

Does Islamic Banking help in Economic Development of Muslim Countries?

Abdelrahman Yousri Ahmad *

Abstract

Islamic banking has developed all over the world but on approach different from what it was visualized. The objective of this paper is to analyse the role that current Islamic banking practices play in development of economies of the Muslim countries. As interest based banks are rejected by people in Muslim countries, Islamic banking was expected to play role by financial inclusion and providing of finance to agriculture, industry and exports sectors. The paper argues that the performance of Islamic banking in four decades has been unsatisfactory. A *ribā*-free banking system should prove that financial resources are mobilized and employed efficiently through profit/loss sharing and Islamic business and investment criteria. A better future role of Islamic banking in economic development is expected with urgent corrections of errors like total elimination of non-compliant Shari'ah products like *tawarruq*, engineering a new *muḍārabah* contract based on Shari'ah compliant restrictions and mechanisms, adopting new production-oriented policy in *murābahah* by using it increasingly in financing promising SMEs and exports oriented activities, and employment of resources through non-banking finance companies (NBFCs) which would be of particular importance for *ijārah*, *muzāra'ah*, and *salam* operations.

Keywords: Islamic banking, Muslim countries, Economic development.

KAUJIE Classification: J3, K0

JEL Classification: E44, G2

1. Introduction

All Muslim countries as at present are classified as developing countries. With exception of the oil producing countries and newly industrialized Muslim countries such as Malaysia and Turkey, Muslim countries are classified in low average per capita income, or low per capita income

* Prof. Dr. Abdelrahman Yousri Ahmad is Professor of Islamic Economics and Finance at QFIS, HBKU, Qatar and Emeritus Professor at the University of Alexandria, Egypt, he is Formerly Director General of IIIE, IIU, Islamabad.

groups (World Bank, 2015).¹ What is the role of the banking system in economic development? Focus is placed in this paper on the Islamic banking system because the conventional *ribā*-based system is rejected. But, are we calling for a replacement of conventional by Islamic banking only to eliminate *ribā* in letter? Or because a *ribā*-free financial system is believed to be more capable of mobilizing and employing financial resources and, hence, can efficiently help in pushing economic development? The targets of Islamic banking should, therefore, be made clear. The paper attempts to evaluate the role of Islamic banking in development in four decades on the bases of what was expected from this system and what has been achieved? Many questions arise in this respect, but most important of them in the context of economic development is: how far Islamic banks succeeded in employing financial resources made available to them in the Production sector, and accordingly how far they were able to help economic development? Have they done a better job than conventional banks which we are rejecting on religious bases?

We have to emphasize that Islamic banking, in principle, is not an option, it is a must. Yet, we have to shed light on pros and cons of Islamic banks in practice. The paper also attempts to present proposals that could ensure satisfactory performance of Islamic banking in future.

2. Targets of Islamic Banking

Islamic banking in theory should be established for three desirable targets: elimination of interest (*ribā*) and other non-compliant Shari'ah transactions, e.g. *bai' al-ṭinah*, *gharar*, *ghaban*; applying Islamic profit/loss sharing modes of finance, and giving priority to financing investment activities to push economic development. These targets ensure compliance to Shari'ah and its tenets, and are bound to bring about monetary stability at the macro level in the short run² besides realizing

¹ Rich Arab countries are yet awaiting for major efforts to be done towards restructuring their economies. Malaysia and Turkey, though achieving relatively high rates of economic growth, cannot yet be classified internationally as developed economies. Muslim countries in some cases are classified as ultra-poor, e.g. Niger, Madagascar, *Somaliland*, and *Bangladesh* [World Development Report, 2015.]

² Elimination of interest-based finance would minimize speculative activities which seek making money from money. In the interest system, therefore, monetary transactions grow in an unbalanced manner with real transactions (the production sector) causing monetary instability and periodical financial crisis. Islamic modes of finance which are profit/loss would normally maintain balance between real and financial transactions and therefore are bound to help in bringing about monetary stability, provided that proper Islamic banking is in practice.

economic development which is the most important target for Muslim countries in the long run (Chapra,1993; Yousri,2013).

Islamic banking may thus be defined as an interest-free institution that provides Shari‘ah compliant financial and investment services, and employs Islamic criterion in allocating investment resources towards achieving economic development. This definition would be difficult to comprehend by all those who thought of Islamic banking on same lines as conventional banking, except that it is a free-interest financial institution³.

Islamic banks have succeeded, as their balance sheets and global reports show, in increasing their financial assets on non-interest bases. Yet, how far available financial resources have been employed in a manner that is different from conventional banks is a serious and disturbing question that has frequently circulated amongst Islamic economists since the last decade.

Islamic banks in practice have succeeded in removing the word “interest” from their dictionary. But on other hand, the past four decades have revealed that they never really escaped the influence of the interest rate system. All parties that are holding the responsibility of Islamic banking have to be questioned about this: Why Islamic banks could not move in 40 years towards a true Islamic application? Why banks are becoming increasingly involved in organized *tawarruq* or in some cases prohibited *‘inah* (disguised interest) transactions (OIC Fiqh Academy, 2009). Why banks extended finance for their own conducted trade transactions (e.g. *murābahah* and *ijārah*) and neglected financing the business customers on basis of profit/loss sharing? These and other questions lead us to a more serious question: Do managers and Shari‘ah people in Islamic banks really understand the targets of Islamic finance? And if they do, why cannot they work for implementing such targets? Are they unable to do this? Is it because of internal reasons or external ones that are beyond their control? All such questions are of extreme importance to the role of this institution in economic development.

