ETHICAL DIMENSION OF ISLAMIC BANKING AND THE FINANCIAL MARKETS

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ABSTRACT

Islam as the complete code of life provides every individual complete direction of life. In the modern world Islamic Banking exists in various corners of the world with progressing steam. The ethical performance put forth by Islamic financial institutions lead the result for the economic growth through-out the Islamic economic sectors. Financial market was disturbed due to various emerged financial crisis started from modern conventional banks since the decades. In order to overcome these lost assets world financial experts thought for the establishment of ethical financial institutionalization. The disturbed world financial market was overcome by Islamic banking in the particular areas. The present paper is the analysis of prevailing financial sectors as authenticity of Islamic banking with its ethical memorandum.

Introduction

Four Decades ago, Islamic banks were unknown to the world; they numbered in the hundreds worldwide and hold more than U.S. $2 trillion in assets now. In the world of global finance, this is not a large amount, but its growth rate is substantial. Furthermore, the concept is discussed heatedly in every financial zone. In light of Islam's rapid development, especially in countries like the United Kingdom, France, Hong Kong, and the United States, Islamic banks will likely play a role in the development and globalization of world financial markets.[1] But more importantly, Islamic banking offers a means of reintroducing ethics into the global financial system.[2]

This paper will argue that the principles of Islamic banking are fundamentally different from those of traditional commercial banking system. The Islamic financial system derives its rules from religious sources, while the conventional banking system's rules originated in the market.[3] At a time when global economic forces are causing great hardship for people around the world, and the harsh demands of the market seems to supersede concern for the well-being of fellow humans, Islamic banking may serve as a means of re-imbuing modern banking with ethical norms.[4] Within the broader financial system, Islamic finance can play a role in re-establishing a sense of ethics that has been lost and to try to make its concept and products acceptable to ethically minded people

[1] Islamic Banking & Finance at the Crossroads of Global Financial Crisis. The Way Forward"**,** Keynote Address by Dato' Mohd Razif Abdul Kadir, Deputy Governore, Bank Negara Malaysia at the soft launch of the IIUM Institute of Islamic Banking and Finance, 20 March 2009, Kuala Lumpur. For a detailed elaboration on the development of IBF please see Askari, Hossein, Zamir Iqbal and Abbas Mirakhor (2009), '*New Issues in Islamic Finance and Economics: Progress and Challenges*, Singapore: John Wiley and Sons, especially Chapter 1

[2] Josh Martin, *"Islamic Banking Raises Interest," Management* Review, New York American Management Association, November 1997.

[3] Mohamed Aslam Haneef, Islamic Economics, Banking and Finance in the 21st century: Selected Issues in Curriculum/Human Capital Development, Thoughts on Economics, Vol. 20, No. 01, P.04

[4] Algaoud, L.M. and Lewis, Mervyn, K. (2001), '*Islamic Banking*' , Edward Elgar Publishing Limited UK. P. 90

throughout the global financial market. As a religion based upon justice, Islam can serve as an ethical framework for regulating monetary transactions between people and, in this Way, influence the global financial market place.

RISK VERSUS CAPITAL

One of the main tenets of Islamic finance is that lenders (in our discussion, bank depositors) must face risk to their investments (deposits) if they are to enjoy a share in the profits of the institution in which they have deposited money. As issue is the injunction in the Qu'ran that forbids the paying and receiving of interest.[2] It does not, however, forbid receiving fair profit on commercial transactions. Islamic institutions, like conventional banks, are intermediaries. However, whereas a conventional bank will take ownership of the depositors' funds and become the borrower's partner, an Islamic bank will mediate the relationship between its aggregate depositors and its aggregate borrowers. If the Islamic bank is profitable, the depositors are entitled to a share of those profits.[5]

Islamic bank serves as a means of gathering depositor funds in a pool and directing them to businesses. The link between the individual depositor and the business to which the depositor's money is lent is no longer direct, but nevertheless the element of risk is present. An agreed portion of the bank's profits made on the business loans is distributed to depositors. Likewise, losses also are distributed to depositors. In a simple scheme of the conventional banking format, the owners of a bank are more at risk than the depositors. When there are losses, the write-off will be made to the profits and the net worth of the bank, thereby decreasing the value of the bank owners' investment. Only when the losses are so large that the capital is totally written off are depositors' funds at risk. However, before net worth is affected, the large bad debt reserves that banks accumulate for just such a purpose must be exhausted. [6]

