Islamic Banking: Doing Things Right and Doing Right Things

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Abstract. To do the right thing, the contract *('aqad*) method is usually employed to define Syariah legitimacy of Islamic banks. Equally important, the Islamic banking business is expected to operate on the moral principles of risk-taking (*ghorm*), work (*kasb*) and responsibility (*daman*). By doing so, the ethico-legal dimension of Islamic banking can be made evident. While claiming Syariah legitimacy, doing things right is critical where Islamic banks must compete on the basis of efficiency. In this way, factors affecting bank performance such as size of capital, scale economies and adverse selection must not be discounted in determining the success of the Islamic banking business.

1. Introduction

The globalisation and liberalisation of the financial sector are expected to result in greater participation in Malaysia of Arab Islamic banks, notably Al-Barakah, Al-Rajhi and Kuwait Finance House (KFH), and western banks such as Citibank, ABN-Amro and Hong Kong and Shanghai Banking Corporation (HSBC). Islamic banking in Malaysia began operations in 1983 and is set to command a 20 per cent market share by the year 2010. Currently, Islamic banking consists of two full-fledged Islamic banks and the Islamic banking system (IBS) banks. Although it only accounts for 11 per cent of the Malaysian market share, up from 2.5 per cent in 1997, it has grown at an average rate of 18 per cent per year, against the global growth rate of 15 per cent. The IBS banks are governed by the Banking and Financial Institution Act (BAFIA) 1992 while the two full-fledged Islamic banks are run under the Islamic Banking Act 1983.

More broadly, the Securities Commission has prepared guidelines on Syariah stock screening. About 80 per cent of the stocks traded in the Bursa Malaysia are Syariah compliant. Although not accepted globally, Malaysian Islamic bonds have a sizeable 50 per cent share of the Malaysian bond market. Sale-buyback (*bay' al-'inah)* and debt-trading (*bay' al-dayn)* contracts are widely used in the Islamic money market. These include the Khazanah bonds, Islamic accepted bills and inter-bank money Islamic negotiable instruments (INI).

The Islamic insurance (*takaful*) business is relatively new and commands about 5 per cent of the Malaysian insurance market. There is no window-based *takaful*. *Takaful* operations are run by four full-fledged *takaful* companies namely, Syarikat Takaful Malaysia, Takaful Nasional Malaysia, Mayban Takaful and Takaful Ikhlas. Unit trust management companies (UTMCs) are also making inroads into Islamic financial markets. Issuance of units is made by the UTMCs via the contract of agency (*wakalah)*. As a *wakil* (representative) of unit holders, UTMCs charge nominal fees for the service rendered. There are more than 13

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Islamic funds in the market with about 5 per cent market share. These funds are invested in Syariah compliant financial assets as approved by regulatory bodies such as the Securities Commission and Bank Negara Malaysia. Some examples are the Syariah Index, equity and Islamic bond funds.

Islamic finance is a huge business today and represents more than USD200 billion in funds worldwide. Western investment banks including HSBC and Citibank have made significant inroads into the fee-based business in structured Islamic finance involving more than USD50 billion global *sukuks*. It has also elevated some Muslim jurists into extremely well-paid global Islamic finance advisors to approve new Islamic financial products such as Islamic hedge funds. To some extent they are becoming more aggressive in ensuring that Islamic finance matters in the global financial market, even though they may cause controversies and misinterpretation of Islamic law. Are they doing the right thing?

2. Modern Islamic Finance: The Contract ('*Aqad)* Approach

The nature of Islamic finance today is largely fashioned by Islamic finance jurists who hold the authority in determining the Syariah value of financial products. Syariah status is given by virtue of contract validation. That is, a financial instrument that uses a contract deemed valid by Islamic finance jurists is usually granted Syariah compliant status.