3. The Experience of Islamic Banks in Funds Eemployment and Reflection on Economic Development

It is not our task in this article to deal with Islamic banks’ experience in collecting funds. Balance sheets of these banks prove that rate of growth in their financial assets was higher than that of conventional banks. Competitiveness of Islamic banks is among factors which explain such

³ Such an incomplete definition has been among factors that caused malfunctioning of Islamic banking in practice since the 1970s!

phenomenon. Reports show that the assets of Islamic banks grew at an average rate of 17% per year between 2008 and 2012. This is two to three times faster than the rate at which conventional banks grew over the same period (Ernst and Young, 2014-2015)⁴. It should be noticed that statistical figures do not distinguish wholesome Islamic banking from Islamic windows in conventional banks. The rapid expansion of Islamic banking assets has been mainly through Islamic windows in conventional banks rather than in full-fledged Islamic banks (Ariff, 2014).⁵ Besides, statistical figures will be different if Islamic banks practicing impermissible Shari'ah finance are ruled out. It is in fact a methodological error to include the latter category amongst Islamic banks.⁶

On the other hand Islamic banks' performance in employing their financial resources has driven away Islamic banking from its most desirable target, namely economic development finance. Following would analyse this aspect:

A. Islamic banks succeeded in extending their business without giving or charging interest on funds received or given, but they have been unable to remove the influence of the interest based system. The profit margin or mark-up in *murābahah* finance is guided by interest rate (like LIBOR). In the leasing/sale operations (*ijārah wā iqtinā'*), the installment consists of two parts: one which covers percentage of the asset's total price, and the other is the bank's profit from leasing. The latter is determined by reference to the interest rate (LIBOR + or – BP).⁷ In the same way the bank profit is determined in *istisnā'* and *mushārahah mutnāqisah*. In brief, the interest rate is used as benchmark in determining the Islamic banking profit margin in all debt-based sale operations.⁸ The only difference in all debt-based sales is that the “so-called profit rate” will not be re-calculated to become a compound one in case of customer's default, as practiced by conventional banks. The defaulted customers, however, in the case of default are subject to a penalty which should be assigned to charity. Shari'ah boards approved the use of interest rate as benchmark. Their

⁴ Ernst and Young attribute this growth to rapid growth of markets in rich Arab producing oil countries on one hand and the global financial crisis which affected conventional banking globally on the other hand.

⁵ In Malaysia, “The banking industry in the country is currently dominated by conventional banks, with Islamic banks accounting for roughly one-fifth. Islamic banks established as subsidiaries of conventional banks outnumber wholesome Islamic banks”.

⁶ Also global statistical data of Islamic banking is including many banks in the Gulf area and Malaysia, which are operating Shari'ah non-compliant *Organized Tawarruq finance!*

⁷ BP: Basis Point.

⁸ *Mushārahah Mutnāqisah* turned in Islamic banking practice to be also “Sale Contract”.

argument is: being guided by the interest rate in determining the profit margin is not *ribā* per se. Yet, such approval captured Islamic banking in the interest system trap! Sharī‘ah boards never realized, in fact, that using of the interest rate as benchmark would not be compliant with Sharī‘ah tenets, because of some serious economic consideration⁹. Current or market rate of interest, for various considerations, cannot simply be taken to measure the opportunity cost of available units of money capital. This is because profit rates would consider expected capital productivity, market conditions and future expectations (Yousri, 2005, 2013). If Islamic banks were able to develop their experience in estimating profit rates in various activities they could have employed available resources in the best possible pattern. If profit rates were rightly estimated by Islamic bankers, more finance, for example, could have been given to *ijārah* or *istisnā’* operations instead of *murābahah* in order to realize more profits. *Murābahah* finance to small enterprises could have been more rewarding than *murābahah* finance to cars or other durable consumer goods. Failure to allocate available financial resources on correct bases means that Islamic finance through banks has not been able to help economic development in Muslim countries¹⁰.

Using *interest rate, as a benchmark*, caused lots of confusion among customers of Islamic banks. An ordinary Muslim customer would not easily, if ever, understand as to what is the difference between charging an interest rate and using it as a benchmark on a deferred payment sale. Leasing/sale operations of real estates, carried by Islamic banks have become marginally different from those traditionally practiced by interest-based mortgage companies. The damage here is serious because it reflects upon the reputation of banks and sheds skepticism about its Islamic authenticity. This is bound to weaken the competitiveness of Islamic banks, as an interest-free financial institution.

Islamic bankers argue that they are pressurized by central banking authorities to be guided by interest rates. This argument is true to some

⁹ Sharī‘ah people who permitted such matter may be excused because of their scant economic knowledge. Replacing “a profit rate” by the interest rate involves high opportunity, as explained below.

¹⁰ Interest-free financial institutions would aim at maximizing their ‘*halāl*’ revenues. Thus, a preference will be given to projects with expected higher return (productivity) over other projects because of partnership in profit and loss. Under these circumstances, deviation from an optimum (or best) pattern of financial resources’ allocation may occur because of some other factors, such as failure (or lack of experience) of bankers to estimate accurately the marginal efficiency of investment of firms that are financed.

extent whenever a dualistic banking system exists, but it does not relieve the bankers and particularly Sharī'ah boards from responsibility.

The 2008 financial crisis uncovered the benchmark policy which Islamic banks adopted in determining their profit margin. Rates of interest were globally lowered to zero or to extremely low levels. Consequently profit rates distributed by Islamic banks to holders of investment accounts followed interest rates in their downward trend. That was a natural outcome of Islamic banking being trapped in the nets of the interest system. Such happening was surely embarrassing and difficult to explain to holders of profit/loss sharing investment accounts. How Islamic banks can serve the economic interests of the Muslim countries under such conditions?

