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# CHALLENGES FACED BY BANKING INDUSTRY OF PAKISTAN IN THE PERSPECTIVE OF GLOBAL FINANCIAL CRISIS

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**ABSTRACT**

The research investigates the performance of Islamic banking compare with the conventional Banking system in Pakistan. Data were collected from six leading conventional banking and four Islamic banks operated in Pakistan. It examines the major products/services offered by various Islamic banking institutions (IB) as well as analyzing such institutions' financial performance based on the latest data available. It was revealed that some of the practices and the financial instruments used by the Islamic banks do not seem to conform to the traditional Islamic principles, and it offers suggestions for improvements. It was revealed that performance of Islamic banking the recession period is better than conventional banking in Pakistan. It was further revealed that Islamic banking has more growth in the recession period in Pakistan. The main reason of slow growth of Islamic banking is due to unawareness among the customers and the conventional banks in Pakistan has longer history and experience in doing the banking business and holding dominant position in the financial sector in Pakistan. The financial ratios such as return on Assets (ROA), return on Equity (ROE), Loan to Deposit ratio(LDR) Loan to Asset Ratio(LAR) Debt to equity Ratio(DER), Assets Utilization(AU), and Income to Expense ratio(IER) are used to assess banking performance. T test and F-test were used in determining he significance of results. It was revealed that Islamic banking is less profitable, less risky and less efficient compare with the conventional banking in Pakistan during the study period 2007- to march 2009.

**Keywords:** Banking, Financial Crisis

## 1. INTRODUCTION

The Concept of Islamic banking started from Egypt in 1963 and its sporadic progress in 1970S, the Islamic banking has grown notably in size and number in the 1980s and 1990s. According to the latest published figures by International Association of Islamic Banks, there were 166 Islamic banks and financial institutions worldwide at the end of 1996 with total assets of $137 billion, deposits exceeding $100 billion, paid-up capital of $7.3 billion, and net profit of $1683 million [Timwell 1998]. These figures exclude the funds managed in accordance to Islamic law (*sharia*) held by conventional banks in Muslim and non-Muslim/Western countries. Indeed, an increasing number of Western banks have established subsidiaries and/ or specialist divisions to offer corporate finance and investment banking services for tapping the deposits of high net worth individuals. The list of these Western financial institutions includes such well known names as Citigroup, ANZ, Grindlays, JP Morgan, Deutsche Bank, ABN AMRO, Goldman Sachs, Chase Manhattan, NatWest, Societe General, and HSBC among others [Siddiqi 1999].

Islamic banks operate in over sixty countries, though mostly concentrated in the Middle East and Asia. In most of these countries, the banking system is dominated by conventional banking institutions with Islamic banks operating alongside. In three countries, however -Iran, Pakistan, and Sudan -the entire banking system has been converted to Islamic banking. Islamic banking is noted as "the fastest growing segment of the credit market in Muslim countries that have Islamic banks: their market share has risen from 2 percent in the late 1970s to about 15 percent today, as measured by assets in the banking system" [Aggarwal and Yousef 2000]. And by some estimates, funds under Islamic management are increasing at the rate of 15-20 percent a year [The Banker 2000], with some banking sources suggesting the total value of Islamic funds may well be approaching $200 billion [Frenchman 1998].

The main objectives of this paper are to review the growth of the Islamic banking on a global basis, assess its performance based on the latest financial data available, discuss its salient products/services, evaluate them for

likely departures from traditional Islamic principles, and offer suggestions for improvement based on the experience of the authors and evidence provided by other recent studies in this area.