Since the Holy Quran has condemned interest and enjoins profit creation via trading (*bay'*), the Islamic finance jurists have resorted to applying the explicit meaning of *al-bay* i.e. trading in determining the Syariah legitimacy of financial instruments. By trading, they usually make reference to sale of goods and services. For example, a contract of sale consists of the following pillars:

(i) Buyer and seller
(ii) Object of sale
(iii) Price
(iv) Offer and acceptance

A valid contract must ensure that each of the above pillars does not contain the following prohibitions:

(i) Interest as *riba*
(ii) Ambiguities (*gharar*)
(iii) Gambling (*maisir*)
(iv) Prohibited commodities such as liquor, pork etc.

As an example, both buyer and seller must be rational. The object of sale is a permissible property (*mal-mutaqawim*). The seller must also hold ownership before making the sale. Price must be determined on the spot. The offer and acceptance is made explicit by way of a written document or verbal statement. These requirements must be strictly observed to avoid ambiguities (*gharar*) in the contract. Some sale contracts become invalid (*batil*) if they are inclined to gambling such as selling fish in the water or determining price using stones or arrows. As long as the contracting parties have fully observed the legal requirements concerning their transaction, the contract of sale is deemed valid (*sahih*).

The Contract Approach therefore looks at the explicit or external (*zahir*) properties of contracts. It does not give qualification to the role of intention (*niyyah*) of the contracting parties. In doing so, the Contract Approach has given birth to a number of products where profits are created by virtue of time value. It opens Islamic banking to a variety of credit sales and credit-based transactions. These are:
(i) *Al-murabahah* (sale with lump sum deferred payment)
(ii) *Al-bai-bithaman Ajil* (BBA) (sale with instalment payment)
(iii) *Bay' al-'inah* (sale-buyback with instalment payment)
(iv) *Tawaruq* (instalment sale + cash sale)
(v) *Bay' al-dayn* (sale of debt at discount)
(vi) *Ijarah Thumma Al-bay* AITAB (interest-free financial leasing)

In 2004, BBA and *murabahah* constituted 49.9 per cent and 7 per cent of total Islamic bank financing respectively while AITAB accounted for 24 per cent.

Table 1: Islamic banking system in Malaysia, 2004

Financing	Percentage
Bai bithaman ajil	49.9
Murabahah	7.0
Ijara Thumma Al-bay	24.0
Mudarabah/Musyarakah	0.5
Istisna	1.2
Others	17.4

Source: Bank Negara Malaysia 2004

In other words, credit financing accounted for 80.9 per cent of total Islamic financing. The Contract Approach has led Islamic banking into offering credit-based products (CBP) as a means of generating profit. The implications are examined in the following section.

3. The Contract (*'Aqad*) Approach: Economic Impacts

Islamic banks today face similar problems as those experienced by conventional banks. However, there are some that are totally new and unique to Islamic banking. These are discussed below.

3.1. Economies of Scale - Reducing Overheads by Adopting the Universal Banking Model

The Contract Approach puts credit-based products to the forefront of Islamic banking operations. It displaces the potential of niche products such as *salam, istisna', mudarabah* and *musyarakah*. Although the Islamic Banking Act 1983 (IBA 1983) allows Islamic banks to venture beyond credit-based financing, Islamic banks have chosen not to do so. The IBA

1983 states that an Islamic bank is, "any company which carries on the Islamic banking business and holds a valid license". Further on, it defines the nature of Islamic banking business as "a banking business whose aims and operations do not involve any element which is not approved by the religion of Islam."

The main idea is to conduct many financing facilities under one roof, say by Bank A. If a customer wishes to renew or purchase an insurance policy he can do so in Bank A; or if he wants to purchase stocks he does not have to waste his time to see a broker elsewhere since Bank A can handle stock transactions as well. Companies that hold accounts with Bank A and plan to go public do not have to look for underwriters since Bank A can also underwrite securities. Leasing and venture capital can also be conducted in Bank A. What we see here is a simple model where bank A does not have to form new subsidiaries to undertake these "non-banking" activities. It can save operations costs and help reduce the cost of banking services and price of financial products.