B. *Murābahah*, *ijārah*, *mushārah* *mutnāqisah*, *istisnā'*, *tawarruq* contracts possessed 95% (or more) of Islamic banks financial resources. *Murābahah* finance was dominant in most cases with an average that reached 60- 80% of banks' resources. The lower average (60%) is prevailing in most Arab Gulf countries while the higher average of 80% is familiar in most other cases. *Tawarruq* operations are growing in Islamic banks in the Arab Gulf area, Malaysia and even in Pakistan and gradually replacing the simple operations of selling goods by genuine *murābahah*.

All these are *Sale contracts* (sale of goods or usufructs). They are based on goods or usufructs firstly purchased or possessed (directly or through agents) by banks and sold after that to customers (or re-sold for their benefit¹¹) against debts that have to be settled over fixed period of time by instalments.

Islamic banks, by such high dependence on debt transactions, are not really different from conventional banking, though such debt from the sale of goods or services is "credit" given to customers, which is surely different from debt in terms of interest-based money loans. Yet, the authenticity of Islamic banking has definitely become at stake (IMF, 2015)¹², especially when the interest rate is used as benchmark. More serious, however, is adopting non-compliant Sharī'ah procedures in *murābahah* (The Supreme Court of Pakistan, 1999), as well as in *tawarruq* operations (OIC *Fiqh Academy*, 2009).

¹¹ Case of *tawarruq*.

¹² One of unique risks that Islamic banking is facing is "Sharī'ah compliance risk which arises from the fact that the products offered to customers may, ex-post, not be certified to be compliant with Sharī'ah principles"

C. *Murābahah* operations are mostly carried through sale of durable consumption goods, which is fulfilling needs of households. This is bound to have favorable effect on the economy if such goods are manufactured domestically. *Murābahah* finance in case of all durable goods which are imported is unfavorable to economic development, particularly to many Muslim countries which are facing BOP deficit. Estimating Islamic debt-based trade finance on GDP rate of growth would, however, need empirical investigations (Patrick and Kpodar, 2015)¹³.

In exceptional cases, *murābahah* played a role in financing the production requirements of small enterprises, e.g. Faisal Islamic Bank, Omdurman branch in Sudan, Jordan Islamic Bank and Nasser Social Bank in Egypt. This is, surely, a credit to Islamic banking. Conventional banking with much greater resources could not play any significant role in financing small enterprises (Todaro, M. and Smith, C., 2012)¹⁴. However, the performance of Islamic banks in this respect was generally less than satisfactory (IFC; MENA, 2014).¹⁵

Ijārah operations are mostly done by leasing/sale arrangements of buildings and apartments to households. Islamic banks reported some cases of leasing/sale arrangements in favour of commercial centres and hotels,¹⁶ but nothing can be found in favour of agriculture or industry except luxurious cars in some cases.

Istisnā' operations were carried frequently for individuals who approached Islamic banks to construct houses or villas for them. In fact, *istisnā'* contract could have played a serious role in industrial development

¹³ Islamic banking finance still counts only for a tiny portion in aggregate expenditure, except in case of Sudan or Iran where the entire banking system has been Islamized. Study by Patrick and Kpodar (2015) concluded that Islamic banking contributed positively to economic development! Yet, expected statistical errors besides measurement of relation between Islamic banks finance and growth by reference to GDP per capita rate of growth is bound to give quite general estimation. The researchers admit that relationship between real GDP per capita growth and indicators of Islamic banking development, which they used, is two way. Justifying their conclusion by saying that: "Islamic banking responds to the specific needs of households and firms, which would have been otherwise unmet, and the associated incremental growth would have been forgone" needs closer examination. In rare cases Islamic banking helped economic development.

¹⁴ According to M. Todaro, small farmers and indigenous small-scale entrepreneurs and traders in both the formal and informal manufacturing and service sectors must traditionally seek financing elsewhere (i.e. not from commercial banks).

¹⁵ A recent report of IFC Advisory Services in the Middle East and North Africa indicates insignificant contribution of Islamic banking in financing SME in MENA Region, which could not be really distinguished from conventional banks.

¹⁶ Some cases can be picked up from Islamic banks' reports, but a total or estimation of these cases or their relative importance is not available.

of Muslim countries (Al-Jarhi, 2008). In some cases, however, *istisnā'* was used in favor of the production sector, such as Dubai Islamic Bank financing developing plots of land for commercial purposes, or implementing infrastructure needed for Dubai airport.

Through syndicated finance, carried in joint ventures by Islamic and conventional banks¹⁷, *istisnā'* was successfully used for implementing giant infrastructure projects in few Muslim countries. In some cases, syndicated finance was initiated and organized by two Islamic banks [Dubai Islamic Bank Pakistan (DIBP) and Standard Chartered Bank Pakistan (SCB)]¹⁸

The experience of Islamic banks in development field was more successful in case of the *istisnā'* contract, as practical evidences show. Yet, Islamic banks were mostly unable to carry giant *istisnā'* projects in the production sector independently.

D. Facts reveal that with exception of Sudan and Iran, where the entire banking system has been Islamized, Islamic banking in Muslim countries could not compete with conventional banking in financing production sector's investments. Conventional banks in spite of all criticism to them in developing countries (Todaro, M. and Smith, S. 2012)¹⁹ continued to be the main source of finance to investment activities. Muslim countries, which have Islamic banking, were not an exception. By employing most resources in debt-based sale operations, Islamic banks have not given any significant finance to investment carried by the production sector. But the important question is as to why such pattern of resources employment happened and continued? Why preference was given to financing of debt-based sale operations, and not to profit/loss investment²⁰? The answer to this question lies in the low risk

¹⁷ PNP Paribas Group, in cooperation with Islamic and conventional banks carried giant projects, e.g. Al Hidd I giant power plant project in Bahrain (2002), Equate project, Shuwaihat Power station at Abu-Dhabi, Sharjah Water & Electricity Authority, acquisition of six Large Crude Carriers for the National Shipping Company of Saudi Arabia (NSCSA), telecom Mobily in Saudi Arabia, telecom Zain in Kuwait (2007).

