Does Islamic banking help in economic development of Muslim Countries?

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Introduction:

All contemporary Muslim countries are classified internationally as developing countries. With exception of the oil producing countries, which are enjoying high standard of living, and newly industrialized Muslim countries such as Malaysia and Turkey, other countries are classified in low average per capita income, or low per capita income groups.[1]

What is the role of the banking system in economic development? Focus is placed in this paper on the Islamic banking system because the conventional Riba-based system is rejected. But, are we calling for replacement of conventional by Islamic banking only to eliminate Riba? Or because a Riba-free financial system is believed to be more capable in mobilizing and employing our financial resources and, hence, can efficiently help in pushing economic development? The targets of Islamic banking should, therefore, be made clear. The paper attempts to evaluate the role of Islamic banking in development in four decades on bases of what was expected from this system and what was achieved? Many questions arise in this respect, but most important of them in the context of economic development is: how far Islamic banks succeeded in employing their financial

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[1]) Rich Arab countries are yet awaiting for major efforts to be done towards restructuring their economies. Malaysia and Turkey are achieving relatively high rates of economic growth cannot yet be classified internationally as developed economies. Muslim countries in some cases are classified as ultra-poor, e.g. Niger, Madagascar, Somaliland, and Bangladesh. [World Bank, World Development Report 2015: Mind, Society, and Behavior, Statistical indicators.] Muslim countries need to take serious steps towards enhancing their economic development. This task needs raising rates of capital accumulation in modern manufacturing industry, modernizing agricultural activities and effectively fostering technological progress.

resources in the Production sector, and accordingly how far they were able to help economic development? Have they done a better job than conventional banks which we are rejecting on religious bases?

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

1- The Role of interest-based Banking in the Economic Development of Muslim Countries

Conventional Interest-based (Riba-based) banking was firstly established in Muslim countries during the period of western colonialism. The activities of such non-compliant Sharia institution led to, and necessitated legislative, cultural, and economic changes.

Many people in Muslim countries, influenced by western culture, modern education, and secularism believe that conventional banks had played, and are still playing an important role in their economies, a fallacy which has to be uncovered and refuted.

The conventional banking system is unfortunately supported not only by secularists but also by some *fuqaha* (Muslim jurists) who are either confusing interest with profit because of their scant and deformed economic knowledge or deliberately patronizing secular political authorities and wish to gain popularity. It can also be observed that many business people in Muslim countries would claim that banking and interest transactions are not replaceable and thus inevitable in modern times.

In fact, the growth of conventional interest-based banking, in Muslim countries, as in other politically subjugated countries, was largely supported by capital transfers from the colonial powers for investment in primary activities on one hand and intra-colonial trade on the other hand. Muslim countries exported their primary products and imported manufactured articles from the colonial powers, i.e. Britain, France and other European industrialized countries. In this manner the interest-based financial system rooted itself in the financial markets and economies of Muslim countries.

After obtaining their political independence Interest-based banking in the developing world, including Muslim countries, was expected, by its defenders, to play a vital role in economic development. Yet, reality was much below expectations. Banks continued to be active in financing traditional import-export trade, mainly, with ex-political masters. Big businesses, particularly in domestic trade, construction and light industries continued to get their normal financial requirements from these banks without troubles. Same services were, however, unattainable to small and medium size businesses except with heavy collaterals and hard repayment terms. Also, banks played a minor or insignificant role in financing big modern manufacturing industries, distinguished by capital intensive technology, with some significant but few exceptions[2].

Failure to finance small and medium size industries or support the growth of high-tech manufacturing industries has certainly had a retarding effect on development. Medium and small size enterprises represent a large percentage in developing countries and neglecting their financial needs by banks, or responding poorly to them, is entirely unfavorable to economic development[3]. Interest-based banks have their reasons to have such an attitude towards these enterprises. Most important among these reasons (obviously inherent in the interest-based loans) are: the relatively high risk involved in lending enterprises whose net assets are either rated below average, or unworthy; loan risk that would be heightened in all cases in which flow of net income of these enterprises is not expected to be stable due to nature of their economic activities. In addition, there is the relatively high administration cost of all interest-based small loans.