Another important factor of traditional banks is the support provided by central banks to depositors in case of bank failure. In the United States, the federal government provides depositors of all institutions a guarantee of up to U.S. $ 100,000 per account. When bank failures have been large, as was the case with some savings and loans in the early 1990s, the government stepped in to guarantee accounts in excess of U.S. $ 100,000.[7] Similarly, when a bank fails in France, the French central bank organizes a bailout of the failed bank through participation by all other banks in the system. This compulsory mutual insurance system operates such that depositors are repaid by all the other banks in France, from each according to its size. When a failure occurs, a stable bank takes over the management of the failed institution. Islamic banks located in the developing world do not offer such guarantees. Even if such systems were available, it is doubtful that they could offer similar levels of security. Indeed, the state providing protection against risk is similar to owners providing their capital as a support against risk.

However, under Islamic banking law, if there is no risk, or very little risk, to deposits, then the profit earned on deposits does not come from participation in a shared commercial venture and simply is interest, forbidden under most interpretations of Islam. One consequence of this problem is that Islamic banking is often said to work well in systems where the entire economy is based on Islamic principles and all the banks are Islamic.[8] This situation now prevails in Pakistan and Iran.

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[5] Al-Omar, F and Haq, M. A. '*Islamic Banking; Theory, Practice and Challenges*', Oxford University Press, Karachi Z Books London. 1996, P. 88

[6] M. Umer Chapra, *Islamic Economic Thought And The New Global Economy*, *Islamic Economic Studies* Vol.9, No.1, September 2001

[7] M.N. Siddiqi, (2009), '*Current Financial Crisis and Islamic Economics*', Radiance Views weekly, Vol. XLVI No.38, 2009-01-04, P. 244

[8] Ziauddin Ahmad, "The Present State of the Islamic Finance Movement" The *Impact and Role of Islamic Banking in International Finance: Issues and Prospects*, U.S.-Arab Chamber of Commerce (June 28, 1985): 49-50,

Islamic banking proponents will claim that the conventional banking system, based on interest, is fundamentally unjust.[9] First, the management and owners of a bank are sophisticated and will use their market knowledge to increase profits and the institution's net worth. Second, they are protected from their mistakes (arising from their willingness to take risks) by the state and the insurance companies whose premiums are in fact paid by lowering returns to depositors. Third, since depositors are guaranteed a certain rate of return on their deposits, banks place the full risk of lending on the borrower.[10]

This eliminates any partnership between bank depositor and bank borrower. Whether or not the borrower makes money from his loan, he is responsible for paying back the principal and the interest. The notion that risk must be shared not only by owners, but by bank depositors as well is probably the single most important reason why Islamic banking has not developed in non-Islamic regions.[11] In the West, for example, central banks and bank regulators are expected to protect the integrity of the banking system and ensure that depositors have enough trust in the system to place their funds in the banks and not withdraw it in times of economic turmoil. Regulators have learned over the years that banks cannot be counted on to always use good judgment. The traditional banking system dictates poor judgment by forcing owners to bear the financial burden of those poor decisions while generally shielding depositors from the same level of loss.

In this manner, regulators feel more confident that management and owners will act more prudently, knowing that their mistakes will hurt their interests more than the interests of their depositors. It should be pointed out that the judgment of Islamic bank managers is no better than that of their peers in conventional Western banks.[12] Kuwait Finance House incurred million-dollar losses during the Souk AI Manakh Kuwait stock market bubble while using the savings of thousands of Pakistani laborers, who had little sophistication in matters of investments, in land and Gulf companies' stocks. Had the Kuwait government not intervened to reimburse depositors, the hard working laborers would have been swindled, even though they banked with an Islamic institution. For Islamic financial institutions to increase their role and influence, they must move away from a narrow legalistic interpretation of risk sharing.[13] Because bank owners and managers are much more savvy regarding financial markets than most of their depositors, and despite Islamic structures against interest without risk, they must be held at least somewhat accountable for bad decisions and absorb losses before passing the burden on to depositors.