¹⁸ In May (2008) the National Bank of Pakistan announced that , with Dubai Islamic Bank Pakistan (DIBP) and Standard Chartered Bank Pakistan (SCB) would provide Rs5 billion syndicated Islamic finance facility to Qasim International Container Terminal (QICT) for expansion of its infrastructure.

¹⁹ Michael P. Todaro, and Stephen C. Smith' Economic Development, 11th Edition (ISBN 13: 978-0-13-801388-2) Pearson, 2012, P.733.

²⁰ Few cases of *muḍārabah* finance appeared in records of some Islamic banks. Yet, when these cases are investigated you discover that it is *muḍārabah* by name only, or you may say "synthetic *muḍārabah*".

involved in debt-based sale operations, in contrast to high risk in case of profit/loss sharing investment finance.

The experience in four decades shows that Islamic banks were able to protect their resources and make reasonable profits through special measures which they have taken against risk of debt-based sale operations²¹. On the other hand banks failed to develop risk-aversion tools or measures in profit/loss sharing finance (IMF;WP/02/192, 2002), (Rosly, S. A. and, M. A., 2003).

The two-party *muḍārabah* contract was transformed, in the 1970s, into a multiple party contract. This allowed banks to successfully collect funds on profit/loss sharing bases. But banks remained unable to use these funds by means of partnership with independent investors. The *mushārah* and *muḍārabah* contracts could not be applied without high risk of default and loss of capital if applied in their classical versions. Such contracts should be qualified in order to take into consideration changes in culture, ethics, size of investment operations domestically and internationally, and changes in the nature of money and monetary transactions. Islamic banks without qualifying and developing the classical *mushārah* and *muḍārabah* contracts would not be able to play a real and significant role in economic development.

4. Innovations and Future Role of Islamic Banking in Economic Development

In four decades, Islamic banking faced external as well as internal handicaps which generally affected its performance. The removal of external handicaps, such as unsuitable legislations and central banking regulations, need work which is beyond the authority of Islamic bankers²². Thus on strategic grounds, focusing on internal problems should be given priority. Islamic banks have to work hard for correcting and improving their competence from within! Internal imbalances have to be corrected.

²¹ For example in all debt-based sale contracts the bank asks for strict collateral against risk of default. In *murābahah* while the commodity or the asset sold by the bank should be registered to the name of the customer (buyer) but the bank keeps authority over the commodity. The car or the house sold to the customer would be treated as pledge, i.e. held as security to guarantee payment of a debt. In selling real assets under a leasing/ sale arrangement the bank keeps the title of the asset until the last installment is paid. In practice there is no real difference with interest-based mortgage except in contract title.

²² External factors that affect Islamic banking are not only confined to these. Institutional changes have to take place in the education system, legislations, and macroeconomic policies. All sincere Muslims have to work for removal of such external handicaps in the long-run.

The magic solution to internal handicaps is financial innovation, which should be done without violating Sharī'ah and its tenets²³. Financial innovation would target: (a) efficiency and competitiveness of Islamic banking in financial markets which are up till now dominated by conventional banking; (b) innovative financial products and mechanisms that are based on partnership while most suitable to the development of highly productive investment projects. Careful considerations should be taken against particular kinds of risk that are associated with such innovation²⁴, e.g. "Sharī'ah compliant risk", and "Partnership investment risk".

To be consistent with *maqāṣid al-Sharī'ah*, financial innovations have to be beneficial to economic development which is the most important economic target in all contemporary Muslim countries. Hence, financial innovations in Islamic banking should lead to greater finance to firms in the manufacturing or services sector which are expected to have competitive or comparative advantages, including SMEs, and primary and agricultural activities which are important for the domestic market or for exportation.

5. Towards New Promising Role of Islamic Banking

First: Urgent Corrections!

Islamic banks are required to:

- a) Stop using the interest rate as benchmark in determining their profit rates in all debt-based sale operations. In all operations (*murābahah*, *istisnā'*, *salam*, and *ijārah*²⁵) the bank's profit margin should in every case be determined by reference to market conditions, estimated gains to the contract's parties (the bank and customer), and risk involved in the operation. In practice, this would necessarily need Islamic banks to acquire high quality and experienced managers and staff.
- b) Drop once and for all "*Organized Tawarruq*". This *per se* will restore lost reputation to many Islamic banks and is likely to release in many

²³ This has to be emphasized. Innovative products, and mechanisms have to be done without misusing Sharī'ah by some tricks that only maintain *fiqh* rules at the surface while violating the core of Sharī'ah and its *maqāṣid*.

²⁴ Besides standard risks associated with banking activities, such as credit, liquidity, market and operational risks.