### 1.1 ISLAMIC BANKING: ORIGIN, SCOPE, AND GROWTH

The first modern experiment with Islamic banking was undertaken in Egypt under cover, for fear of being labeled as a manifestation of Islamic fundamentalism, which was anathema to the government in power. It took the form of a saving bank based on profit-sharing in the town of Mit Ghamr, lasted until 1967, by which time there were nine such banks in the country. These banks neither charged nor paid interest, invested mostly in trade and industry, directly or in partnership with others, and shared profits with depositors [Ariff 1988]. The 1970s heralded the arrival of a new age in Islamic finance witnessing the establishment of the Nasr Social Bank in 1971 (Egypt), Philippine Amanah Bank in 1973, the Dubai Islamic Bank in 1975, the Kuwait Finance House, the Faisal Islamic Bank of Sudan, and the Faisal Islamic Bank of Egypt, all in 1977, the Bahrain Islamic Bank in 1979, and the Qatar Islamic Bank in 1981, to mention a few [Ariff 1988, Wilson 1995, Edward 1999]. By the end of 1996 the number of Islamic banks, IBs, rose to 166 with a total paid-up tier-one capital of $7.3 billion, and total assets of $137 billion [Time well 1998]. Moreover, if one excludes the Iranian and Pakistani IBs, the countries that operate under the Islamic system of banking (along with Sudan), only 40 percent of the paid-up capital and 30 percent of total assets are commanded by those from other countries. These percentages do not tell the whole picture. The 19 Gulf Cooperative Council, GCC, states command 18 percent of the total paid-up capital, and 13 percent of total assets of all IBs. In other words, 10 Iranian, 46 Pakistani, and 19 GCC IBs totaling 75 out of 166, command 78 percent of total paid-up capital and 83 percent of total assets for the IBs. These numbers appear impressive if one ignores the size of a single large commercial bank in many developed economies of the West [Business Week July 13, 1998]. Thus, it is quite obvious that IBs are relatively very small and a few of them are not even profitable [Time well Op. Cit.].

Table 1 shows the number of IBs by region, their capital, total assets, and capital-to-asset ratios for the year-end 1996. Of the 50 financial institutions in South Asia, 5 are in Bangladesh (total capital of $20.6 million, total assets of $594 million), 1 is in India (total capital of $1.2 million, total assets of $3.5 million), and the remaining 46 are in Pakistan. Of the 35 institutions in Africa, Algeria, Djibouti, Gambia, Guinea, Mauritania, Niger, South Africa, Senegal, and Tunisia have 1 bank each, and the remaining 26 are in Sudan. Total capital of those 9 countries' institutions is $102 million with assets of $376 million representing roughly 48 and 19 percent respectively of those of all Africa. Of the 30 IBs in Southeast Asia, 3 are in Brunei, 4 are in Malaysia, 1 is in the Philippines, and the remaining 22 are in Indonesia. Two Malaysian Banks-Bank Islam Malaysia Berhad and Lembaga Tabung Haji-together account for $3.3 billion of the total assets of $3.8 billion for the entire region.
In early September2008, mortgage lenders Fannie Mae and Freddie Mac, which account for nearly half of the outstanding mortgages in the US, were rescued by the US government in one of the largest bailouts in US history. Lehman Brothers filed for bankruptcy protection, becoming the first major bank to collapse since the start of the credit crisis. During this time 94 year old US bank Merrill Lynch, agreed to be taken over by Bank of America for $50mln to avoid bankruptcy. The US Federal Reserve announced an $85mln rescue package for AIG, the country's biggest insurance company, to save it from bankruptcy, in return for an 80 per cent public stake in the firm. Following a run on its shares Britain's biggest mortgage lender HBOS was taken over by Lloyds TSB in a £12 mln deal creating a banking giant holding close to one-third of the UK's savings and mortgage market. Soon after Washington Mutual, the giant mortgage lender which had assets valued at $307 MLN. hit by mortgage defaults was closed down by regulators and sold to JPMorgan Chase. By the end of September, the credit crunch hit

### 1.2 LITERATURE REVIEW

Interest-free banking seems to be of very recent origin. The earliest references to the reorganization of banking on the basis of profit sharing rather than interest are found in Anwar Qureshi (1946), Naeem Siddiqui (1948) and Mahmud Ahmad (1952) in the late forties, followed by a more elaborate exposition by Mawdudi in 1950 (1961). Muhammad Hamidullah’s 1944, 1955, 1957 and 1962 writings too should be included in this category. They all have recognized the need for Islamic commercial banks and the evil of interest in that enterprise, and have proposed a banking system based on the concept of Mudarabha - profit and loss sharing. In the next two decades interest-free banking attracted more attention, partly because of the political interest it created in Pakistan and partly because of the emergence of young Muslim economists. Works specifically devoted to this subject began to appear in this period. The first such work is that of Muhammad Uzair (1955). Another set of works emerged in the late sixties and early seventies. Abdullah al-Araby (1967), Nejatullah Siddiqui (1961, 1969), al-Najjar (1971) and Baqir al-Sadr (1961, 1974) were the main contributors.
The recent research regarding financial crisis was conducted by Dr.Umer Chapra, senior research advisor at Islamic Research and Training Institute of the Islamic Development Bank Jeddah. He argued that overall banking sector

growth is pretty slow because of the Global Economic recession; It is the worst than the Great depression. He further revealed that Global economic crisis may have to exposed longer period.