Regarding modern high-tech manufacturing industry, banks in most developing countries (Muslim countries included) have never initiated special lending policies or credit facilities to help their development. Only exceptionally under socialist government

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[2]) Exceptions can be found in some Muslim countries during the socialist era in the 1960s and 1970s, and also in Turkey and Malaysia until present time. See also foot-note (4)

[3]) Most SME are active in the informal sector, and according to **ILO reports** percentage of labor employed in this sector reaches about 42% in Egypt, 62% in Morocco, 36% in Tunisia, and an average of 73.6% is reported in North Africa which is mainly a Muslim region. In East and South East Asia, in Muslim and other countries the average % of Labor in SME is about 44-60%

pressure (mainly in the 1960s and 1970s) banks extended finance to some heavy and strategic industries.[4]

We may recall from western history that large capital-intensive firms could not rise by dependence on banking loans, and had to resort to equity finance through the capital market. Interest-based banks could not share in giving birth to large high-tech industrial entities in the western world but they hurried to serve them later on when they succeeded to stand on own feet and started to have their own financial surplus.

Conventional banking whose normal target is maximizing net interest returns[5] does care foremost for repayment of loan plus interests. Purposes to which loan is given receive much less care. The adverse selection and moral hazard problems in conventional banking are in fact deeply attached with risk of loan repayments rather than risk involved in how loan is used by the customer. Credit-worthiness and collateral are the most important factors to be considered by bankers and not whether loans are used in high or low productive investment, or in purely speculative activities, in or outside the country.[6]

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[4]) Examples for exceptions are in Egypt, Pakistan, and Syria (and in other countries such as India) whose governments adopted socialist strategies, established big public sector, and conducted the banking system to be in services of economies. National urge to develop and Government newly oriented economic development policies in both Malaysia, and Turkey played key role in mobilizing financial resources for investment. In Malaysia, development financial institutions (DFIs) have been established and funded by the Government to develop and promote certain strategic sectors of the economy, and to achieve social goals. Besides, The Malaysian Financial system is unique in dependence on both conventional and Islamic banking in implementing development.[Reports of Bank Negara, Malyasia]. In Turkey state-owned banks have a long history, since 1923. And, despite criticism and recent calls for their privatization they continued to play an important developmental role, "The Critical Role of State-Owned Banks in Turkey's Development" by Thomas Marois, Development Studies Department, SOAS, and Ali Rıza Güngen, Department of Political Science, Ondokuz Mayıs University, School of Oriental and African Studies, Centre for Development Policy and Research, SOAS, University of London, Development Viewpoint, Number 75, June 2014.

[5]) Credit interest earnings – Debit interest earnings

[6]) At the end we can positively ascertain that conventional banking for more than one reason could not play more than a marginal role in the economic development of Muslim countries. Few exceptions can be found, however, when government initiated ambitious development policies and the central bank effectively regulated banking policies towards that end. But even in cases of success, development cannot be defended on Islamic bases, simply because banking finance was based on Riba and Islamic investment priorities were either neglected or not seriously taken into consideration.

Equity finance in general, a priori, gives consideration to purposes to which money is used. Adding the Islamic dimension will take us to quite different perspective, since money should be used rationally for production or consumption that is beneficial to people on bases of Sharia and its Maqasid (tenets).

2- Targets of Islamic Banking

Islamic banking in theory should be established on three desirable targets: elimination of interest (Riba) as well as all other non-compliant Sharia transactions, adopting Islamic profit/loss sharing modes of finance, and applying Islamic investment criteria in allocating financial activities to particularly push economic development in society[7]. These targets ensures compliance to Sharia and its tenets, and are bound to bring about monetary stability at the macro level in the short run[8] besides pushing economic development in the long run.

It has been familiar to define Islamic banking as a financial institution that do not have any interest transactions in receiving funds from customers, or in giving finance to them. This, in fact, is not a definition but an expression stating one Sharia necessary condition of Islamic banking. A definition of Islamic banking should (at least) state that Islamic banking is an institution that provides financial and investment services that are compliant with Sharia and its tenets. Such definition when taken into practice means not