²⁵ Mabid Al-Jarhi (<https://scholar.google.com/citations?user=IAewrkoAAAAJ&hl=en>) suggested that rental in case of *ijārah*, to be guided by a weighted average rate of return on *ṣukūk* maturities taken into consideration). This may be used as a benchmark. But what if rates of returns on *ṣukūk* as in practice, are guided by rates of interest?

cases between 20% - 40% of financial resources from speculative investments which can be assigned to more efficient and more productive employment²⁶.

c) Remove imbalances caused by excessive dependence on retail *murābaḥah* finance for durable consumption goods. For sake of economic development, such target can be achieved in two ways: firstly, by using *murābaḥah* in financing imports of primary and intermediate goods which are demanded by domestic producers. An Islamic bank can make large deals with companies or agents involved in wholesale trade of such commodities, import for them by their order²⁷, finance operations on its own risk, and bear all risks involved in carrying goods from foreign manufacturers until delivery is made. Wholesale *murābaḥah*, in contrast to retail *murābaḥah* finance, would open door for banks to benefit from economies of scale.²⁸ Besides, the bank would be able to get the price of the deal from companies or big domestic dealers in one or two installments, instead of many, which would further help in raising its financial capacity. To the economy, this style of *murābaḥah* finance is expected to directly benefit the producers and development.²⁹ And, Secondly, by using *murābaḥah* increasingly in financing promising SME projects.³⁰ The SME sector is an important one in most of Muslim countries (Yousri, 2000). The profit margin in *murābaḥah* has to be bargained between the enterprise and the bank, and not to be benchmarked by some interest rate, or fixed on all operations like a post stamp. Readiness of the enterprise to pay higher mark-up would, under normal conditions, indicate its expectation of higher returns from the operations. This mechanism, by giving priority to promising enterprises would promote efficiency in bank's financial resource employment, on one hand, and help economic development, on the other hand. Islamic banks in practicing *murābaḥah* by this mechanism shall have to collect accurate and sufficient information about small enterprises and refrain from

²⁶ Based on my own estimation, through personal observations and contacts.

²⁷ The market is expected to be highly competitive when such *murābaḥah* operations are carried, since big home companies or dealers are ready to import directly by getting credit facilities from conventional banks. Yet, such *murābaḥah* operations would benefit the domestic companies by saving all efforts, costs and risk of importation.

²⁸ Operational costs involved in purchasing and selling to small number of dealers would naturally be reduced.

²⁹ Vogel and Hayes proposed using *murābaḥah* internationally in more diversity, (Vogel, F. and Samuel, 1998).

³⁰ The example of Faisal Islamic Bank (Omdurman Branch) in this regard has been remarkable and successful.

financing cases where the financial position or current market performance of the enterprise is unsatisfactory.

Second: A Push to Partnership Finance: Reformation of *Restricted Mudārabah*

The new *Restricted Mudārabah* contract which is proposed here is a revised version of the classical contract (Yousri, 2005)³¹.

The *mudārabah* contract will be restricted by legal conditions and terms of finance based upon, and derived from, detailed feasibility study of the prospective project that have to be submitted by the customer (*mudārib*) and approved by the bank. Conditions and terms of finance, as such, are part and parcel of the contract, to secure best possible use of finance at minimum possible risk. In case the *mudārib* infringed the conditions that are endorsed in the contract he (she) will have to bear loss or compensate the bank.

To manage the risk in practice some innovative methods and mechanism have to accompany the new restricted *mudārabah* contract. **First:** Rating the *mudārib*'s enterprise faculty, achievement motivation, managerial skill, previous experience, personal record and reputation. **Second:** The *mudārib* has to submit to the bank a feasibility study for his project, and the bank would in turn carefully examine it and estimate its viability on sound economic criterion. Preference should be given to the projects which help economic development directly as well as promising higher profit rates at reasonable or acceptable degree of risk. **Third:** The contract will state that *mudārabah* fund shall not be delivered in one single payment, as in old days. The *mudārib* will receive total amount of finance that is agreed in the contract in several payments. Payments shall be scheduled in accordance to the progress of the project at successive stages as outlined and described in the approved feasibility study. **Fourth:** the bank will keep full rights to get periodical progress reports from the *mudārib*, to examine the accuracy and transparency of these reports and to

³¹ Mālikī and Shāfi'ī schools of *fiqh* are against restriction of *mudārabah* because the *mudārib* is not paid for his work, and is only getting a share profit when this is realized. Thus the *mudārib*'s effort should not be restricted. Hanafi and Hanbali *fiqh* schools allow for restriction to be imposed on *mudārib* provided that it does intervene with his entrepreneurial efforts. Restrictions in fact are imposed only to avert general kinds of risk, such as venturing trade in risky or insecure places, or products. Suggested new contract and mechanism for Restricted *Mudārabah* in this article means endorsing standpoint of Hanafis and Hanbalis. It should be noticed that though restrictions will be intensified in the new suggested contract but will not intervene with freedom of action that the *mudārib* should have, as will be explained.

halt or stop the flow of finance if terms of finance are violated. **Fifth:** the *mudārib* will undertake to pay back intact to the bank, funds that he (she) received, in case if he has violated terms of finance stated in the contract. This is in compliance with Sharī'ah rules of restricted *mudārabah*. The bank may ask for a third party's guarantee. This is important in some cases, e.g. new entrepreneur, new firm, or new product. The guarantee does not concern the capital fund but only the *mudārib*'s fulfilment of his undertakings in case of contract violation.

The new *restricted mudārabah* contract would be suitable to finance new industrial development in Muslim countries. It would not remove risk but minimize it to lowest possible level within Sharī'ah frame. Yet, when finance is needed for large industrial entities or for longer periods, *restricted mudārabah* finance has to be carried with more care in procedures and in risk mitigation.

Extending *mudārabah* finance to businesses which have long-run large industrial development projects will best be done, therefore, by resources that can be secured for this purpose without yielding greater liquidity risk to the bank. Proposal here is that the bank firstly approves finance on basis of restricted *mudārabah*, with same considerations and similar procedures to those mentioned above. Secondly, it will issue special bank shares or investment certificates to cover the required amount of *mudārabah* finance. The shares (or certificates) will be sold to holders of investment accounts who will be informed that value of their certificates is subject to profit/loss in a specific investment project, and that their potential value cannot be determined before the end of financed project.