## 2. DATA COLLECTION METHODOLOGY

Data was collected from various secondary sources like income statements and balance sheets of Islamic banking compare with the six conventional banks in Pakistan. In order to compare the financial performance of Islamic banking compare with conventional banking in Pakistan the study were uses 12 financial ratios for the banks performance broadly categories in four groups: (a) Profitability ratio, (b) Liquidity ratio, (c) risk and solvency ratio, and (d) efficiency ratio. Since there are six conventional banks and two Islamic Banking so first we will calculated ratios of each bank in that group and then calculated average of those six conventional banking and average of two Islamic banking in each year.

## 3. EMPIRICAL RESULTS

### 1.3 Profitability Ratios

Return on Assets (ROA) ROA of both assets showed pretty similar results but ROA of conventional banking is much higher than the Islamic banking, and constant. In 2009 the (ROA) of Islamic banking is slightly higher than the conventional banking this seems to that future of Islamic banking in Pakistan is bright. Finally the ROA of conventional banking is higher than the Islamic banking.

| | 2005 | 2006 | 2007 | 2008 | 2009 | Mean | SD |
|---|---|---|---|---|---|---|---|
| Islamic Banking | 1.37 | 1.30 | 1.43 | 1.48 | 1.51 | 1.418 | 0.00298 |
| Conventional Banking | 1.59 | 1.47 | 1.38 | 1.51 | 1.54 | 1.49 | 0.003156 |

Middle East is defined here as Egypt, Iran, Iraq, Jordan, Lebanon, Turkey and Yemen. Egypt has 4 IBs (total capital of$337 million with assets totaling $4. billion), Iran has 10 (total capital of $32.4 billion with assets totaling $50.2 billion), Iraq has 1 (capital $402 million with assets of $9.9 billion), Jordan has 2 (capital of $23.5 million

TABLE 1
ISLAMIC BANKS AND FINANCIAL INSTITUTIONS AT YEAR-END 2008-09 (in $ million)

| Region | # of Banks | Capital | Total Assets | Total Deposits | Net Profit | Capital to Asset in % | Net Profit as % of Total Assets |
|---|---|---|---|---|---|---|---|
| South Asia | 50 | 962 | 45,201 | 27,042 | 350 | 2.1 | 0.8 |
| Africa | 35 | 213 | 1,951 | 603 | 39 | 10.9 | 2.0 |
| Southeast Asia | 30 | 136 | 3,801 | 1,572 | 184 | 3.6 | 4.8 |
| Middle East[1] | 24 | 4,060 | 67,142 | 54,288 | 373 | 6 | 0.6 |
| GCC[2] | 19 | 1,340 | 18,084 | 16,494 | 686 | 7.4 | 3.8 |
| Europe & America | 8 | 559 | 952 | 1,164 | 54 | 58.7 | 5.7 |
| Total | 166 | 7,270 | 137,131 | 101,163 | 1,686 | 5.3 | 1.2 |

1 -Middle East includes Egypt, Iran, Iraq, Jordan, Lebanon, Turkey, and Yemen.
2- GCC stands for Gulf Cooperation Council, consisting of Bahrain, Kuwait, Qatar, Saudi Arabia, and United Arab Emirate (UAE).
SOURCE: International Association of Islamic Banks, Jeddah, Saudi Arabia, quoted by Timewell (1998).

With assets of $871 million), Lebanon has 1 (capital of $7.7 million with assets of $21.6 million), Turkey has 4 (capital of $33.8 million with assets of $1.2 billion), and Yemen has 2 IBs with a total capital of $12 million. It should be pointed out that about 49 percent of all assets of IBs in the world are commanded by this region and this is principally because of Iran, whose entire financial system is based non-interest bearing transactions and instruments.

