The Growth of Islamic Banking

Islamic banks as novel phenomena in the financial world since the mid twentieth century have been construed as financial intermediaries that mobilize resources in the direction of *Shari'ah* approved projects by using Islamic financing instruments (Siddiqi, 1983). Islamic modes of financing comprise two basic principles. These involve interest-free financing instruments and development instruments based on cost and profit sharing. Some of the principal instruments involved in such forms of resource mobilization are as follows (various Islamic Development Annual Reports):

(1) Trade financing and cost-plus mark-up on traded goods (*murabaha*),
(2) profit-sharing (*mudarabah*) and equity participation (*musharakah*) in which cost-sharing among partners is also included,
(3) rents on purchased equipment (*ijara*),
(4) Islamic banking portfolio using secondary financing instruments, such as shares and stocks revolving around the above-mentioned instruments.

However, the financial resources are to be mobilized with the important condition of *Shari'ah* in view. They are therefore to be directed into *Shari'ah* recommended projects and goals. Hence socioeconomic development and ethical prerogatives become part and parcel of the Islamic financing modes. Being so, Islamic banks have a mandate that extends beyond simply serving its clientele by securing funds in the above-mentioned kinds of portfolios. They become development institutions, and thereby play an important role in the economic and moral uplift of the Islamic society or community from the viewpoint of *Shari'ah*. Islamic banks are thus to cooperate with other national development institutions in this regard.

Precepts of *Shari'ah* that should guide the goals and instruments of Islamic banks

What are the precepts of *Shari'ah* in the financial field? They are to establish social security, property rights and the rights of progeny. In the extensive domain of *Shari'ah* these goals are combined with the mandate of preservation of the Islamic State.

Within the mix of the above-mentioned *Shari'ah* precepts, we find that the social, economic and political goals are taken up together with the financial ones. These together comprise the totality of the social, economic and political development issues of an Islamic society. Hence, when Islamic banks are linked with such a comprehensive network of goals in the light of *Shari'ah*, the totality of the socioeconomic and sociopolitical goals along with the financial ones would predominate in the objective criterion of an Islamic bank.

For example, in the attempt to secure the funds of its clientele in *Shari'ah* recommended ways, which comprise the tenet of securing property rights, the Islamic bank must embrace the other *Shari'ah* tenets as well. Thereby, socioeconomic development goals become important in the *Shari'ah* determined social wellbeing function.

What is the social wellbeing objective criterion of Islamic banks?

The social wellbeing function as the objective criterion of the Islamic bank serving the tenets of maintaining social security, protection of progeny and preservation of the Islamic State, becomes a description of ways and means of financing resource mobilization that establish sustainability and the high ideals of Islamic faith. The last goal involves the principle of *taw hid* as the highest moral attribute of Islam. The model of implementing the principle of *tawhid* in the socioeconomic, financial and political order involves organizing the modes of resource mobilization, production and their financing in ways that bring about complementary linkages among *Shari'ah* determined possibilities. In this way, there appears co-determination among the possibilities, evolution of the instruments to be selected and implemented by many agencies in society at large. Islamic banks form a part and parcel and interconnecting medium of this lively developmental organism.

The developmental possibilities are realized both by the medium of discourse between management and shareholders of an Islamic bank as well as in concert with other Islamic banks, the central bank, enterprises, government and the community at large. In this way, a vast network of discourse related networking and relational system is established between the Islamic banks and the socioeconomic order as a whole. Such unifying relations as participatory linkages in the economy wide sense convey the externalized meaning of *tawhid*. This highest principle is now understood as unity of knowledge emanating from the oneness of God as the one, who is complete and absolute in knowledge. The external meaning of *tawhid* is now explained in terms of an increasingly relational, participatory and complementary developmental order wherein possibilities unify among themselves. This unification process and sign in the externalized world is a meaning of the principle of *tawhid* as we live it. The discourse related process and institution of determining such unifying possibilities by Islamic banks within the comprehensive outlook of *Shari'ah* is called *shore* of the Islamic banks.

In the end, by combining the totality of *Shari'ah* precepts Islamic banks become as much investment oriented financial intermediaries as they are agencies of sustainability of the socioeconomic order, the sociopolitical order and preservation of community assets. It is now obvious that Islamic banks even when using the most modern kinds of instruments to attain such goals and sustain them over the long term would promote human resource development. In this way, the internal efficiency of Islamic bank and its informed connection with the community at large can be harnessed. Yet human resource development as a powerful instrument that causes Islamic banks to become development centered financial organisms in the total life of the Islamic community must be appropriately determined in the light of *Shari'ah*.

