people and toward ourselves». Thus, part of the domain of religion is human behavior in all its aspects. Now, according to the well-known economist, Paul Samuelson, economics is «the study of human behavior in relation to using scarce productive resources to produce goods and services, and distribute them for consumption». Therefore, economics deals with certain aspects of human behavior, in particular regarding production, distribution and consumption.

It shall be clear from the foregoing definitions that religion comprises economics. Indeed, the Quran — the Holy Book of Islam — gives several emphatic examples of the teachings of earlier Prophets — may peace be upon them all — in relation to economic affairs. For instance, the message of Prophet Shuaib was an economic one. The Quran reports him as saying to his people: «Will you not fear Allah? I am to you an apostle worthy of all trust. So fear Allah and obey me. No reward do I ask of you for it, for my reward is only from the Lord of the Worlds. Give just measure and cause no loss (to others through fraud). And weigh (things) with scales that are true and upright. And do not withhold things that are due to other people, nor do evil in the land working mischief».

Islam has laid down a set of codes and values encompassing all aspects of life including its social, economic, political and spiritual spheres. In Islam, the economic injunctions and instructions are very numerous and explicit in the Holy Quran and in the honorable Tradition (Sunnah) of Prophet Mohammad, peace be upon him¹. Indeed, Islam considers the economic activities of man, not as a secondary affair, but rather as an important aspect of the fulfillment of his duties toward God.

¹ See *The Meaning of the Glorious Koran*, translated by M.M. Pickthall (New York: Mentor, 1953). For a useful discussion on the subject, see, for example, Kaht (1978), and Ahmad (1980).

2. The Elimination of Interest Rates in the Islamic Banking System

Our purpose in this study is to address one key component of the Islamic economic system; namely, the banking sector. Any society requires some means of channeling funds from savers to investors. The institution that performs that function is called a financial intermediary or, more commonly, a bank. In western societies, the bank obtains funds from its customers (depositors) on the basis of a fixed interest rate payable to the depositors; and the bank in turn lends these funds to investors (borrowers) on the basis of another (higher) fixed interest rate payable to the bank. Thus, interest rate represents the basis of western banking system.

In Islam, however, interest is considered usury and thus prohibited. The Holy Quran is very explicit in prohibiting all interest-based transactions. Roughly translated, in Chapter II, verses 278-279, the Almighty God states, «O you who believe! Observe your duty to Allah and give up what remains from Riba [the arabic word for interest], if you are believers. And if you do not, then be warned of War from Allah and His Messenger. And if you repent, then you have your principals [without any interest]. Wrong not, and you shall not be wronged». Besides these verses, there are several others in the holy Quran which confirm the decisive prohibition of all interest-based transactions².

Therefore, the basic distinguishing characteristic of an Islamic banking system is the absence of the payment or receipt of any predetermined (fixed) interest rate which is considered usury. Interest rate is the predetermined return on the use of money. There is consensus among Muslim scholars, who base their opinion on the Quran and the Sunnah, that the term Riba is usurious and it covers all forms of interest. Instead of such a predetermined interest rate, the Islamic banking system operates under the general principle of profit-loss sharing which effectively transfers Islamic banks into equity-based firms. One, of course, can only speculate on the possible rationales for

2 It should also be noted that religious teachings before Islam had also prohibited interest as usurious. For example, in a letter which gave some reference to the concept of usury or interest charging, Pope Urban III (1185-1187) cited the words of Christ, «lend freely, hoping nothing thereby» (Luke 6:35). Here, a specific command of Christ is authoritatively interpreted by a Pope as prohibiting usury. See Hastings (1922). In Judaism, there are three Biblical passages which forbid the taking of interest in the case of «brothers», but permits it when the borrower is a Gentile. The passages are Exodus 22:24, Leviticus 25:36-37, and Deuteronomy 23:20-21. In Leviticus, «increase» is the rendering of the Hebrew «marbit» or «tarbit» which denotes gain on the creditor's side. Lending on usury (interest) or «increase» is considered by Ezekiel (18:13,17) among the worst sins. Also, in Psalm 15, among the attributes of the righteous man is reckoned the fact that he does not lend on usury. See *The Jewish Encyclopedia*, vol. 12 (New York: Ktav Publishing House, Inc., 1901), p. 338.

the prohibition of interest in Islam, for the actual rationales are known only to God. Among others, a possible rationale relates to equity and the protection of the poor from the exploitation of the rich whose wealth is comprised only of money and no other skills. Islam also regards the accumulation of wealth through interest as selfish compared with accumulation of wealth through hard work and personal activity³.