The success of such *mudārabah* shares depends on successful selection by the bank of projects that are highly promising (e.g. supplying new products, introducing new technology, or exporting) and conducted by trusted executives and experienced management team. Islamic banks should further benefit (within Sharī'ah frame) from the experience of Venture capital firms in the developed world.

Mudārabah shares will open a new venue to finance long run industrial projects by Islamic banks, which will help effectively in economic development. Shares will gain popularity only if it is proved in practice that higher rates of profit can be achieved in this manner, while the long run value of shares remains fairly secured at minimum possible risk due to the restricted *mudārabah* mechanism.

Third: Employment of Resources through Non-bank Financial Companies (NBFCs)

Islamic banks showed comparative efficiency in the financial market when collecting funds (Patrick and Kpodar, 2015; and DIEDC, 2015)³². However, they could not prove same thing in practicing trade and investment finance. Islamic banking products are all enveloped within Shari'ah tailored contracts to suit Islamic banking practice (Ariff, 2014)³³. In practice *murābahah* and *ijārah* turned to be quite similar to or an imitation of some well-known conventional products, such as hire purchase and mortgage. According to the devised contracts, selling procedures of such products require many documents, and much more time than similar interest-based conventional products. Such procedures involve higher costs in practicing Islamic trade finance, and consequently inability to be market competitive. Practice of *istisnā'* faced same problem of expensive documentation procedures and time consuming. Besides, some modes were rarely practiced (*salam*) or not at all (*muzāra'ah*), because of inability to device suitable Shari'ah compliant risk-management "contracts" and banking "procedures" for them.

Islamic banks would, in fact, be able to employ indirectly their resources in trade and investment activities in an efficient, competitive, and less risky manner through NBFCs. NBFCs, well known in the conventional system, facilitate bank-related financial services.³⁴ Islamic banks can either establish relations with some existing NBFCs, or take the initiative to establish NBFCs within existing legislations and central banking regulations. The latter option requires adoption of a new strategy. Taking into consideration the existing secular laws and central banking regulations³⁵ a group of Islamic banks can cooperate in establishing large

³² According to the Dubai Islamic Economics Development Centre, Shari'ah-compliant commercial banking assets are set to increase at a compound annual growth rate of 9.8 per cent between 2014 and 2020.

³³ Mohamed Ariff wrote "The current Islamic banking products are mirror images of conventional products, Shari'ah compliance being the main differentiator."

³⁴ Investopedia.com, "Non-bank financial companies (NBFCs) are financial institutions that provide banking services without meeting the legal definition of a bank, i.e. one that does not hold a banking license. These institutions typically are restricted from taking deposits from the public depending on the jurisdiction. Nonetheless, operations of these institutions are often still covered under a country's banking regulations. <http://www.investopedia.com/terms/n/nbfc.asp>

³⁵ Under secular legislations and the central banking regulations banks are restricted in establishing companies. In case of commercial banks, the risk involved in ownership of

Islamic NBFCs, and support them by *muḍārabah* finance to carry trade and investment activities. Co-operation among Islamic banks would minimize capital required from each bank in the group while allowing each bank to gain from economies of scale realized by a large size entity. A single Islamic bank may, however establish *mushārah* companies of medium scale size. In compliance with central banking regulations, an Islamic bank would be only keeping the allowed stake in the company's capital, but making sure at same time to keep seat in the company's executive board. After establishing the company, bank will work for increasing its size by means of *mushārah* and *muḍārabah* finance. This can be carried by encouraging the holders of investment accounts or other customers to buy shares issued by the company.

The NBFCs in carrying trade and investment activities by Islamic modes would not be subject to procedures, restrictions or limitations which Islamic banks face in practicing the same activities, and therefore would be bound to be market competitive. Establishing NBFCs will also help in developing a secondary market for Sharī'ah compliant shares / certificates in Muslim countries.

The Role which NBFCs can play

a) Islamic Leasing NBFCs

NBFCs in the field of *ijārah* would be able to help economic development if they focus directly on serving the production sector. Leasing, apart from purchasing equipment at the end of contract or not, minimizes the upfront investment which an enterprise needs to make. Excluding methods of finance which are interest-based, we have to benefit from the experience of leasing companies in the non-Muslim world. In fact these companies are doing excellent job in providing lease finance to small and medium size enterprises for a wide variety of asset classes that suit different types of manufacturing businesses, medical services, furniture, fixtures, warehouses, and else. Leasing companies are keen to furnish small enterprises with technical advice, offer high-quality equipment to help ensure production of goods that meet customer needs and expectations and help enterprises to upgrade their technology. Thus they help their customers to maintain competitiveness and develop their production.³⁶

companies is high above certain minimum level. Islamic banks at present, except in rare cases, are subject to same secular conditions.

³⁶ An advertisement of one of the Leasing companies says, "--provides a hedge against technological obsolescence" and at the end of the leasing contract, enterprise "can purchase its equipment, if that makes sense. If not (enterprise) can upgrade by leasing

The difference between Islamic and conventional leasing finance should not only remain confined to rejection of interest. Elimination of interest and any other Sharī'ah prohibited practice is necessary condition. Rental of the leased assets should be determined according to market rental of same or similar asset (Rental of the equivalent as in Sharī'ah). Islamic leasing finance should serve producers for sake of economic development and should not be less competitive than conventional one by complicated procedures that have nothing to do with Sharī'ah.

b) *Muzāra'ah* NBFCs

Muzāra'ah has not received any considerations by Islamic banks till now, in spite of its vital importance to agricultural development in most Muslim countries. It is amazing to find out how conventional banks in many countries have served farmers, and farm related business³⁷. Islamic banks have almost done nothing in this field. Conventional banks do their business on interest bases, which is prohibited, and normally they would have no mercy if farmers default and become unable to settle their debt. But, is it logical, on the other hand, to attribute the negative role of Islamic Banking in agricultural development, throughout 40 years, to the prohibition of interest? Impossible!