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[7]) Happiness of mankind in this world is mentioned in Quran. Allah SW promises " good life" to people who have good deeds. -مَنْ عَمِلَ صالِحاً مِنْ ذَكَرٍ أَوْ أُنْثى وَهُوَ مُؤْمِنٌ فَلَنُحْيِيَنَّهُ حَياةً طَيِّبَةً وَلَنَجْزِيَنَّهُمْ أَجْرَهُمْ بِأَحْسَنِ ما كانُوا يَعْمَلُونَ- سورة النحل: 97 . Happiness in Islamic philosophy can only be achieved with total development of man in all dimensions, i.e. with a balance between material development on the one hand and moral and spiritual development on the other. See: M. Umer Chapra, Islam And Economic Development: A Strategy for Development with Justice and Stability, International Institute of Islamic Thought, and Islamic Research Institute [First published in Pakistan in 1993 by the International Institute of Islamic Thought, Islamabad and Islamic Research Institute, Islamabad] Abdelrahman Yousri Abdelrahman, Fundamental Issues in Islamic Economics, Chapter Six: An Introduction to an Islamic Theory of Economic Development, Lambert, 2013 and 2015

[8]) Elimination of interest-based finance would minimize speculative activities which seek making money from money. In the interest system, therefore, monetary transactions grow in an unbalanced manner with real transactions (the production sector) causing monetary instability and periodical financial crisis. Islamic modes of finance which are profit/loss would normally maintain balance between real and financial transactions and therefore are bound to help in bringing about monetary stability, provided that proper Islamic baking is in practice. In this article focus is placed on the role of Islamic banking in pushing economic development in Muslim countries. However, it should be noticed that the development target in the long run is not separable from monetary stability in short-run.

only the elimination of Riba, but also other prohibited practices (Bay Eina, Gharar, Ghaben etc.), and employing Islamic modes of finance to achieve (according to Islamic criteria) economic interests of the Muslim society, which economic development comes on the top of them. This is a point which seems to be difficult to comprehend by all those (Sharia people, economists, or bankers) who thought of Islamic banking on same lines as conventional banking, except that it is a non-interest institution. Such miscomprehension has been, in my opinion, main source of malfunctioning of Islamic banking in practice since the 1970s!

When a proper definition of Islamic banking is taken into practice, financial resources must be employed on bases of partnership for most productive purposes.

Islamic banks have succeeded, as their balance sheets and global reports show, in increasing their financial assets on non-interest bases. Yet, how far available financial resources have been employed in a manner that is different from conventional banks is a serious question that has frequently circulated amongst Islamic economists in the last decade[9].

No one would question the fact that Islamic banks in practice have succeeded in removing the word "interest" from their dictionary. But on other hand, the past four decades have revealed that they never really escaped the influence of the interest rate and the interest system. All parties that are holding the responsibility of Islamic banking have to be questioned about this. Why Islamic banks could not move in 40 years towards a true Islamic application? Why banks are becoming increasingly involved in prohibited Eina (عينة disguised Riba) transactions such as Organized Tawaruk التورق المنظم ?[10] Why banks extended their own conducted trade transactions and neglected financing business customers on bases of profit/loss sharing?

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[9]) Ten years back, Islamic bankers and fuqaha who helped them used to hurry not only in defending everything belonging to their activity but also in accusing people who raised such question of being anti-Islamic banking! Such a stand is not any more acceptable and we have to confirm that questioning the present state of Islamic banks is highly necessary for their future success and for sake of Islamic identity, to be or not to be!

[10]) This is happening in spite of the Fiqh Academy declaration (at Al-Sharjah 2009) that organized tawaruk is not Sharia permissible. See amongst papers of this round, paper on Tawaruk (in Arabic) by the Author. There are many papers on Tawaruk available at trusted internet sources by known authors.

These and other questions lead us to a more serious question; Do bankers and Sharia people who are helping them really understand the targets of Islamic finance? Or, if they do understand and recognize such targets, Why cannot they work for implementing them? Are they unable to do this? In this case, is it because of internal reasons or external ones that are beyond their control? In fact the present state of Islamic banks causes anxiety to many Islamic economists.

All these questions while concern various dimension of Islamic banking, are of extreme importance to the role of this institution in economic development.

3- Suitability of Islamic Banking to Economic Development: A Comparative Perspective

It can be argued on pure theoretical grounds that:

(a) Islamic banking, in comparison to conventional banking is more capable of mobilizing funds from Muslim population.
(b) In contrast to interest-based loans, Islamic Profit/loss sharing finance would necessarily direct banking resources towards productive activities which are favorable to economic and sociable development.
(c) Economic behavior of partners who are sharing profits and loss is more favorable to economic development in contrast to that of interest earners who are sleeping partners.