It should be immediately pointed out that an interest-free banking system is not totally alien to western economic thinking⁴. For example, prominent American economists like Henry Simon (1948) and Charles Kindleberger (1985) have recently proposed certain banking reforms to reduce existing banking risks. At the heart of such reforms is the elimination of a guaranteed fixed interest rate which in effect restructure western banks to a system resembling that of the interest-free Islamic banks⁵.

As mentioned earlier, the Islamic banking system prohibits the payment (or receipt) of a fixed, predetermined return on money without any risk involved. Islam, however, allows and even encourages an uncertain rate of return—which could be positive (profit) or negative (loss). That is, to lend and borrow money on the general principle of profit-and-loss sharing. Thus, depositors of funds in an Islamic bank becomes a shareholder and is not guaranteed a fixed interest rate but simply a share of whatever profit or loss the bank will reap. The funds thus obtained will then be invested by the bank either directly in the bank business projects and/or indirectly through lending the funds to other investors, again on the basis of the profit-and-loss sharing. Whatever the bank obtains from such direct or indirect investment projects (profit or loss) will be distributed among its «depositors» (shareholders) according to an agreed upon formula⁵.

There will be basically two kinds of deposit accounts in an Islamic bank which, besides its own capital, are the main sources of funds for the bank. These are (a) Transaction (or current) accounts and, (b) Investment accounts. Transaction accounts are equivalent to regular (non-interest bearing) checking accounts in western banks. Deposits in such accounts are funds that the customer (depositor) intends to use shortly. Consequently, the bank can not use these funds in any short or long-term investment project since they could be withdrawn by the depositor any time (demand deposits). By depositing funds in current accounts, the depositor gets services in the form of safety, convenience

3 For more on this, see Qureshi (1967), and Ahmed *et al* (1983).

4 See M. S. Khan (1986).

5 For more details, see S. R. Khan (1983), and Al-Jarhi (1985). A lucid discussion of a theoretical model of Islamic banking can be found in M.S. Khan (1986).

and the use of checks instead of cash. For these services, the bank then will charge the depositor full fees to cover the bank's cost to produce such services⁶.

The investment accounts represent the major source of funds for an Islamic bank and such accounts are actually shares rather than saving accounts. As we mentioned earlier, investment accounts in Islamic banks guarantee no fixed, predetermined interest rate. Depositors are shareholders entitled to a fair share of the profit or loss made by the bank. The only contractual agreement between the «depositor» and the bank is the proportion in which the profit (or loss) is to be distributed between the two parties.

3. Some Theoretical Rationales of Islamic Banking

Does the Islamic banking system have merits from a purely economic standpoint, independent of its consistency with the guidelines of Islam? It can be argued that banks functioning on the basis of profit-loss sharing instead of fixed interest rates yield desirable effects at least in regard to the financial stability of the system and to the level of economic activity. It has been suggested by many prominent western economists (e.g., Simon and Kindleberger) that the practice in western banks of paying depositors a fixed interest rate on their deposits, regardless of whether the bank is doing well or not, is perhaps a major cause for many banks to fail in recent years. According to the Federal Deposit Insurance Corporation (FDIC) Annual Report (1987, Table 122), no less than 1,333 banks failed in the United States due to financial difficulties in the period 1934-1987. About half of that number (631) closed in the years 1980-87, and 184 banks failed in 1987 alone. As Khan (1986, *Ibid*) showed, the payment of a fixed interest rate prevents western banks from instantaneously adjusting to potential financial shocks. In contrast, Khan showed why the alternative Islamic banking system can provide immunity against bank failure and financial instability. While we do not claim that the only reason for recent failures in western banks is the guarantee of paying a fixed interest rate, we do however argue that such a practice has certainly contributed to their financial instability.

As to the impact of the Islamic banking system upon the level of aggregate production (economic activity) consider the creditor-debtor relationship from the standpoint of the creditor⁷. The creditor (e.g., a western bank) is of course concerned primarily about

6 Besides these two main deposit accounts, an Islamic bank could also provide a range of many other services (for fees) like money transfers and offering expert advice on business projects. For more details on actual practices of Islamic banks, see Uzair (1980), and M.F. Kahn (1983).