Take for example the questions relating to analytical methods of project evaluation. While it would be necessary to understand the complex methods of asset valuation from the viewpoint of interest-based concepts of time value of money and the like, yet the truly Islamic methods of project evaluation would be central to the training of human resources in Islamic banks. In the same light such training is to be imparted to the community through educational and practical training programs.

Likewise, human resource development for project evaluation, technical assistance and feasibility report preparation on projects must keep in view the integrated outlook of the Islamic economy keeping the goals of *Shari'ah* in mind. This can be realized by using a model of linkages among economic sectors that together can mobilize money into real economic activities and thus deter funds from speculative ventures, portfolio investments, bonds and money market funds.

On the other hand, resource mobilization in all avenues of *Shari'ah* recommended possibilities should be promoted so as to create a close link between monetary aggregates and real productive activities. The nature of money now turns out to be endogenous through its circulation in the real economy as a 'quantity'. Money is not determined in this case by demand and supply concepts, since it does not have a market of its own as in the case of goods and services. Instead, there are markets only of real goods and services that value the worth of money in the first place. On the basis of such real market exchange, real returns are measured in terms of prices, output and profits. These in turn determine the return on money. Islamic banks thus become important links between the national central banks, the economy and community in realizing such endogenous money-market relations.

Given below is a model of the balance sheet of an Islamic bank in the light of the above-mentioned kind of general system of interactive, integrative and dynamic relations. It relates money to the real economy endogenously in terms of a developmental outlook and a sure way to reduce interest rates in an economy wide sense.

Table 1: Model inter-Islamic bank balance sheets in the case of endogenous money

Balance Sheet for Islamic Bank B1	Balance Sheet for Islamic bank B2
Initial deposit = ID 1.00	Initial deposit = 0
Reserve ratio = r' = 0	new deposit = $1.g_2$
Retention = $1.g_1$	retention = $1.g_2.g_3$
Loan = investment (spending)	loan = $1.g_2 - 1.g_2 .g_3 = 1.g_2^2$
In joint venture = $1.g_2$	

ID = Islamic Dinar.

In table 1, let us explain the relationship between the reserve ratio, r', and inter-bank loan flow as demand for liquidity for undertaking investments or spending. This is resource mobilization. Since inter-bank loans for liquidity will increase in the face of increased demand for investment (spending), therefore, the reserve ratio, r', will decrease. Now the change in the quantity of money (M) is related to the change in the demand for liquidity (D), dD, by the multiplier, $dM = dD/r'$. dM is inversely related with r'. Investment (spending) demand increases as r' decreases and vice versa. See Choudhury (1998) for details.

B1 and B2 are two Islamic banks engaged in inter-bank loans. In a joint financing of venture let g_1 denote the return to B1. This return then forms an asset of B1. Let g_2 denote the return to B2, which then forms a liability to B1. Likewise, g_2 forms a return to B2 and g_1 forms a liability to B2.

New money in the economy equals the amount of investment (spending) equal to 1ID.g_2. In this way, in a multiple inter-Islamic bank loan flow under joint venture, the total quantity of new money or investment capital (spending) arising from 1ID of initial spending equals,

$$g_2 + g_2^2 + g_2^4 + g_2^8 + \ldots\ldots = g_2 (1 + (g_2 /(1 - g_2^2))$$

The total amount of spending, Sp, which must be matched by the quantity of endogenous money in circulation is now given by,

$$Sp = 1ID + g_2 + g_2^2 + g_2^4 + g_2^8 + \ldots\ldots = (1 + g_2 - g_2^3)/(1 - g_2^2).$$

To a linear approximation the above expression reduces to,

$$Sp = \text{new money} = 1 + g_2.$$

Likewise, for M ID of initial spending as endogenous money, the total money creation or new spending equals $M(1 + g_2)$. Since g_2 is determined by the growth of real sector output, therefore, money is created in exact equivalence with this growth rate. For the concept of endogenous money see Choudhury (1997).

One of the many healthy consequences of endogenous money is that inflation remains controlled, since value of transactions (as a reflection of investment or spending demand) per unit quantity of money in circulation remains stable. Another implication of endogenous money is that it creates a currency-denominated economy rather than demand-supply of money based on promissory notes and thus on an interest-bearing reserve ratio set both between the central bank and commercial banks and by the excess reserve ratio set by commercial banks.

Evolution of Islamic banks

We have now explained the Islamic banking concept in the framework of a general system of relations. Islamic banks are seen to involve themselves as financial intermediaries and investment oriented institutions in bringing about wellbeing of the community, society and the economy in the light of *Shari'ah*. Next we will examine what role Islamic banks have played in recent time in these directions.