Although these are kind of hypotheses that cannot be empirically examined before a true Islamic banking experience exists, they can be strongly defended on theoretical grounds.

The first hypothesis can definitely be backed by an important axiom, namely that Muslims should not accept Riba (interest) whether paid to others or earned from them. Thus if Muslims are adhering strictly to Sharia, none but interest-free financial institutions will be able to collects their savings or investable funds.

Another axiom is also supporting same hypothesis. Muslims who do not accept Riba earnings will not keep their money balances idle, since hoarding is prohibited on one hand and money or wealth should be subject to rational use on the other hand[11]. Their savings would normally, therefore, be directed towards investment .Most savers lack experience and information about possible and best investment opportunities, and are highly vulnerable to the adverse selection and moral hazard problems. Many of them may therefore decide to keep their money idle and pay zakat to avoid sin of hoarding instead of falling into failure projects and losing their money. In contrast, banks, in principle should be more capable of acquiring better information about various investment projects and therefore are less susceptible to problems arising from asymmetric information. Islamic banks therefore offer to all Muslims savers who are keen to maintain Sharia halal (حلال), less risky and more rewarding investment opportunities. Besides, unlike conventional banks they will be sharing risk of investment with savers.

Islamic banks should also be ready in principle to co-operate with small savers. In fact, experience in various Muslim countries in the last four decades showed that Islamic banks in many cases relaxed their rules of investment accounts beside allowing for different types of saving accounts to encourage flow of small savings. Such small savers normally find no way to deposit money in conventional banks.

The second hypothesis maintains that Islamic banks, in contrast to interest-based one, would necessarily direct banking resources towards best productive activities. In fact, Sharia tenets (Maqasid) necessitate employing capital resources in activities that are important to the development and welfare of the Muslim society. Theoretically speaking, profit and loss sharing motivates banks to investigate thoroughly investment projects that need financing and give careful consideration to trustworthiness of the investors, their business expertise and entrepreneurial capabilities. Willingness of banks to maximize net returns from partnership would drive them to give priority to projects with highest possible profit rates without neglecting risk aversion consideration.

Conventional banks are totally different in this respect. The economic rationale of the interest system may only be backed by the Keynesian hypothesis that firms would not get banking finance when marginal efficiency of investment is lower than interest rate. But

[11]) Rational behavior or (Roshd الرشد) is supported in Quran and Sunnah

such hypothesis could not be defended in practice for many reasons. Least which can be mentioned here is that conventional banks give clear preference to creditworthy customers while protecting themselves in other cases heavily by unusual collaterals that borrowers have to submit even if finance is needed for promising or highly productive projects.[12]

Another credit is to be given to Islamic banking. Banks in accordance to Islamic norms and *Sharia Maqasid* have to extend help to small and medium enterprises. Finance in such cases may not be rewarding in terms of high profits or productivity, a matter which appears to be against the logic of our second hypothesis. But we have to bear in mind that the conception of efficiency within an Islamic financial market would differ from the secular one, which is recognized in liberal oriented market economies. However, economic efficiency in its pure economic sense would not be lost in an Islamic banking system when banks select carefully small and medium size enterprises which are potentially efficient and market competitive. Public interest is realized in such cases in the long-run, which is equally (or may be more) important to consideration of private interest in the short-run.

Islamic banks should, in theory, adopt Islamic criterion in allocating their resources to different sectors and give priority to investment that can effectively push economic and social development.

These targets cannot be separated from the desirable targets of an Islamic economic system, and banks' financial activities, in an ideal situation, ought to be guided by an Islamic central bank and helped by suitable government policies when extending finance to small enterprises or to some public projects that are necessary for development[13].

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[12]) Abdelrahman Yousri, " Prohibition of Riba (Interest) in Islam: its Economic Rationale and Implications", the Annual Seminar of Islamic Economics, The Islamic Foundation, Mark field, Leicester, U.K., 1999. Also published by; "Journal of Islamic Banking and Finance 19(2)", June 2002, London. Revised and re-published in Abdelrahman Yousri, "Fundamental Issues in Islamic Economics" by Lambert Publishers 2013.