7 See Siddiqi (1981)

the return of his principal plus the interest stipulated. Thus, the bank will make loans only to credit-worthy borrowers who have sufficient collaterals, giving only secondary attention to the nature and soundness of the project for which the borrower requested the loan. It is thus conceivable that many unsound projects could be financed by western banks because the borrower has sufficient assets to back up his loan in case of default. Consequently, under western banks, funds are generally lent to the most credit-worthy investors and not necessarily to those with the most promising projects.

In contrast, an Islamic bank will finance primarily those more promising investment projects, with the credit-worthiness of the borrower receiving only a secondary importance. This is because the Islamic bank lends money on the profit-loss sharing basis. Hence, the soundness of the project is the most important aspect of the project in this case. Consequently, if financed, the expertise of the bank must join that of the debtor (borrower) in order to ensure efficient management and the highest possible productivity of the project. In other words, the relationship between the creditor (the Islamic bank) and the debtor (the borrower) is harmonized under the Islamic banking system as both have an interest in the welfare and soundness of the project, and the share of each in the profit is positively related to its success. It can thus be concluded that investment projects financed under the Islamic banking system are less likely to fail compared with those financed based on the fixed interest rate arrangements. Of course, such an outcome will be very beneficiary for the whole economy under the interest-free banking system and both productivity and the level of aggregate production can be expected to rise⁸.

4. Some Empirical Evidence

The preceding analysis has showed that the Islamic banking system does have some merits. However, such analysis is purely theoretical. Indeed, most studies to date published on Islamic banking system have been theoretical in nature. Perhaps the case for the Islamic banking system would gain further credibility if some kind of supportive empirical evidence can be found. In a paper published by one of the authors, Darrat (1988) has provided some empirical evidence on the subject using actual data from a Muslim country; namely, Tunisia. Darrat's main purpose was to test empirically (using actual

8 For the several desirable effects of the Islamic banking system on the allocation of resources and the stability of the value of money (price stability), see Siddiqi (1981), and Chapra (1983).

time series data from 1960-1984) the hypothesis that the financial (banking) system in Tunisia becomes more efficient if interest transactions were to be eliminated within the Tunisian banking sector. Efficiency was defined in terms of four criteria: a) the stability of the velocity of money (the ratio of national income to money supply), b) the stability of the public demand for cash balances, c) policy controllability of the monetary aggregate, and d) the monetary aggregate/ultimate policy goal linkages. The empirical findings were striking. First, in contrast to the interest-based financial system, an interest-free financial system is found to exhibit a well-behaving and smoother velocity of money. Second, only the interest-free system has a structurally stable demand for money function. And, third, only the interest-free monetary aggregates can be usefully utilized by the monetary authorities in Tunisia as an appropriate intermediate policy target. The latter evidence is based on the finding that only the interest-free monetary assets can be effectively under the control of policy-makers and that only such assets have a reliable link with the ultimate policy objectives.

Therefore, the available empirical evidence seems to support the theoretical analysis in the preceding sections and show that the Islamic banking system does seem to be meritorious both on theoretical and empirical grounds.

5. Concluding Remarks

This paper has provided some outlines of the Islamic banking system, and assessed its viability in modern economic systems both from the theoretical and the empirical standpoints. An interest-free banking system is consistent with the teaching of Islam and its unequivocal prohibition of any fixed interest rate in the society. Independent of its consistency with the Islamic teachings, an interest-free banking system is shown in this paper to be both efficient and feasible in modern economic systems to warrant serious attention in academic and policy-making circles alike particularly in this contemporary era of rampant western banking failures.

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Abstract

This paper provides some general outlines of the interest-free Islamic banking system and assesses its theoretical and empirical viability in modern economic systems. In addition to its consistency with the Islamic prohibition of interest-based transactions, an interest-free banking system is shown to be both efficient and feasible. Indeed, this Islamic banking system appears worthy of more serious attention in academic and policy circles particularly in view of the rampant western banking failures in recent years.

LES BANQUES ISLAMIQUES: UNE ANALYSE THEORIQUE ET EMPIRIQUE

RESUME

Cet article se propose de mettre en lumière certains aspects d'un système bancaire islamique qui ne prévoit pas de taux d'intérêt et d'analyser ses fonctions autant du point de vue théorique qu'empirique dans un système économique moderne.

Un système bancaire sans taux d'intérêt est non seulement compatible avec la prohibition de l'Islam concernant les transactions financières à titre onéreux mais encore est applicable et efficient. En plus, on peut ajouter que les systèmes bancaires islamiques devraient attirer l'attention des milieux académiques et politiques spécialement à cause des très graves difficultés financières des banques occidentales ces dernières années.