Islamic banks have not tried to open branches in villages as specialized conventional agricultural banks do to finance agricultural activities. It is said that *muzāra'ah* finance, in comparison to loans given by conventional banks to farmers, is much risky and it would require specialized staff which can efficiently carry specific non-banking operations such as purchasing of agricultural inputs, storage of products, and selling crops after the harvest. But all what is considered highly costly, risky, or impractical to be done by Islamic banks can be done professionally and at lower risk by specialized *muzāra'ah* financing companies. These

newer, more modern devices in order to stay competitive" [Omni Leasing Corporation in the U.S. state of Colorado, <http://omnileasing.net/manufacturing-equipment-leasing/>].

³⁷ For example, PNC Bank has specialized agricultural bankers and opened branches in different locations in USA. Agricultural Bank of China has played an important role in China's economic development through financing farmers. It gives small loans to farmers and farm related small business activities. HSBC Agriculture is having banking specialists in farming industry and offer services and finance to modernize farming business (e.g. supporting organic farming), Lloyds bank in UK also offers a range of products and services specially designed to help farming business. Branches of State Bank of India have covered a wide range of agricultural activities. Some of them for example are: Crop production, Fisheries, Poultry, Sheep-Goat production, Land development and reclamation, Farm mechanization and refurbished second hand tractors, Digging of wells, Tube wells and Irrigation projects.

companies have to open branches in different locations, and to employ dedicated and specialized agricultural staff. They can play a really important role in villages through financing farmers, not by giving loans but by buying production requirements, helping them in selecting best rewarding crops, advising them on new crops and new technology. All this will be rewarding to farmers and companies because of partnership in produce. *Muzāra'ah* financing companies should have their own specialists and experts in agricultural marketing.

The classical *muzāra'ah* contract, as other financial contracts, is not a dogma. It ought to be modernized. This can be carried by specialized economists assisted by Sharī'ah experts, to suit farming and new farming business activities. One condition has to be firmly preserved, namely that Sharī'ah is not violated or misused by naïve *fiqh* tricks. *Muzāra'ah* companies should be able to finance animal farm production, fisheries, and poultry production. By close cooperation with Islamic leasing financing companies, *muzāra'ah* companies can also help farmers in land reclamation by extending leasing facilities of tractors and other agricultural equipment, digging of wells, and constructing modern irrigation facilities.

c) *Salam* NBFCs

Salam finance has been practiced at very limited scale by some Islamic banks in the Gulf countries although it is the perfect Islamic method of providing cash finance without paying *ribā*. In Arabic it is called بيع السلم أو السلف which simply means “*Sale based on advance cash with liability to deliver commodity later*”. Someone is getting money against an undertaking to pay back in “commodity terms”.³⁸ *Salam* finance when practiced by Islamic banks is likely to be highly risky, in spite of “hedging” that can be done by Sharī'ah compliant “*Parallel Salam*”³⁹. Risk associated with *salam* cannot be mitigated by banks unless

³⁸) Money paid in advance is called in *fiqh* “*salam price*” or “*salam capital*”. The *salam* price may be a quantity of some commodity, i.e. someone is borrowing in commodity terms. See details of *salam* Contract in: “Sharī'ah Standards” published by AAOIFI.

³⁹) It is permissible for the bank as buyer of *salam* (i.e. lent money to someone who undertakes to pay back in terms of quantity of some specific commodity to be delivered at specific future date) to enter into a separate, independent *salam* contract with a third party in order to acquire goods of a similar specification to those specified in the first *salam* contract, so that the first *salam* obligation will be discharged by delivering these goods. Yet, it is not permissible for the bank to link the obligations under the two *salam* contracts together so that the execution of the obligations of one contract is contingent on the outcome of the other. AAOIFI, “Sharī'ah Standards”, Ibid.

specialized marketing agents and experts are employed. Such experts have to organize hedging and efficiently operate storage and marketing diversity of merchandise after delivery is made by the borrower (*salam seller*) in case if, or when, actual delivery dates of the first and second *salam* contracts are not perfectly synchronized. Specialized *salam* NBFCs would have specialized management and the expertise to perform *salam* and *Parallel Salam* operations with possible minimum risk.

Salam transactions can help effectively in economic development in Muslim countries. To give an example; *salam* companies can purchase exportable goods from the domestic market, directly or through known dealers. On the other hand, enter into a *Parallel salam contract* undertaking the delivery of the same goods to importing firms in foreign markets. Transactions of future delivery are usually well organized at the international level and will allow for much better chance to develop deals based on *salam* finance successfully. A successful practice of *salam* and parallel *salam* can reflect favourably on export development and hence on economic development.

6. Conclusion

Call for Islamic banking to replace the conventional system cannot be based only on *ribā* prohibition. *Ribā* prohibition is mandatory for all Muslims; individuals and institutions, banking or else. It is undeniable that economic development is the most important target for all Muslim countries, and the paper asserts that all institutions including Islamic banks have to serve this target. A *ribā*-free banking system should prove in practice that financial resources will be efficiently mobilized and employed through profit/loss sharing and Islamic investment criteria. The paper argues that the performance of Islamic banking in four decades was unsatisfactory. There is a wide gap between what was expected from Islamic banking in theory and what has been achieved in practice. Islamic banks succeeded in collecting funds for investment, and failed in employing these funds in the production sector. The majority of funds have been employed in retail trade of durable consumer goods and services. In fact, from a purely economic viewpoint, conventional banking, in spite of criticism which it faces, is comparatively having an undeniable role in financing the production sector in almost all Muslim countries. Truly, Islamic banking represents a small portion of the banking system, but it showed no significant sign of competition with conventional banking in financing real investment in the modern manufacturing industry, agriculture, or in other activities in the production sector.