The essence of Islamic banking is not only for profits. This financial instrument or that management technique renders a depositor a true commercial risk taker rather than a receiver of interest; the essence is that banking should be done in a just manner. Islamic ethics are based on the principle of social justice. From a legalistic religious position, it may be correct to force unsophisticated depositors to absorb losses that bank managers and owners have caused, but it is not just.[14] Making owners and managers suffer first for their mistakes would make Islamic banking more acceptable to Western banking regulators and more appealing to depositors, who will have

556-58. Also, Zuhair lqba and Abbas Mirakhor, "Islamic Banking, Occasional Paper No.49'Washington, DC: International Monetary Fund (March 1987): 1-7.

[9] World Islamic Banking Competitiveness Report 2013–14 the transition begins.

[10] Syed Nawab Haider Naqvi, The Dimensions Of An Islamic Economic Model, *Islamic Economic Studies*, Vol. 4, No. 2, May 1997,

[11] Sarath Delpachitra, *Is Islamic banking capable of meeting corporate social responsibility*? International Journal of Islamic Bnaking, Volume 10, Issue 02,

[12] M, Anwar, Islamicity of banking and modes of Islamic banking', *Arab Law Quarterly*, vol. 18, no. 1, pp. 62-80

[13] Baker Ahmad Alserhan, The Principles of Islamic Marketing, *United Arab Emirates University*, *UAE*.

[14] 'God has made business lawful for you' (Quran 2:275), and Prophet Mohammad says: 'Nine tenths of sustenance is in commerce'. Prophet Mohammad was himself engaged in commerce before prophet-hood. He was a successful businessman known for integrity and he bore the title, 'the trustworthy(*Ameen*)

less need to watch their money.[15] The issue of sharing risk with unsophisticated, versus sophisticated, depositors is akin to the issue investment funds faced in the United States. Funds willing to deal with a limited, but less costly pool of investors will limit their efforts to sophisticated investors and thus not have to follow the stringent regulations and disclosure demands of the Securities and Exchange Commission. In Islamic banking, some banks have struck such a de *facto* arrangement. For example, AI-Baraka, one the largest Islamic banking groups, only takes deposits from large and sophisticated investors.[16]

IDEALOGICAL ISSUES OF ISLAMIC BANKING

The words 'Islamic banking' has a strong emotional effect. In the Islamic World, some individuals and institution representatives talk as if patronizing Islamic banks makes them more pious than those who patronize traditional banks. For many more, there is a certain pride in knowing that their institutions, organized under their religious laws, have successfully adapted modern financial instruments yet remained true to the tenets of their religion. Others, however, both Muslim and non-Muslim, feel certain uneasiness. To use an American expression, there is a certain sense of 'in-your-face' about the term 'Islamic banking' a certain defiance of the secular Western edifice. This ideological bent to Islamic banking greatly obfuscates the true value of Islam to the financial world.[17]

As mentioned above, Islamic banking should not be applied from a rigorously legalistic viewpoint, especially regarding interest. Rather, it should emphasize the application of social justice in the financial realm, a notion that has been forgotten by Western banking institutions. Much writing on Islamic banking has a strong ideological bent. There seems to be an assumption that Islamic banking is a newly developed thought, a new form of Islamic unity (*Itihaad),* or exegesis of the religious texts. S.H. Homood has pointed out that interest and usury are discussed in the Bible. These paragraphs, which apply to Jews and Christians alike, clearly forbid the use of usury in dealing with people.[18] For centuries, Christians had a very strong prejudice against interest, which they used, however reluctantly.[19]

Today in Europe, for example, it would be frowned upon for relatives to charge interest to relatives.[20] The Catholic Church only lifted the ban on interest in the mid nineteenth century.[21] Today, there are banks in Israel that cater to Jews who refuse to take or pay interest. Despite the above-mentioned pride in Islamic banking, there also is certain ambivalence. While conservatives argue that it is impious for Muslims to participate in Western and Western-style financial institutions, others argue that there have been various forms of interest-style lending in the Islamic world for centuries. Given that previous generations of Muslims did not appear to have wrestled

[15] , S, Sairally, Evaluating the 'Social Responsibility' of Islamic Finance: Learning from the experience of Socially Responsible Investment Funds, Chapter 10, Advances in Islamic Economics and Finance, Ed. Iqbal, M, Ali, S. S. and Muljawan, D., Islamic Training and Research Institute, Islamic Development Bank, Saudi Arabia. (2007).