[13]) Such talk may look like expressing a fantasy or telling dream vision particularly within the present unfortunate circumstances of many Muslim countries which face malicious attack on their Islamic tradition. But we cannot drop our dreams or ideal visions. We have to work for them seriously. Inability to implement all we target should not prevent us from trying to implement whatever possible of them. Any

4- The Experience of Islamic Banks in Fund employment and Reflection on Economic Development

It is not our task in this article to deal with Islamic banks experience in collecting funds. Balance sheets of these banks prove that rate of growth in their financial assets was higher than that of conventional banks. Competitiveness of Islamic banks is among factors which explain such phenomenon. Reports show that the assets of Islamic banks grew at an average rate of 17% per year between 2008 and 2012. This is two to three times faster than the rate at which conventional banks grew over the same period.[14] It should be noticed that statistical figures do not distinguish wholesome Islamic banking from Islamic windows in conventional banks. The rapid expansion of Islamic banking has been mainly through Islamic windows in conventional banks rather than in pure Islamic banks.[15] Besides, statistical figures will be different if Islamic banks practicing impermissible Sharia finance are ruled out. It is in fact a methodological error to include this latter category amongst Islamic banks.[16]

Islamic banks' performance in employing their financial resources was different story. The following observations would reveal that such performance has deviated Islamic

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way we have to set our ideal targets rightly from now, and put them in mind and before our eyes. What cannot be realized now can be carried and implemented by next generation.

14) Ernst and Young (E&Y), "World Islamic Banking Competitiveness Report",2014-2015. E&Y attribute this growth to rapid growth of markets in rich Arab producing oil countries on one hand and the global financial crisis which affected conventional banking globally . The Report identifies 25 "rapid growth market" countries which they predict will account for half of global GDP by 2020. Of these, 10 have a high Muslim population. [http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamic-banking-competitiveness-report-2014-15]. See also: Hamadan Bin Mohammed Smart University, Islamic Banking Growth, Efficiency And Stability, DCIBF, Annual Report,2014 [http://www.dcibf.ae/system/files/DCIBF_Report_English.pdf]

15) In Malaysia, "The banking industry in the country is currently dominated by conventional banks, with Islamic banks accounting for roughly one-fifith. Islamic banks established as subsidiaries of conventional banks outnumber wholesome Islamic banks".." Evidently, the wholesome Islamic banks pale in comparison. Their market share of the Islamic banking business has declined steadily over the years. Their share of total Islamic deposits has fallen from 53.4% to 22.8% between 2007 and 2012, while their share of Islamic financing has also shrunk from 48.9% to 16.9%. In terms of total Islamic banking assets, the share of wholesome Islamic banks has also fallen from 51.8% in 2007 to 20.3% in 2012". See: Mohamed Ariff, "Islamic Banking In Malaysia: Industry At Crossroads"[INCEIF: http://www.inceif.org/research-bulletin/islamic-banking-malaysia-industry-crossroads]

16) Also global statistical data of Islamic banking is including many banks in the Gulf area (important banks) which are leading in Organized Tawaruk finance! How a bank can be classified as Islamic when a considerable portion of its resource is employed in non-permissible Sharia finance?

banking from its desirable targets, especially that one which concerns economic development.

First: Murabaha, Ijarah, Musharaka Mutnakisa, Istisna, Tawaruk contracts possessed 95% (or more) of Islamic banks financial resources. Murabaha finance was dominant in most cases with an average that reached 60- 80% of total available resources. The lower average (60%) is prevailing in most Arab Gulf countries while the higher average of 80% [or over], is familiar in most other cases. Tawaruk[17] operations, which are based on Murabaha, are seriously growing in Islamic banks in the Arab Gulf area and Malaysia and gradually replacing the simple operations of selling goods by Murabaha.

All these contracts, including Musharka Mutnakisa (i.e. diminishing partnership, which is not in practice based on partnership of profit/loss as its name indicates), are *Sale contracts* (sale of goods or usufructs). They are based on goods or usufructs possessed by banks firstly and sold after that to customers against debts that have to be settled over fixed period of time by means of installments.