A firm is said to benefit from economies of scale when cost per unit falls as output increases. BAFIA 1992 does not allow banks to be engaged in leasing, insurance, stock and underwriting transactions under one roof. Hence to circumvent banking laws, attempts to venture into new "non-banking" activities can only be made by forming subsidiaries. These subsidiaries are no longer governed by banking laws. However, if bank A plans to form a subsidiary, or many subsidiaries, the cost of doing so is not cheap. New CEOs, managers and officers must be appointed, which adds more pressure on manpower shortages. Other costs such as rentals of office premises and maintenance must also be met, putting more pressure on capital.

However, when these "non-banking" operations are carried out by one bank alone, unnecessary costs can be avoided. It can reduce the cost of banking operations. Banks can run more efficiently when they are allowed to take on "non-banking" activities under one roof.

In banking, cost reduction from economies of scale refers to the non-financial aspects of banking operations. These costs include the physical cost of operations, sometimes known as the resource costs involving personnel, fixed overheads and buildings. How these costs are translated into cost of financing, namely interest rates or profit rates, can easily be observed in the following equations:

(i) Contractual interest-rate = base lending rate + risk premium (spread)
(ii) Contractual profit-rate[1] = base profit rate + risk premium (spread)
(iii) Base lending rate or Base profit rate = cost of deposits + operating cost + bank's profit margin.

If a bank embarks on the "non-banking" activities under one roof, it can reduce cost of operation. This in turn lowers interest rates on loans or profit rates on credit-based products.

In Japan and Germany, banks are allowed to do all of the above, hence the name "universal banking". They are allowed to purchase stocks of public listed corporations as well as those

[1] Since interest is not allowed in Islamic banking, financing is done through sale with deferred payments, so the profit rate refers to the ratio of profit margin over total financing given by the bank to the customer.

over the counter. In Germany a bank provides insurance as well as stockbroking services. But in Malaysia, the BAFIA 1992 prevents commercial banks from doing the same as their main business is lending and borrowing. However, they are allowed to pursue non-banking transactions by forming subsidiaries.

Interestingly enough, full-fledged Islamic banks in Malaysia, namely Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat are free from BAFIA 1992, since both run under the Islamic Banking Act 1983. Since businesses relating to insurance services (takaful), leasing (*ijarah*), stockbroking (*wakalah*), unit trusts (*wakalah-mudarabah*), underwriting (*al-bay'*) and equity (*musyarakah*) are approved by Islam, they can be pursued under one roof by Islamic banks. But why they are not in fact pursued is an interesting question.

Economies of scale can only be realised as size increases. One way of doing so is through portfolio diversification. What seems to happen today is the opposite. For example, BIMB promotes credit sale products. Whilst the Islamic Banking Act 1983 allows BIMB to offer multiple services under one roof, it opted not to do so. Instead, it has opened new subsidiaries such as Syarikat Takaful Sdn. Bhd. (Insurance), Amanah Saham Bank Islam (Unit Trusts), Bank Islam Brokerage (Stock Broking), Bank Islam Consumer Financing (Trading) and Bank Islam Research and Training (BIRT).

What we see in the above is an Islamic banking operation that seems to run under BAFIA control. The losers are not the bank managers since they are salaried personnel but the customers who may have to absorb the bank's high overheads. If BAFIA 1992 put a wall between banking and commerce, why didn't the Islamic banks pursue universal banking when such walls do not exist in the IBA 1983?

Failure to adopt the universal banking model can impact Islamic banks in two ways. First, it has to compete with conventional banks on size alone. But with a small asset base, the average cost per unit of financing will be much higher than conventional banks, and this explains why profit rates and transaction costs of Islamic banks are usually higher than conventional rates. Second, the credit system will not allow asset diversification since it is easier to manage financing via credit than financing under a system of partnership.

By adopting the universal banking model, Islamic banks can help reduce the price of credit-based products (CBP). Cheaper financing can lead to higher demand for CBP funds and increase the volume of Islamic financing. In the same vein, to increase the supply of CBP, the supply of deposits must increase. This is only possible when Islamic deposits provide better rates of return than conventional deposits. But this approach requires an Islamic bank to diversify its assets by reducing credit based financing. A good mix of equity, leasing and credit sale activities is a workable option, as it poses no violation of the Islamic Banking Act 1983.