The various states constituting the Gulf Cooperation Council, GCC, have 19 IBs of which 10 are located Bahrain, the de facto center of financial activities for the GCC. Of the 10 IBs, data are incomplete for 2. Except for Faysal Islamic Bank of Bahrain E.C., the rest of them have capital less than $100 million each. Bahrain Islamic bank with assets of $376 million is the largest, with the Faysal Islamic Bank a close second with $356 million in assets. Kuwait has three IBs (total capital of $276 million with assets of $4.9 billion), Qatar also has three (capital of $78 million with assets of $1.3 billion), Saudi Arabia has two (capital of $453 million with assets of $10.5 billion), and the United Arab Emirates has one Islamic banking institution with capital of $136 million and total assets $1.9 billion.

The IBs in Europe and America are 8 in numbers shown in Table 1. Of these, one is in the Bahamas ( capital of $15 million with assets of $26 million), one is in the Cayman Islands (capital of $300 million with assets of $388 million), one is in Switzerland (capital of $14 million and assets of $73 million), one is in United Kingdom (capital of $182 million and assets of $385 million), and four are in the U.S., of which data are available only for two (capital for the two totals $49 million with assets of $60 million). These eight IBs are essentially investment banking, credit and fund management outfits as can be seen from their combined capital-to-asset ratio of 58.7 percent.

In general, the IBs of the various regions except Africa seem to have inadequate capital by the basic standard of capital adequacy. The worst situation is in South Asia where Pakistan dominates the number and assets of the IBs. Like Iran, Pakistan declared that its banking is to be based on the Islamic system, and it does not seem to be running them efficiently. The next precarious region is Southeast Asia where Indonesia dominates the IBs. Most of the IBs in Indonesia are very small-only three of them have capital between $100 and $162 million with combined assets of $2.3 billion. In general, return to assets (net profit as percentage of total assets) of the IBs seems to be very low in South Asia and the Middle East where most of them are located. Table 2 sheds more light on this.

Table 2
FINANCIAL POSITION OF THE TOP 20 ISLAMIC BANKING INSTITUTIONS AT YEAR-END 2008-09 (in $ millions)

| Region | Rank by Assets | Capital | Total Assets | Total Deposits | Net Profit | Capital to Asset in % | Net Profit as % of Total Assets |
|---|---|---|---|---|---|---|---|
| Bank Melli Iran | 1 | 656 | 19,297 | 18,617 | 53 | 3.4 | 0.2 |
| Iraqi Islamic Bank for Develop. & Invest | 2 | 402 | 9,900 | 10,900 | NA | 4.0 | NA |
| Halib bank of Pakistan | 3 | 72 | 9,827 | 5,684 | 21 | 0.7 | 0.2 |
| National Bank of Pakistan | 4 | 73 | 9,348 | 6,081 | 90 | 0.8 | 1.0 |
| Meezan Bank Pakistan | 5 | 400 | 8,608 | 6,051 | 322 | 4.6 | 3.7 |
| Bank Tejarat, Iran | 6 | 326 | 8,544 | 6,978 | 23 | 3.8 | 0.3 |
| Bank Sedarat, Iran | 7 | 542 | 7,055 | 466 | 0.5 | 7.7 | -- |
| Bank Mellat, Iran | 8 | 346 | 6,535 | 4,967 | NA | 5.3 | NA |
| United Bank, Pakistan | 9 | 49 | 5,088 | 3,704 | 9 | 1.0 | 0.2 |
| Kuwait Finance House | 10 | 169 | 4,732 | 3,767 | 271 | 3.6 | 5.7 |
| Muslim Comm. Bank Pakistan | 11 | 45 | 4,071 | 2,816 | 3 | 1.1 | -- |
| Agricult. Bank of Iran | 12 | 233 | 3,024 | 1,001 | 11 | 7.7 | 0.4 |
| Allied Bank of Pakistan | 13 | 20 | 2,558 | 1,493 | 4 | 0.8 | 0.2 |
| Islamic Int'l Bank for Invest. & Develop, Egypt | 14 | 134 | 2,358 | 1,494 | 34 | 5.7 | 1.4 |
| Agricult. Develop. Bank of Pakistan | 15 | 104 | 1,982 | 81 | 6 | 5.2 | 0.3 |
| Dubai Islamic Bank, UAE | 16 | 136 | 1,935 | 1,754 | 16 | 7.0 | 0.8 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Faisal Islamic Bank of Egypt | 17 | 100 | 1,900 | 1,508 | 85 | 5.3 | 4.5 |
| Lambaga Tabung Haji, Malaysia | 18 | NA | 1,877 | 1,817 | 145 | NA | 7.7 |
| Bank of Industry & Mine, Iran | 19 | 729 | 1,778 | 147 | 88 | 41.0 | 4.9 |
| Bank Islam Malaysia Berhad | 20 | 53 | 1,442 | 1,278 | 15 | 3.7 | 1.0 |

NA = not available

-- = insignificant percentage.