[16] Malik & Shah, (2004), '*An Analysis of Islamic Banking and Finance in West: From Lagging to Leading*', CCSE, Asian Social Science, Vol. 7, No.1, pp.179-185

[17] F. Al-Omar, and M. A Haq, '*Islamic Banking; Theory, Practice and Challenges*', Oxford University Press, (1996),

[18] 4 S.H. Homood, *Islamic Banking* (London: Arab Information, 1985), 5-6. Also, Reyaz A. Kassamali, The *Ethics of Banking on Faith:An Examination ofthe Religious Attitudes of Judaism, Christianity and Islam Toward Prohibiting Usury*, unpublished senior thesis, Yale University

[19] Roszaini Haniffa, Mohammad Hudaib, Exploring the Ethical Identity of Islamic Banks via Communication in Annual Reports, Journal of Business Ethics (2007) 76:97–116, Springer 2007

[20] Reyaz A. Kassamali, The *Ethics of Banking on Faith: An Examination of the Religious Attitudes of Judaism, Christianity and Islam Toward Prohibiting Usury*, (New Haven,Yale University, 1994).

[21] Max Weber, *Economy and Society* (Berkeley, CA: University of California Press, 1979),

with their consciences over it, many Muslims today resent being described as sinners for similar activities.

PRICING

An examination of the way money is made and the way banks decide how much to charge their clients demonstrates that there are surprisingly few differences between the pricing mechanisms of Islamic and traditional banking services. A traditional bank will price its services according to what the market can bear. A bank will try to pay as little interest to its depositors as it can without losing them to competitors. Likewise, it will try to charge as high an interest rate on loans as it can without losing good borrowers to a cheaper bank. However, these minimums and maximums are based themselves on certain parameters.

A bank will attempt to charge as much as it can on its loans but the minimum is computed as a function of basic requirements. Pricing must: I) cover the expense of running the bank, including staff salaries, rent, depreciation of equipment, communication expenses, etc;

2) allow the bank to build a reserve for bad loans;

3) provide shareholders with a minimum return on their investments that matches alternative investment potential;

4) account for regulatory and FDIC insurance processes; and

5) cover the cost of funds of the bank: interest payments to private and corporate depositors and payment for borrowings from other banks, including the central bank. In highly simplified terms, and assuming that banks will try to maintain 18-to-19 funds-to-capital ratio, the pricing of a loan will be at cost of funds plus a spread computed as follows:

Over head costs	1%
Reserve for bad loans	1%
Minimum return to investors (corresponding a return on Capitalof 12% per Annum)	0.75%
Regulatory costs	0.25%

Any loan rate set above these amounts will generate a premium, allowing the bank to increase its risk reserve or its dividends.[22]

In the competitive banking environment in Western Europe and the United States, the average pricing will be at cost of funds plus the percentages mentioned above. In contrast, an Islamic bank computes it's pricing as profit sharing on a given instrument or transaction.[23] However, for the bank to stay in business, it must obtain a minimum return on its loan. This minimum is computed as follows:

I) It must cover the cost of running the bank. An Islamic bank, like any other financial institution, will have to pay competitive salaries, rent, electronic data management, communications and legal fees. As is the case with commercial banks, this will usually amount to 1 percent.

[22] Anwar, M., *Islamicty of banking and modes of Islamic banking*, *Arab Law Quarterly*, vol. 18, 2003). no. 1, pp. 62-80.Of course, the nature of any business is to obtain the maximum return for the minimum risk. Indeed some succeed in obtaining higher returns than others.

[23] Archer, S & Abdel Karim, RA, (2002). 'Agency theory, corporate governance and the accounting regulation of Islamic banks', *Research in Accounting Regulation*, vol. 1, no. 1, pp. 97–114.