3.2. Dealing with Adverse Selection and Default Risk

Financing contracted under the *murabahah*, BBA and AITAB (i.e. CBP) contracts usually embrace the credit culture. The financial requirement includes collateral, guarantors and a system of credit assessment in determining the credit worthiness of a prospective customer. Islamic risk management generally points to credit risk management, i.e. protecting banks from defaulting customers.

Table 2 shows that Islamic banks have a higher default rate than conventional banks.

The six months non-performing financing is almost double that of conventional banks at 9.6 per cent. This may have to do with the problem of adverse selection. With a smaller market share in assets and deposits, economies of scale are harder to come by for Islamic banks relative to conventional banks. To that effect, Islamic banks usually run under high operating budgets, which are absorbed by bank customers who have to pay high profit rates.

When credit products are sold at higher rates than conventional loans, liquidity in Islamic banks may increase as the demand for credit-based products is lower than the demand for loans. To reduce the idle balances, Islamic banks may have acted with less prudence when approving credit based products. But only the bad paymasters are willing to pay higher rates. Often rejected by conventional banks, they have nowhere to go except the Islamic banks. The good ones usually resort to loans. This may well explain the higher rate of non-performing financing in Islamic banks.

Table 2: Malaysian banking system: Non-performing loans/financing 2004

Banks	3-month (%)	6-month (%)
Conventional	7.6	5.9
Islamic	13.7	9.6

Source: Bank Negara Malaysia 2004

Credit risk management in Islamic banks therefore should go beyond assessing the credit worthiness criteria of customers. The problem of adverse selection can be overcome by not extending new facilities to customers with less financial viability, but this may not improve the liquidity problem. By not doing the right thing how can one do right?

3.3. Coping with Interest Rate Volatilities

Islamic banking products should be able to withstand changes in the cost of funds, notably interest rates. Products contracted under partnership (*musyarakah*) and leasing (*ijarah*) can make the necessary adjustment as the former faces price risk while the latter can adjust the rental rates once the leasing period expires. Neither is tied to the rate of interest, as both are not based on credit. Likewise, sale by order contract (*salam* and *istisna*) is subject to price-risk.

But the same does not apply to products contracted under sale by deferred payments (*murabahah*/BBA). BBA prices are usually determined the same way as loans. Rising cost of funds can cause the BBA profit rate to increase just like the interest rate on loans. But this is not how it works today. Islamic banks cannot alter the *al-bai bithaman ajil* (BBA) profit rate, as it will change the selling price in existing contracts. Doing so will violate the third principle of sale (*al-bay')*, according to which the contractual price cannot be altered. The law of contract says there must be only one price in one sale. A sale with two or more prices is not a valid sale.

3.4. Rising Interest Rates

When an Islamic bank sees conventional banks raising interest rates on loans, there is nothing much it can do to stop customers from using its services since now loans are relatively more expensive.

Although it is ideal to increase BBA financing, it would be relatively difficult to do because Islamic banks need more deposits to make new BBA. As existing BBA financing have locked in a specific profit margin, Islamic banks will find it tough to compete with conventional deposits that offer higher interest rates. To give higher returns (*hibah)* would cut earnings since the locked-in BBA financing is unable to generate more revenue.

In the final analysis, Islamic banks will find themselves on the losing side. To secure more deposits, they have to resort to the inter-bank money market where the cost of funds is even higher than *hibah* rates. Doing so will erode earnings as the cost of deposits increases more than revenue.

3.5. Declining Interest Rates

If interest rates are expected to trend downwards, Islamic banks may see more trouble. This time the bad news is excess liquidity. As more people expect interest rates to fall, the demand for BBA financing will drop. Now it can be more expensive using BBA. This is because existing loans can now charge lower interest rates that existing BBA cannot do.