SOURCE: International Association of Islamic Banks, Jeddah, Saudi Arabia, quoted by Timewell (1998)

Table 2 presents data on financial positions of the Top 20 IBs for the year-end 1996. It appears from the data that the IBs in Pakistan and Iran, the two countries officially under Islamic system, fared rather poorly compared to the other IBs operating under dual banking systems. Only an Iranian bank, Bank of Industry and Mine, which performed relatively well, is a very specialized bank with a capital-to-assets ratio of 41 percent. The banks in GCC, with the exception of Dubai Islamic Bank, showed relatively higher return to assets ratios among the Top 20 IBs. One Malaysian bank, Lembaga Tabung Haji, had the highest return to assets for the year-end 1996 among this group. Probably, this picture is completely changed in the aftermath of the crash of the financial markets in the South East Asian region in 1997.

To gauge the relative performance of the IBs in terms of returns to assets, we examined around 200 banks worldwide with total assets ranging between $1.5 billion and $20 billion--the same range as the top 20 IBs in Table 2. For the year-end 1996, we found that the mean return was 1.53 percent, with a median of 1.22, and these ranged between -- 12.43 and 16.45[1]. Twelve of our top twenty banks performed well below the averages, for two we have no information, and only six IBs were above these averages. The June 1998 ranking of world's banks by Moody's Investor Services show that the banks in IBI countries are in either vulnerable or very weak financial condition with rankings of Ds and Es, respectively [*The Wall Street Journal* 1998].

The better performance of the IBs in the dual banking system countries (i.e., IBs working side by side with predominantly modern banking and financial institutions) calls for an explanation. It seems as though the need to compete with the regular banks in attracting depositors' money, pressures the IBs to essentially follow the practices of those banks under Islamic garb and try to manage their portfolios more carefully so that their customers and investors do not get disillusioned [see for example the study of IBs and conventional commercial banks in Turkey [Kuran 1995]. As we discuss the actual practices of IBs in the next section, this point will be made clearer.

**Products/services of Islamic Banking Institutions**

It would be helpful, at the outset, to review some of cardinal elements of economic transactions according to Islam, which laid the foundation of the Islamic banking system. The most salient characteristic of such system is the prohibition of *riba* (often translated as usury or interest), a pre-determined -fixed or variable -charge levied for the use of a loaned commodity be it real or financial asset.

That *riba* is unequivocally banned in Islam is borne by four specific references in Islam's holy book, Quran, and several *ahadith* -narrations attributed to prophet Mohammad. For example, Quran states, " Believers! Do not consume *riba*, doubling and redoubling. .." [2] (Ch. 3, verse 130), and "...God has made buying and selling lawful, and *riba* unlawful..." (Ch. 2, verse 274). Prophet Mohammad condemned not only those who take interest but also those who give it, record it, or witness it, saying that they are all alike in guilt. Indeed, not only Islam, but also Judaism and Christianity ask their followers to shun usury to avoid hell fire [Homer 1977]. The common thread running through all such condemnations of *riba* is its exploitative nature and not the concept of profit, which is lawful in Islam if justly and fairly earned.

As such, while there is considerable debate among Muslim scholars as to the exact nature of this prohibition and exactly what constitutes a usurious transaction[3], there is a common perception that ban on *riba* is tantamount to ban on interest, be it paid or received. Hence, the various financial instruments developed by Islamic banks have been

based on two principles: the profit-and-loss sharing (PLS) principle and the mark-up principle [Errico and Farahbaksh, 1998, Aggarwal and Yousef 2000]. The financial contracts offered by the IBs can be classified into five basic categories: (1) non-interest bearing demand deposits (checking accounts); (2) *mudaraba*, (3) *murabaha*, (4) *musharaka*, and (5) *ijara*.