We have to admit that Islamic banking faces many problems in practice because of various crippling external and internal factors. Financial innovation, remaining within the Sharī‘ah limits, of course, can provide a magic solution to most of these problems. On a strategic basis, however, internal factors which are handicapping Islamic banking should be given priority in treatment.

A better future role of Islamic banking in economic development is expected if, or with: i) Urgent corrections of errors and initiating new policies. This can be done through total elimination of non-compliant Sharī‘ah products (mainly *tawarruq*), and termination of using the interest rate as benchmark, adopting new production-oriented policy in *murābaḥah* by using it increasingly in financing promising SMEs, and raising the efficiency of *murābaḥah* operations by giving increasing portion of funds to financing wholesale instead of retail trade; ii) Engineering a new *muḍārabah* contract, based on Sharī‘ah compliant restrictions and mechanisms; and iii) Employment of resources collected by Islamic banks through NBFCs which would be of particular importance for *ijārah*, *muzāra‘ah*, and *salam* operations.

At the end, we can say that the role of Islamic banking in economic development, which until now is insignificant, can be quite promising in future if, and only if, stern measures are taken to correct wrong practices, better policies are adopted, and innovative products and mechanisms have taken place in practice.

References

- AAOIFI, Bahrain (2015) ; Shari'ah Standards.
- Ariff, Mohamed, (2014) "Islamic Banking In Malaysia: Industry At Crossroads", INCEIF: <http://www.inceif.org/research-bulletin/islamic-banking-malaysia-industry-crossroads>
- DIEDC (Dubai Islamic Economic Development Centre), 2015
- Ernst and Young (E&Y), "World Islamic Banking Competitiveness Report",2014-2015: <http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamic-banking-competitiveness-report-2014-15>.
- Hamadan Bin Mohammed Smart University, Islamic Banking Growth, Efficiency And Stability, DCIBF, Annual Report,2014. http://www.dcibf.ae/system/files/DCIBF_Report_English.pdf
- Harrison, Tina, Ibrahim, Essam (Eds.), (2016) " Islamic Finance: Principles, Performance and Prospects". eBook ISBN 978-3-319-30918-7.
- IFC Advisory Services in the Middle East and North Africa (2014) " Islamic Banking Opportunities Across Small And Medium Enterprises In Mena", PP. 32-35 and 38-45.
- IMF (2015); "International Monetary Fund and Islamic Finance" <http://www.imf.org/external/themes/islamicfinance/>
- Khan, M. M. and M. H. Syed (Eds.) (2010), "Interest Free System in Islam" ISBN : 978-81-8274-375-5
- Mabid Ali Al-Jarhi (2008), "Shari'ah-compliant Project And Production Finance: Istisna' And Other Relevant Modes" (Lecture-notes, Emirates Islamic Bank, Shari'ah Structuring And Coordination Department, Dubai.
- Mondher Bellalah (editor), (2014) "On Islamic Banking, Performance and Financial Innovations", Cambridge Scholars Publishing, UK.
- Munawar Iqbal and Philip Molyneux, (2005) "Thirty Years of Islamic Banking: History, Performance and Prospects", Palgrave Macmillan, London, UK, and J.KAU: Islamic Econ., Vol. 19, No. 1, pp: 37-39 (2006 A.D./1427 A.H.)
- Murat Çizakça, (2011)," Islamic Capitalism And Finance Origins, Evolution and the Future,, INCEIF, the Global University, Malaysia.

OIC Fiqh Academy (2009):

<https://zulkiflihasan.files.wordpress.com/2009/12/oic-fiqh-academy-recommendation-tawarruq-may2009.pdf>

Patrick, Imam and Kangni Kpodar (2015), “Is Islamic Banking Good for Growth?”, IMF, African Department, WP/15/81.

Saiful Azhar Rosly and Mohd Afandi Abu Bakar, (2003), “Performance of Islamic and mainstream banks in Malaysia”, International Journal of Social Economics, Vol. 30 Iss 12 pp. 1249 – 1265

Supreme Court of Pakistan on Riba and practice of Mark-up (Murabaha) sale(1999). The Report is originally in English. An Arabic translation has been published by IRTI, Islamic Development Bank.

Todaro, Michael P., and Stephen C. Smith’ Economic Development, 11th Edition (ISBN 13: 978-0-13-801388-2) Pearson, 2012, P.733.

Vogel, Frank and Samuel, (1998), “Islamic Law and Finance: Religion, Risk, and Return, PP.242-244, Published by Kluwer Law International, The Hague, The Netherlands.

World Bank, World Development Report 2015: Mind, Society, and Behavior, Statistical indicators.] Muslim countries need to take serious steps towards enhancing their economic development.

Yousri, Abdelrahman (2000), “Small Industries in Developing Countries; their development and financial problems in secular and Islamic systems”; Series of Research of Visiting Scholars, IRTI, IDB, Jeddah, 2nd edition.

Yousri, Abdelrahman (2005) “Islamic Banking Modes of Finance: Proposals for Further Evolution”, Islamic Perspectives on Wealth Creation; in “Munawar Iqbal and Rodney Wilson (editors), “Islamic Perspectives on Wealth Creation, Edinburgh University Press, 2005.

Yousri, Abdelrahman(2013), “Fundamental Issues in Islamic Economics”, Lambert, Germany (second edition 2015)

Yousri, Abdelrahman, (2007), Small and Medium scale enterprises, their Finance and Development Problems (with special reference to the Islamic view point, Lecture Notes in Arabic, Training Session arranged by IRTI, ISDB and Central Bank of Jordan (Amman, Jordan)