In public opinion, Islamic banks by such dependence on debt transactions have not really been different from conventional banking. This in itself is not true, because debt resulting from sale of goods or services is surely different than debt from interest-based loans. Yet, authenticity of Islamic banking has definitely become at stake, especially when procedures of Murabaha were reported to be done in non-compliant Sharia manner[18], and Tawaruk operations which the Fiqh Academy judged to be against Sharia have gradually and seriously increased[19].

The side effects of high reliance on debt-based transactions are rather unpleasant. Islamic banks' reputation has been shaken and their ability to employ their resources by means of

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[17]) Tawaruk is simply Eina or disguised Riba.

[18]) See in particular Text of the Historic Judgment on Interest given by the Supreme Court of Pakistan on Riba and practice of Mark-up (Murabaha) sale. [http://www.assaif.org/Modes-of-Financing/Rib%C3%A0-Interest-rate/The-Historic-Judgement-on-Interest-Given-by-the-Supreme-Court-of-Pakistan]. The Report is originally in English but a good translation in Arabic has been done by IRTI, Islamic Development Bank.

[19]) One of unique risks that are facing Islamic banking is " Sharia compliance risk which arises from the fact that the products offered to customers may, ex-post, not be certified to be compliant with Sharia principles", IMF; International Monetary Fund and Islamic Finance; [http://www.imf.org/external/themes/islamicfinance/]

partnership is surrounded by doubts. How under such conditions Islamic banks would be able to extend finance to individuals or firms in order to carry their investment projects? How they can help in economic development; they cannot give loans to firms as conventional banks, and they are unable to offer finance on partnership bases?

Second: Murabaha operations are mostly done by sale of durable consumption goods. Financing of durable consumption goods would fulfill needs of households. It would reflect favorably on the production sector if such goods are manufactured at home. Otherwise such finance is reflecting on foreign imports, which is a problem to most Muslim countries that face deficit in their balance of payments. The Islamic banking experience by Murabaha (most important modes in practice) has not been favorable to economic development. In exceptional cases Murabaha played a role in financing small enterprise, e.g. Faisal Islamic Bank, Omdurman branch in Sudan, Jordan Islamic bank, and Nasser Social Bank in Egypt. But the performance of Islamic banks in financing the needs of SME was generally unsatisfactory. [20]

Ijara operations are mostly done by leasing/sale arrangements of buildings and apartments to households. In some cases leasing/sale arrangements were in favor of commercial centers and hotels.[21] But the Ijara contract not was not used for the development of industry or agriculture.

Istisna operations were carried frequently for individuals who approached the bank to construct houses or villas for them. In fact, Istisna contract could have played a serious role in industrial development of Muslim countries[22]. In some cases the Istisna contract was used in favor of the production sector, such as Dubai Islamic Bank financing

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[20]) A recent report of IFC indicates insignificant contribution of Islamic banking in financing SME in MENA Region, which could not be really distinguished from conventional banks. See; IFC Advisory Services in the Middle East and North Africa: Islamic Banking Opportunities Across Small And Medium Enterprises In Mena, PP. 32-35 and 38-45 [http://www.ifc.org/wps/wcm/connect/551782004460ca8bb56cbdc66d9c728b/IFC+Final+Executive+Summary+8-6-2014+.pdf?MOD=AJPERES].

[21]) Some cases can be picked up from bank reports, but you cannot give an estimation of their relative importance

[22]) Mabid Ali Al-Jarhi, Shari`Ah-Compliant Project And Production Finance: Istisna' And Other Relevant Modes (Lecture-notes), Emirates Islamic Bank, Shari`Ah Structuring And Coordination Department, Dubai, 2008.

developing plots of land for commercial purposes, or implementing infra structure needed for facilities expansion in Dubai airport. Istisna was used, however, for implementing giant infra structure projects in few Muslim countries through ***syndicated finance***, which depends on cooperation of group of banks. Istisna operations through syndicated finance were carried by conventional banks cooperating with Islamic banks. Syndicated finance In many cases was initiated and organized by an Islamic window of a big French conventional bank (PNP Paribas Group)[23] in cooperation with conventional and Islamic banks. In some cases, syndicated finance was initiated and organized by two Islamic banks [Dubai Islamic Bank Pakistan (DIBP) and Standard Chartered Bank Pakistan (SCB)][24]

These practical evidences are really in favor of the Istisna contract, per se, but reveal that Islamic banks were unable to carry giant Istisna in the production sector independently. The previous paragraphs reveal that Islamic banks have mainly served the needs of the households, while minor consideration to financing needs of the producers sector.