Conventional checking accounts in modern commercial banks are non-interest bearing deposits, and since IBIs shun interest rate based dealings, most of them offer such demand deposit accounts. Ideally, IBs should not be charging any fees on checking accounts as they are free to employ the depositors' money, subject to the reserve requirements, if there are any, into earning assets [Siddiqui 1978]. In practice, however, this is not always the case. Depending on the size of the deposit, service charges and fees get collected to meet operating "costs".

IBs offer savings and time deposits in the form of investment accounts under the system of *mudaraba*. The depositors of such accounts share profits and/or losses of the institutions under an agreed-upon formula [Siddiqui 1986]. The depositors in *mudaraba* accounts are the suppliers of capital, *rabb al-mal*, who entrust their funds to the bank, *mudarib*, in the tradition of Western style investment banking, subject to dealings with only non-interest bearing instruments [De Belder and Khan 1993]. The *mudarib*, acting as money manager or agent, invests the money and then distributes the profits and/or losses on the basis of the agreed-upon contract. The following conditions must be met:

1) Profits to be shared must be proportional to the funds contributed to the *mudaraba* account and these cannot be in lump sums or in guaranteed amounts.
2) The loss to the depositor (contributor of funds) cannot be more than the amount of deposit.
3) The *mudarib* does not share in the losses, except for the time and efforts put into the management of the *mudaraba* funds or in cases of *mudarib's* negligence.

The third principle leaves it wide open for an unscrupulous or careless money manager to engage in questionable transactions leading to losses to depositors, or worse--even failure of the financial enterprise. This is especially problematic in the Muslim countries where there is a general lack of transparency in economic transactions, and where periodic public disclosure of financial performance of firms to their stakeholders, are essentially non-existent.

Siddiqui ( 1986) cites the use of four other forms of *mudaraba* ventures by the existing IBs. In one case, *two-tier mudaraba*, the depositors and the bank combine their funds to invest in ventures such as mutual funds and then share profits and/or losses. Another variation of the *mudaraba* account is that an outside entrepreneur comes to the bank and borrows depositors' (and the bank's) money to invest in a venture. The bank and the entrepreneur become partners and share in profits and/or losses. The examples Siddiqui provides to illustrate the cases of *mudaraba* accounts deal with a 20 percent profit or loss on the invested amount and the way they are distributed among the parties. In this particular type of *mudaraba*, the entrepreneur has to return the principal amount borrowed and share equally in the profits and losses. It is not clear, however, what would happen if the entrepreneur lost the funds borrowed completely. There are two other variations of these types of accounts. The jurists are not all in agreement as to the conditions that satisfy a particular transaction in a *mudaraba* [Naqvi 1993].

The *mudaraba* accounts are popular with the IBs partly because they assume very limited liability and risk while earning rather hefty margins. As currently practiced, they simply collect "profits" (estimated ahead of time) from the borrowers. Suppose an individual wants to borrow $100,000 for building a single-family home. The IBI agrees to lend the money at an agreed upon "profit" rate of 12 percent per year. However, the borrower receives a check for only $88,000 and is asked to pay back the full amount of $100,000 at the year-end. This *mudaraba* account yields the equivalent of 13.64 percent to the bank. If the "profit" rate were named "interest" rate, the borrower would still pay the 13.64 percent effective rate. If the borrower could not pay back the loan because the project failed for whatever reason, it is not clear how the IBs will treat the loan and the defaulting borrower.

Similar problems are faced by depositors and/or subscribers of capital to the IBs. If the institutions fail to invest their depositors' and shareholders' money judiciously, there is no recourse to recover some of the funds lost. The failure of the Ar-Ryaan investment banking outfit in Egypt devastated the poor Egyptian subscribers, some of whom lost their life's savings.

The third instrument, *murabaha* (or more specifically, *bai-mujal murabah* -cost plus financing), used by the IBs consist of transactions where the institution buys a product (e.g., a car or a machinery) on a client's behalf and then resells this with a mark-up to a client, the borrower [DeGelder and Khan, Op Cit., Chapra 1985]. Thus, an automobile selling at a price of $20,000 may be bought by the IBI and resold to a client at $25,000, to be paid

back in monthly installments (or a lump sum at the end of the loan term) over a 2-year period. The implied rate of interest is 11.21 percent for this transaction. If the buyer of the car went to a conventional bank and borrowed $20,000 at a rate of 11.21 percent interest for buying the car directly from the dealer, s/he would pay a total of $22,418.59 (monthly installment of $934.11 multiplied by 24 months), instead of the $25,000 charged by the IBI. The additional sum of $2,581.41 for the same car for the privilege of calling interest rate a profit rate cannot be justified on any ground.