Historical performance of Islamic banks

We first examine the recent portfolio of financing made by the consortium of Islamic banks globally (International Association of Islamic Banks, 1988). First we will examine the Islamic banks' balance sheet during the early years. We will then infer what structural change has taken place in recent times from the past trends in Islamic banks' financing. Since data remain scarce, therefore, specific cases may be mentioned here including the experience of Islamic Development Bank. It should be remembered nonetheless that IDB being a regional development bank, it functions differently from an Islamic bank. An Islamic bank is a private sector financial intermediary. It is subject to the statutory monetary policy requirements of the central bank of the parent country of the bank.

In the early years between 1987 and 1988 alone, the aggregate balance sheets of Islamic banks showed an increase in the balance of accounts by 7.4 per cent. This increased further by 14.9 per cent in 1989 over 1987. Total assets increased by 107.4 per cent between 1987 and 1988. Shareholder's equity increased by 12.4 per cent from US$469.3 million in 1987 to US$527.3 millions in 1988. Net distributed income increased from US$230.3 million in 1987 to US$280.1 million in 1988, a growth rate of 21.7 per cent. Rate of return on total investments was 15.8 per cent between 1987 and 1988. Equity volumes increased by 50.3 per cent, while the rate of return on equity was 18.6 per cent between 1987 and 1988. Total rate of return on capital was 18.6 per cent in 1988. Net profit rate was 11.1 per cent in 1988.

Much of the high returns were due to concentration of resource mobilization in trade financing (*murabaha*). Equity financing and joint ventures formed a distant small ratio. Hence in the aggregate, Islamic banks performed remarkably well during this early period of time as far as financial returns on *murabaha* were concerned. Shareholders' wealth was thus well protected by this financial instrument.

The 1988 sectoral allocations of selected Islamic banks resources are shown in table 2. We note from it that agricultural and social allocations were minimal, except in the case of Sudan Islamic bank.

Table 2: Sectoral allocation of investment of Islamic banks (percentages of total financing) 1988

Faisal Islamic Bank of Egypt

Industry	30.6
Trade	30.4
Agriculture	3.0
Other sectors	36.00
Total	100.00

Dubai Islamic Bank

Trade	90.6
Services & Family	7.6
Other sectors	1.8
Total	100.00

Sudan Islamic Bank

Agriculture	34.0
Industry	23.5
Trade	10.8
Transportation	10.0
Other sectors	21.7
Total	100.00

Faisal Finance Institution Inc. Turkey

Metal industry	26.3
Chemical & Petroleum	17.8
Clothing	16.7
Food	7.9
Tools	5.7
Paper & printing	5.3
Agriculture	16.9
Contracting	3.4
Total	100.00

Source: *The Aggregate Balance Sheet of the International Association of Islamic Banks,* Cairo, Egypt, IAIB.

Recent performance of Islamic banks

In recent times, Islamic banking and financing services have increased phenomenally around the world. There now exist 150 such banks spread over most countries of the world. Yet, the same trend in financing with a concentration around *murabaha* (trade financing) is found to intensify. Equity participation and profit sharing have remained distant minimum in the total allocation of resources. Secondary financial instruments in accordance with *Shari'ah* could not be developed so as to give rise to a viable Islamic capital market. Islamic financial instruments are therefore traded in conventional stock markets. As a result, neither the developmental aspects of Islamic banking in favour of realizing an Islamic economy nor the distributive goals for the poor and marginal enterprises could be attained.

Bank Islam Malaysia Berhad, one of the most progressive Islamic banks in the world today, quoted the following proportions of their *mudarabah* and *musharakah* funds (BIMB, 1994). *Mudarabah* financing stood at 0.21 per cent of the total financing in 1993 and 0.34 per cent in 1994. *Musharakah* financing stood at 1.85 per cent and 1.81 per cent, respectively, for the same years. These funds held by shareholders did not involve any active stakeholding and participation in decision making except for major shareholders. The bank acted as management *mudarib* on behalf of its customers to make all decisions singly. Thus a principal-agent relationship existed in financial management and decision making. *Mudarabah* and *musharakah* became sleeping partnership in financial contracts between the clientele and the bank (Choudhury, 2001).

In the case of Al-Rajhi banking and Investment Corporation in Saudi Arabia, Islamic banking services have shown good share values in its various Islamic financial instruments. This is indicated by their appreciating unit values. As shown in table 3 for Al-Rajhi banking services, unit shares of all funds increased within the span of a mere single week. Yet the condition behind all these instruments is their nature of fixed deposit without dividends allowed to be withdrawn in the short-term (internet version, 4/22/01).