Third: Islamic banks succeeded in extending their business without giving or charging interest on funds received or given. This is true, but they have been unable to remove the influence of the interest system. The profit margin or mark-up in Murabaha finance is always guided by interest rate (quite often the LIBOR). In Ijarah Wa Iqtina (Muntaheya Bi-Tamlik إجارة منتهية بالتمليك), the leasing/sale installment, named rental, consists of two parts: one which covers percentage of the real estate's total price, and the other is the bank profit from leasing. The latter is determined by reference to the interest rate (LIBOR +or – some basis points). Similarly Istisna price is paid normally through installments. The bank profit in Istisna which is included in installments is also determined by reference to the LIBOR + or – 0/000. Similar arrangement is carried by Islamic banks in

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

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

Musharaka Mutnakisa. In brief, the interest rate is depended upon as bench-mark in determining bank profit in all financial operations of Islamic banks.

Using the interest rate as bench-mark by Islamic banks, though defended by banks' Sharia boards, caused lots of confusion among their customers who are keen to avoid interest. A question is normally asked by them: what is the difference then between Islamic and conventional finance if the interest rate is there? Ordinary Muslim customers would not easily, if ever, understand what is the difference between interest charged on deferred payment sale and Murabaha sale in which mark-up is equal interest rate? In Ijarah customers always noticed that installments in buying a house by the leasing/sale arrangement Islamic system are determined in same way as in the interest-based mortgage system.

The only difference in all sale transactions that are carried by Islamic banks on debt bases is that so called profit rate (equal to interest rate) charged on goods or usufruct is not subject to be re-calculated on compound rate in case default as in conventional banks. Customers, however, in case of default are subject to penalty that to be spent on charity purposes.

Islamic bankers say that use of interest rate as bench-mark is approved by Sharia boards because it never involves Riba which is entirely prohibited[25]. They argue that: (1) competitiveness of Islamic banks in financial market which is dominated by conventional baking would necessitate keeping profit margins in line with interest rates, (2) the central bank in all dualistic banking systems for regulatory purposes exerts pressure on Islamic banks to be guided by interest rates in distribution of profits, and (3) the global dominance of the interest system add pressure on all external Islamic banking operations.

[25]) Sharia people who permitted such matter may be excused because of their scant economic knowledge. They could not estimate that adoption of interest rate as bench-mark would take Islamic banking into the economic and financial circle of the interest system. It seems to me that they are unable to absorb the economic argument concerning the high opportunity cost of replacing "profit rates" by "interest rates" in terms of misallocation of resources. More serious, however, is that neither Sharia people nor bankers are listening to Islamic economists who are warning of the adverse effects of using interest rate as bench mark on Islamic banking reputatation in the long run.

Arguments justifying using interest rate as bench-mark emphasize one fact at the end, namely that the interest system has maintained its influence in practice over Islamic banking although interest-based finance has not directly been allowed.

The damage that has resulted to Islamic banking from being guided by the interest system is serious. It is not confined to ill reputation of Islamic banking and skepticism about its future. Misallocation of Islamic banks' financial resources because of using interest rate as bench-mark incurred much greater loss. This has to be clarified because misallocation of financial resources has negative effect on development of Muslim economies.

In a free market economy, where the interest system is prevailing, loanable funds would not be optimally or best allocated by dependence on interest rate. In such system, banks do not distinguish between borrowers on bases of productivity or profit rates that are expected to be realized from loans.[26] All firms that are ready to pay the cost of borrowing (interest rate) would be able to request finance. Theoretically speaking an Islamic free-interest financial system would offer a much better substitute for allocating available funds among firms and activities. Assuming that interest-free financial institutions would aim at maximizing their 'halal" (i.e. permissible by Sharia) revenues, a preference will be given to projects with expected higher return (productivity) over other projects because of partnership in profit and loss. Under these circumstances, deviation from an optimum (or best) pattern of fund allocation may occur because of some other factors, such as failure (or lack of experience) of bankers to estimate accurately the marginal efficiency of investment of firms that are financed.[27]

Islamic banks by reliance on Sharia-compliant debt finance lost advantages that could have been realized from an Islamic partnership-based finance. On the other hand (Sharia-compliant) debt finance in which the interest rate (as bench-mark) replaced an estimated profit rate, has led Islamic banks to be in same boat with conventional banks. Islamic banks, being under such system, are unable to distinguish between different financial operations on bases of their actual profit rates. Financing Murabaha, Ijarah, Istisna, or

[26]) Abdelrahman Yousri, " Prohibition of Riba (Interest) in Islam: its Economic Rationale and Implications", Ibid.
[27]) Ibid.