For example, if annual profit rate of a BBA is 12 per cent, a drop in interest rate cannot allow Islamic banks to revise the rate downwards, as this will induce changes in the contractual selling price. Suppose at 10.5 per cent profit rate per annum, an asset costing RM150,000 will command a selling price of RM428,882 at a monthly instalment of RM1,416 with a 25-year maturity. If the bank plans to reduce profit rate to 9.5 per cent to keep up with the competition, the monthly instalment will fall to RM1,310, which translates into a lower selling price of RM393,162. Changes in contractual price such as this will invalidate the BBA contract.

In the case of Islamic banks, the inability to cut profit rates will make it possible for them to increase the return on Islamic deposits. To some extent non-Muslim depositors will find Islamic deposits more attractive. Placing their money in the Islamic deposits shifts some deposits away from conventional products.

What we see in the above is the following: a lower demand for BBA but higher supply of Islamic deposits. Such a mismatch can destabilise Islamic banking operations. It leads to excess liquidity as the BBA-dependent Islamic banks have fewer options in financing.

3.6. Performance of Islamic Banks

Empirical studies on Malaysian Islamic banking are limited to Bank Islam Malaysia Berhad (BIMB). As a credit-intensive Islamic bank that has opted not to adopt the universal banking model, BIMB has to compete based on price and market share. Without niche products, BIMB's credit-based products must be competitive in order to do well.

Samad (1999) evaluates BIMB's productivity and managerial efficiency in the sources and uses of the bank's funds. He finds that managerial efficiency of mainstream banks is higher than BIMB. Productive efficiency or the average fund utilisation rate and profit earned by BIMB are also found to be lower than those for mainstream banks. All profitability indexes indicate that profits earned by BIMB are lower than those for the mainstream banks.

Dirrar (1996) evaluates the performance of BIMB and makes comparisons with Maybank

Berhad and BSN Commercial. He examines the growth, profitability, liquidity and the capital adequacy ratio of the three banks. He finds that BIMB's major financing is concentrated on credit-based investment compared to the other two banks. Wong (1995) evaluated the performance of BIMB after 10 years in operation. He showed that BIMB's achievements are commendable, although the over-dependence on credit finance remains its major shortcoming. His study shows that an Islamic bank has the ability to maintain its viability and growth in a capitalistic financial environment. However, in terms of social obligations, generally, BIMB has not made sufficient contributions towards achieving a more equitable distribution of income in Malaysia.

Kader (1995) conducted a survey on BIMB's Muslim depositors and found that 61.4 per cent of them also hold accounts in the mainstream banks for reasons related to financial deepening. As the banking industry is further developed, the willingness of, and the opportunity for, the public to utilise the system, is directly affected by factors such as accessibility to, and the attractiveness of, the financial instruments and the kind of services they are able to provide. Kader (1995) also showed that Muslims hold accounts in the mainstream banks mainly due to convenience such as the availability of more branches and ATMs as well as location convenience. The religious factor is not in itself sufficient to drive Muslims to use Islamic banking facilities.

The above findings show that increasing asset size and asset portfolio is not possible if the Contract Approach is used in determining the Syariah legitimacy of products. The Contract Approach has led many Islamic banks to offer many credit-based products. The displacement effect of changing interest rates is serious when very few non-banking facilities are made available by the Islamic banks.

4. The Remedy: The Equivalent Countervalue (*Iwad*) Approach

The Contract Approach adopted by Islamic banks in Malaysia has shown evidence of product duplication using features commonly found in interest-bearing instruments. By doing so it is readily exposed to credit risk. It is also prone to instability when interest rates are volatile. Without niche products, Islamic banks are heavily dependent on credit-based products and cannot be expected to outperform conventional banks as the latter are larger and therefore run on lower overheads than Islamic banks.

The author believes that the Contract Approach is an important methodology in determining Syariah value but must incorporate an additional criterion to further define Syariah legitimacy on a broader scale. The criteria reflect both legal and moral dimensions of contracts such that they are able to fend off any attempt to instil credit mechanisms under an Islamic label and making money from time.