Table 3: Al-Rajhi Islamic banking services: current unit price

Dated 4/22/01 internet version

Name of Fund	Unit Price (This Week)	Unit Price (Last Week)
Commodity *Mudarabah* Fund	$1,580.73	$1,579.31
Local Shares Fund	SR3,651.81	SR3,636.02
Global Equity Fund	$139.98	$138.37
Fund for Egyptian Shares	$55.60	$53.65
Middle East Equity Fund	$92.69	$91.08
Balanced Fund - 1	$1.1129	$1.1079

In April 2001 (internet version April 29, 2001), Al-Rajhi Islamic banking service posted 17.5 per cent increase in its profits over the first Quarter a year ago. Equity shareholders' capital increased by 8 per cent to Saudi Riyals 7 billion. Customer deposits rose to SAR 37 billion and operating revenue stood at SAR 904 million.

Al-Rajhi has much of its Islamic funds in fixed deposits revolving around several kinds of Islamic financing instruments. Fixed deposits although good for affluent investors, who do not need to cash off in the short run, are not conducive for the marginal depositors and enterprises. Financial needs and exigencies affect marginal clientele continuously over the short run, particularly in financial markets and economy that have become volatile these days. Hence a good degree of liquidity should be available to marginal depositors upon demand. Flexibility of cashing off without penalty to depositors should mark the feature of such funds. This would establish one of the conditions of *Shari'ah*, which is easy access to property rights by the needy depositors.

It is also found that some of the unit values are too high and may preclude small-scale investors from enjoying such financial instruments. It might be good to think of diversifying the large unit value shares into shares of smaller ones with affordable unit values. The result would be both product and risk diversification without diminution in the total unit value of shares. A good area to so diversify the shares is unit trusts with sectoral diversification. Linkages between sectors can then be generated by means of the Islamic financing instruments as a sign of economic development.

In recent times, the same composition of Islamic bank financing concentrated in foreign trade has continued, for this instrument was found to be the most profitable and attractive from its low risk point of view. Foreign trade financing comprised 72 per cent of total financing of IDB on a cumulative basis between 1976 and 1995. Of this, much was on short-term trade financing. Long-term trade financing comprised a mere 2.87 per cent of total trade financing between 1976 and 1995. Yet foreign trade financing instrument is not of a developmental type. Dependence upon imported goods and inputs from non-Muslim countries can increase the debts of importing countries. This problem was in fact noted with the foreign trade portfolio of IDB during the 1980s. In spite of the concentration of IDB financing in foreign trade, inter-communal trade among the member countries is a mere 9-10 per cent of their global trade since many years now. Member countries' global share of trade was a mere 7 per cent in 1995.

Over the twenty years period, 1976-1996, IDB had financed only three profit-sharing projects. Financing in these comprised only 0.15 per cent of total project financing (IDB, 1996). Recently, IDB has established a number of cooperative projects with Islamic banks. The emerging Islamic Banks' Portfolio for Investment and Development is a fund jointly established by IDB and Islamic banks along with other participants. Between 1988 and 1996 a total of US$100 million was allocated in syndicated operations. IDB's participation was 24.5 per cent. Islamic banks' portfolio comprised 8.7 per cent. IDB's Unit Investment Fund comprised 5.8 per cent. Pension Funds comprised 3.5 per cent. Other Islamic banks held 57.5 per cent of their assets in this portfolio. Such syndicated operations have been opened up in only two countries, Pakistan and Egypt, and then too they comprise only lease and trade financing operations. It had only 5.5 per cent of total IDB financing between 1976 and 1995. Participation in Islamic banks' portfolio is of a *mudarib* type, whereby IDB acts as the manager of the Islamic banks' portfolio.

Inferences drawn

From the quantitative picture given above it is clear that Islamic banks have done well in being profitable institutions towards maintaining the liquidity position of their depositors and shareholders. Yet the element of socioeconomic development and a better prospect for diversification of project financing instruments is lacking. Consequently, the full impact of Islamic banks in development financing and in establishing sustainability of an Islamizing community remains a potential. Social wellbeing of the type we have explained in this paper in terms of measuring and directing complementary relations among *Shari'ah* recommended possibilities, needs more extensive networking and complementary relations among the financial and socioeconomic development goals in accordance with the tenets of *Shari'ah*.

Conclusion

We have noted in this paper that Islamic banking in accordance with *Shari'ah* precepts is a landmark in new paradigmatic thinking interrelating finance, economy, community and society. Islamic banks are therefore to carry out their operations and organize their plans and programs according to such a general systems outlook of finance with socioeconomic development. It would then combine the goals of economic efficiency (growth) and social justice into complementary relations with each other. Such a model of socioeconomic development is very different from the financial, economic and social models we are facing in the present age of capitalist globalization. To achieve the complementary goals and so actualize wellbeing for all, Islamic banks ought to focus on both financing as well as development in accordance with the tenets of *Shari'ah*. We have laid down this perspective in this paper.

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