Other variants of *murabaha* transaction are *al-bay' bithaman ajil* where a bank allows deferred payment within an agreed period, and *bay' salaam* where a buyer pays an agreed price in advance for commodities that will be delivered at a future date [Chapra, Op. Cit., Siddiqi 1999]. In order to justify *murabaha* transactions, IBs have come up with elaborate contract requirements between the bank and the seller of the merchandise, and between the bank and the buyer of the product [De Belder and Khan, Op Cit., Edwards, 1999]. These contracts detail the rights and responsibilities of each party including financial terms of the contract. The title to the property is retained until the debt is paid off just like in conventional banking. Borrowers with deep religious feelings may accept *murabaha* transactions, but average consumers or business clients would notice the higher implied costs and the striking similarity with conventional discount loans! [see Abdul Gafoor 1995, ch. 4, section titled "Uneasy questions of morality" for further discussion of such dubious practices].

The fourth instrument used by IBs is *musharaka*, which is a form of equity financing through joint ventures. Unlike the case of *mudaraba*, here the bank not only participates in the supply of capital to the venture, but also in its management. Thus, the IBI assumes the role of an entrepreneur as well as that of a financier [Chapra, Op Cit., 1999]. Like *mudaraba* and *murabaha* transactions, *musharaka* also requires elaborate written contracts defining the conditions under which the parties are to operate. For an IBI to become an efficient partner in projects under *musharaka* agreement while performing the role of a depository institution and that of a financial intermediary seems to be unrealistic. Even the well-trained bankers in the modern financial institutions of the West seldom perform such varied tasks for their clients! If the return on assets and the size of net profits are any indication of the performance of financial institutions, then surely the IBs are not up to par with the modern financial institutions.

The fifth instrument used by the IBs is *ijara* or leasing. Two types of leases are used. In one, the lessee pays the lessor installment payments that go towards ultimate purchase of the equipment by the lessee [Wohabe 1997]. This type of lease/purchase agreement is known as *ijara Wa-iqtina* [Martin 1997]. The second type of lease maintains the ownership of the lessor as per the lease contract. DeBelder and Khan (1993) cite the provisions of a model contract between the lessor (the IB) and the lessee in Pakistan. These provisions seem to have been drawn from the practices of modern finance companies, only these are more favorable to the IBs. For example, the provision that "The lease can be terminated at any time by the Lessor after twelve months...", or "...current Pakistani business practice results in monthly lease rentals generally working out to be equal to installments of principal plus about an amount equivalent to interest of 22 percent per annum" (p. 6 of the electronic version). The demand for lease financing seems to have prompted the IBs to come up with contract instruments that satisfy their religious councils and yet earn them returns equivalent or better than those earned by conventional finance and banking institutions.

## 4. CONCLUSION

The foundation of the Islamic banking system is based on the prohibition of interest from transactions. The IBs, under the guidance of their religious councils (usually such councils differ among themselves on the Islamicity of various transactions) have developed various financial instruments discussed above. Despite their intention to avoid interests, most of the transactions indeed involve use of fixed percentages of profits (and presumably, losses) that are nothing but interest under a different name. The financial instruments are based on contracts made by the various parties. It is argued that as long as all conditions are written down and known to the participants in the contract, it does not matter whether the financial institution collects "profits," fees and commissions ahead of time or later. From the various references cited in the paper, it appears that the IBs set their "profit" rates for each contract that reflect the going interest rates plus, usually, some premium. The Annual Reports of Bank Islam Malaysia Berhad for 1994 through 1996 show that the rate of profit for investment accounts (similar to time deposit) to the depositors goes up consistently as the time length of deposits increases. For interest-based banks, this should not be surprising because the depositors would expect to be compensated for maturity risks. However, for an Islamic bank based on "profit" sharing, how is it possible that all long-term investments are more profitable than the ones with shorter durations? These "profit" rates seem to be prefixed just like interest rates of conventional banks, or "quite comparable with the rates of return offered by conventional banks"! [Ariff, 1988]. In the same vein, Aggarwal and Yousef (2000), based on their own case studies of banks in Jordan, Malaysia, Egypt, and Iran, as well as other studies that they review, find that Islamic banks rely much more heavily on markup (debt-like) financing than on PLS

(equity-like) financing. Only in Iran, they note, is there a significant PLS component to *new* flows of financing; that most financing does not appear to be long term in nature[4]; and the evidence on whether or not Islamic banks provide financing to capital intensive sectors of the economy, such as, industry , to be mixed at best. Large banks, they note, use *murabaha* financing more frequently than do smaller banks and offer more financing to agriculture/industry.