2) It must permit the buildup of a reserve for bad loans. The cost of building a reserve for bad loans will also be the same as that for traditional banks, that is, I percent.

3) The bank must then estimate its profit and thus the return to its shareholders. In a global environment of relatively free capital flows, the required returns to shareholders will also be the same as for traditional banks or any commercial venture.

As was the case above, this would imply in a leveraged institution that the return portion in the pricing of a loan would be between 0.75 percent and 1.25 percent. 0 4) the cost of regulatory processes, if any, must be included. This still is not a direct cost to many Islamic banks, but as the industry develops in countries with extensive supervision, this cost will rise to the same level as that of traditional banks. 5) It must estimate the amount of Profits it will have to pay to its depositors to keep them as depositors. The result is that the minimum loan rate required by the profit sharing, Islamic bank is based on a spread of about 3 percent above what the estimated cost of funds (a profit sharing arrangement with the depositors) would be. (The difference in pricing between the two types of banks comes down to the difference in their relative cost of funds.)While conventional banks pay their depositors an interest amount determined by market forces at the time of the deposit, Islamic banks pay their depositors an amount corresponding to the expected profit or loss from investment and lending activities.

Pricing for deposits by a traditional commercial bank is bound by competition, but this competition is bounded by some basic requirements. Banks must pay their depositors a higher return than inflation, or else see funds used for immediate consumption rather than deposited into the bank. The amount above inflation will be determined by the needs of individuals for a return on what they view is their risk regarding the deposit. In most cases in the West, the risk of placing funds in a bank (rather than in the stock or commodity futures market) is very low. This risk is calculated as somewhat higher than that of U.S. Treasury bills (which they include a small premium to account for expected inflation). With inflation at, say, 1.5 percent per year, the premium on the risk of placing deposits in a U.S. bank today varies between 1.5 percent and 3.5 percent. In a situation where there is competition between conventional banks and Islamic banks, such as in Bahrain or Kuwait, clearly both banks will end up with similar results or else see most depositors transfer funds to the higher-paying institutions.[24]

Conventional banks in the Arab-Persian Gulf have begun to feel competition from Islamic banks. Today, most conventional institutions, both Arab and Western, have established Islamic funds to compete with the Islamic financial institutions. Citibank has started a separately capitalized affiliate in Bahrain. Many British banks, including Dresdner Kleinwort Benson, have been managing Islamic funds for many years. Even in Iran and Pakistan, where Islamic institutions are the only ones allowed to operate, the pricing has to be competitive for depositors. Iranian banks have been allowed to estimate their profits for the year and compute a certain amount of profit sharing, which each bank manipulates in an effort to win customers. This approach became necessary in 1992, when banks started losing large amounts of deposits.

At that time, banks paid an amount of profit sharing stated by the Bank Markazi (the central bank).The Bank Markazi computed an industry-wide profit and required all banks, regardless of performance, to pay the same rate to all depositors. This discouraged both careful managers and savvy depositors. Further the payments were based on year-old profit figures that did not take a 50 percent annual inflation rate into account. Depositors actually lost money by placing funds in bank accounts. This encouraged depositors to spend, rather than save, their money. As soon as the state allowed each bank to set its own profit estimate for the coming year, banks could factor the inflation rate into their expected profits. This brought depositors back into the sector and allowed the banking system to work more effectively.

[24] M. Quddus, H. Bailey and L. White 'Business ethics: perspectives from Judaic, Christian, and Islamic scriptures.' *Journal of Management, Spirituality & Religion*, (2009).