Although the main trust of Islamic banking and finance has been the prohibition of interest, the application of trade and commerce *(al-bay')* as an alternative to *riba* has not received equal attention as had the interest (*riba*) factor. This has led many people to think that the only distinction between an Islamic bank and a conventional bank is that the Islamic bank operates without interest.

But the cornerstone of Islamic banking is that it runs on the principle of trade and commerce (*al-bay').* Justice and fairness can be realised from trading but is absent in riba. It is argued that profit arising from trade contains an equivalent countervalue *('iwad)* in the form of: (i) risk (*ghorm*), (ii) work and effort (*kasb*), and (iii) responsibility (*daman*).

As an example, a trader buys 100 units of goods X for $50 per unit wholesale and sells it for $80 retail where he earns $3000 profit. The question is "what earns him the $3000 profit?" A quick answer can be the following:

(i) He has put his money or capital ($5000) at risk. There is no guarantee that he can sell the goods for $80. He may not find buyers at all or only manage to sell a few at a lower price. By facing market or price risk he thus deserves the profit.

(ii) He has put a lot of hard work in terms of planning, promotion, negotiation and networking skills to get the goods sold. This addition in value earns him the profit.

(iii) By providing warranties on the goods sold, he holds responsibility over any product defects. The customer can return the goods for cash or accept a rebate or discount.

When the *'iwad* factors are incorporated in contractual obligations, there is less tendency for Islamic banks to use credit-based products (CBP) as it is clear that the CBPs actually make profits out of time and not risk, effort and responsibility. And when profit is created from time, then it is plainly a *riba* mechanism at work. Interest or *riba* is paid as a reward for waiting. It compensates the creditor for postponing his current consumption. The creditor must be compensated for the displeasure or disutility for postponing his current spending. He believes that money today gives more pleasure than money tomorrow since the future is uncertain.

Likewise, the elements of risk, work and responsibility are not apparent in the contract of loan with interest. For example:

1. *Risk*: A prudent bank will only give loans that are free from default risk. A debtor must place a collateral or guarantor on the loan. If the debtor fails to pay up, the bank can recover the loan from the sale of the collateral or payments from the guarantor. Thus interest as profit is generated from waiting and not risk-taking.

2. *Work and effort*: The interest received by the bank does not come from skills, knowledge and other value-added elements originating from the loan agreement. The loan to the borrower is money. For example, when the bank makes a loan to a businessman, it does nothing to the business but still receives interest income from the loan.

3. *Responsibility:* The bank holds no responsibility over the business performance of borrowers. A business failure will still require the borrower to pay up. The interest charged on the loan is the payment for waiting and has less to do with responsibility.

5. Conclusion

This paper examines the nature of the Contract Approach and its impact on the Islamic banking business. Although it is a right thing to do, disregarding the intentions of the contracting parties has led Islamic banks to generate income (via CBPs) by virtue of time instead of price risk, effort and responsibility. When operations are largely based on credit financing, Islamic banks can be exposed to credit risk which is a norm in conventional banks. The pricing of CBP products is also similar to interest-bearing ones when a default premium (i.e. spread) is added to the cost of funds and overheads. Adverse selection is also a worrying trend. With smaller market share and sizes, Islamic banks run on higher operating costs. It is hard to do things right under these circumstances. With higher overheads, CBP's profit rates are usually higher than interest-rates. Lower demand for credit-based products increases idle balances. To mop up the excess liquidity, it is suspected that Islamic banks have acted with less prudence in conducting credit assessment. Adverse selection seems to have affected Islamic banks more than their conventional competitors as is evident in their relatively higher non-performing financing (NPF). The CBPs are also prone to destabilising the bank's earnings, as they are predominantly fixed-rate assets.

The right thing to do is to adopt the '*iwad* approach. The globalisation of Islamic banking should lead to Islamic banking products which contain the elements of risk, effort and responsibility. These three elements should be explicitly defined in the contractual agreement in writing and be recognised by the civil law of the countries where Islamic banks are doing business. By doing so, asset sizes should increase. This can help cut down the cost of operations and therefore reduce the cost of Islamic financial instruments. In this way Islamic banks can become more competitive in the global financial system.

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