The prohibition of usury (*riba*) in Islam is to ensure economic justice and fair play by providing the stronger partner in transactions from taking advantage of the weak one. This can be achieved if the lender receives a return that covers the costs of funds and provides a return to shareholders commensurate with earnings that a silent partner can muster from the joint ventures in business. That is, the return must be in proportion to actual earnings from the borrowed funds, minus the compensation to the borrower as the entrepreneur and manager of the undertaking. Of necessity, this return will vary over time. As a result, the stipulated profits to be distributed will also vary from one period to the next (whether monthly, quarterly, semi-annually or annually). Whether this is called interest rate or profit does not make any difference to the nature of payments by the borrower and receipts to the lender. The ideal Islamic transactions (i.e., transactions that establish economic justice) will be the one where rates of payments and receipts closely resemble the ever-changing costs and returns. Flexible interest rates that adjust quarterly, or as soon as costs and profits can be estimated, would go a long way toward the abolition of usury than the current methods of ascertaining "profits" by the IBs. Until this is done, it is not feasible to establish standard banking practices across the Muslim countries. Such absence of the institutional framework needed to create the type of security and standardization required by the international banking system is noted as one of the major limitations constraining the growth of Islamic banking [Proctor 1997, The Banker 2000]. At present, religious scholars of different countries differ on the suitability of one instrument or another.

The conventional banking institutions are not the answer for the Muslims. What are needed are institutions that charge or pay interests which are not only flexible, but also reflect actual costs of and returns from operations. Thus, a true IBI could not offer long-term CDs on fixed rates, nor could it provide fixed-rate mortgages or installment loans. The ideal rates will vary with the changing business and economic conditions so that neither the depositors nor the borrowers and investors face undue economic hardships from financial transactions. To make this possible, there is an urgent need for qualified and trained people, a free press and unobstructed flows of information. All these are wanting in today's Muslim states.

**Note**

[1] The data were collected from the World Scope of the Disclosure Data Base, June 1998, and the estimates were made by using the Minitab statistical package.

[2] According to Tabari (*Jami*, no date, V .4:49), *riba* in the pre-Islamic period consisted of doubling and re-doubling of the principal amount of commodities lent over a period of time. When a borrower, at the appointed date could return the original amount borrowed in full, no additional amounts were charged to him. However, if he failed to pay in full, the lender would allow the borrower to pay back next year in double the quantity borrowed originally. If again, the borrower could not pay back the next time, the loan would be extended for another year for double the amount that was due at the end of the second year. Similarly, al-Zamakhshari (*al-Kashshaf*, no date, :234) points out that even a small debt could consume the wealth of a debtor because of repeated doubling of the original amount of goods borrowed arising out of the inability of the debtor to pay back. Afzal (1996) details the various interpretations of *riba* by classical as well as modern *Islamic scholars/jurisprudents* and goes on to show how the controversies arose since the early time of Islam.

[3] Despite the interpretation of *riba* as doubling and redoubling of the principal lent, the *Fuqaha* extended the scope of *riba* to cover all transactions that call for any increase over the amount lent, and at any time any *faqih* (a religious scholar) gives contrary opinion is declared a heretic. Among those who do not believe all transactions involving interest are usurous are Sanhuri (1954-1959), al-Saud (1985), Tantawi (1989), Salus (1991), Suhail (1936), Ali (1994, commentary on Quran Chapter 2, Verse 275, commentary no.324), Shah (1967), and Rahman (1980:41), to name a few.

[4] Such focus on short term project is also noted by Abdul Gafoor [1995] as well as Edward [1999] and, at times, has been attributed to the shortage of trained personnel with expertise in assessing long-term projects [Iqbal and Miakhor, 1987] or absence of backup institutional structures such as secondary capital markets for Islamic financial instruments [Ariff 1988].

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