The Iranian government itself started competing with the banks for funds by issuing development bonds to finance its needs. The bonds carried a coupon, not based on interest, but on a recomputed return on government investments. In Pakistan, the banks compute their profits every six months and pay a portion of their profits to depositors. Although this does not guard against potential losses due to inflation, the system does give banks an ability to respond to inflation, a benefit to depositors. The pricing mechanism of conventional banks is based on competitive interest rates prevalent at the time the loan is approved. The pricing mechanism of Islamic banks is based on actual or expected profit sharing realized subsequent to the disbursement of the loan. The end result to the depositor, however, is virtually the same. As the Islamic banking industry matures, it will offer a pricing mechanism that will be similar to traditional banking in competitiveness, but different in ethics.[25]

TRENDS IN ISLAMIC BANKING

Financial markets as a whole, including Islamic ones, are going through constant change. The globalization of markets, as mentioned above, has placed a premium on profits at all costs. Islamic banks also are going through changes. Of course, the concept of creating Islamic instruments is quite new, and this new industry, like any other, has to find its own way. Today, the trend in Islamic banking appears to be toward the development of boutique Islamic investment banks. In fact, a number of relatively new institutions are not banks in the traditional sense. They are closer to what the U.S. comptroller of the currency calls "non-bank banks." These institutions focus on a precise instrument. For example, the Islamic Leasing Company of Bahrain borrows money from other banks, including, but not exclusively, its parent, A-Faysal Investment Bank. There is a privately held company in Jeddah that provides consumer loans on an Islamic basis. As mentioned above, AI-Baraka invests the funds of sophisticated buyers, somewhat like a privately held merchant bank in Europe. Islamic mutual funds are growing strongly. There also are a large number of Islamic funds in the United States investing in a variety of instruments, from shares to mortgages. Islamic institutions have been springing up almost everywhere Muslims live. There appear to be many of these institutions emerging in former Soviet Central Asia. It will be particularly interesting to follow the contribution of Islamic banks to development in the Commonwealth of Independent States, particularly in countries such as Kazakhstan and Uzbekistan.[26]

Attempts to develop new Islamic instruments by looking at instruments currently in use in the Western markets may prove difficult because of the West's reliance on interest. For example, foreign exchange funds usually can make money only if they extensively use futures and options, both of which are priced exclusively in terms of interest differentials between currencies. Under an Islamic schema, foreign exchange funds could be based only on educated positions regarding relative currency strengths. However, experienced traders know that such an approach almost certainly will end up with major losses. Nevertheless, most commodity funds should be acceptable, provided they do not include options or futures. Again, this would force funds managers to take uncovered positions, which would result in substantial losses in the long run.[27]

Bond funds also are difficult to organize in an interest-free manner. However, many other instruments are being developed today. Perfectly acceptable Islamic instruments could include venture capital funds, investment funds underwriting share issues for industrial companies and growth stock funds. In fact, should such funds be developed, they could have a major impact on the

[25] A. J Ali. and M. Gibbs, (1998). 'Foundations of business ethics in contemporary religious thought: The ten commandment perspective.' *International Journal of Social Economics*

[26] M. U. Chapra, *Islam and the Economic Challenge*. International Institute of Islamic Thought. (1992). P.34

[27] A Kattih, '*Islam and business*.' The Islamic Education and Services Institute. 2010, P. 18

economies of Muslim states, many of which suffer from a lack of investment capital. In the world of global international capital, Islamic banking is not a large force, but its role in the Muslim world and its influence worldwide are potentially large. Beyond the rhetoric of piety surrounding Islamic banking and the legalistic discussion of the use of interest, is a more important issue, the idea of justice. Practitioners and theorists in the field must move beyond these discussions and work to increase the visibility of Islamic banking to facilitate its most important contribution: the reintroduction of ethics into financial transactions.[28]

Conclusion

Islam is old as per its foundation and primary sources are concerned and as new as the problems and challenges emerge. Islam; being a complete way of life as well as final and ultimate code of life for whole human race. Keeping the financial challenges of the classical financial markets, Islam always proved its worth and provided the solutions to the problems whenever and wherever emerges. Islam is not lagging behind in order to face the contemporary challenges of financial market it proves its stamina of ethics in every walk of life.

Islamic economics and finance is as old as the sources itself and Islamic banking literature is as new as the Islamic Banking itself. This younger discipline proves its worth since its infancy and is growing with excellent margin in world financial market assets. In addition to its principles and modes , it bears a unique and infallible asset which is the sole and sprit of Islamic Banking known from a simple learner to banker of Islamic finance that asset is accepted recognized as 'the asset of ethics of Islam'.

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