Musharaka Mutanikesa was all done on bases of the interest rate as a bench-mark. If profit rates were estimated by Islamic bankers, more finance could have been given, for example, to Ijarah or Istisna operations instead of Murabaha sale. Murabaha finance to small enterprises could been more rewarding than Murabaha finance to cars or other durable consumer goods. Other examples can show that Islamic banking by approving the interest rate as bench-mark has fallen in trap of the interest system mechanism. Failure to allocate available financial resources on bases of actual or expected possible profit rates means that Islamic finance through banks has not been able to help economic development in Muslim countries.

Besides, dependence on the interest rate as bench-mark is bound to weaken the competitiveness of Islamic banks in collecting financial resources on bases of profit/ loss sharing. The 2008 financial crisis uncovered the actual conditions of Islamic banks. In the conventional banking system rates of interest were lowered to zero or to extremely low levels. Profit rates distributed to holders of investment accounts in Islamic banks matched interest rates in their down scale movement. This is simply because profit rates are bench-marked by interest rates. Dependence on interest rate as bench-mark, if continued in future, is apt to weaken competitiveness of Islamic banks in collecting savings from Muslims who are becoming increasingly suspicious of the relation between interest and profit rates. This would consequently weaken competitiveness of Islamic banking whose reputation is closely linked with applying Sharia.

In four decades, Islamic banks succeeded in attracting funds from Muslims who accepted the principle of profit and loss sharing. Banks employed funds mainly in trade by selling, on interest-free bases durable consumer goods and usufructs to customers. Islamic banks carried trade activities directly without intermediaries. Trade activities conducted, as observed, have mainly served households, and indirectly the production sector when goods or services were supplied by domestic producers. Theoretically speaking, effect of selling consumption goods and services on GDP or GDP rate of growth is bound to be insignificant in many cases where: (1) Islamic banking finance on households goods counts only for a tiny in aggregate expenditure, and (2) most of durable consumption goods financed by Islamic banks are imported. Empirical investigation is, however, needed in case of Sudan or Iran where the entire banking system has been Islamized. [28]

The matter was different in cases in which Islamic banks financed the production sector through modes like Murabaha, Istisna, Ijarah or Musharaka. Finance was not based on partnership, but so far economic development is concerned its effect would have been greater if Islamic banks gave it due consideration. In fact within forty years financing of the production sector by Islamic banks was exceptional, or unfamiliar in comparison to operations in households' needs.

Facts reveal that in Muslim countries in which Islamic banking grew, with exception of countries in which the banking system has entirely been Islamized, conventional banking continued to be the main source of finance to the production sector. This is in spite of all our criticism to such banking system. Direct finance to the production sector which Islamic banks could have given by profit/loss sharing modes, such as Mudaraba was really insignificant , if anything at all![29]

5- Future Role of Islamic Banking in Economic Development:

Islamic banks: how to correct their path? How to acquire competence in financing economic development?

In four decades, Islamic banking could have done much better role if not handicapped by many external and internal factors. Surely, a better external climate, e.g. favorable

[28]) A study by Patrick Imam and Kangni Kpodar, " Is Islamic Banking Good for Growth?", International Monetary Fund, African Department, WP/15/81. Authorized for distribution by Doris Ross, April 2015, concluded that Islamic banking contributed positively to economic development! Yet, expected statistical errors, measurement of relation between Islamic banks finance and growth (which is different however in conception from development) by reference to GDP per capita rate of growth is bound to give quite general estimation. The researchers admit that relationship between real GDP per capita growth and indicators of Islamic banking development, which they used, is two way. Justifying their conclusion by saying that: " Islamic banking responds to the specific needs of households and firms, which would have been otherwise unmet and the associated incremental growth would have been forgone" needs closer examination. In rare cases Islamic banking helped economic development.

[29]) Few cases of Mudaraba finance appeared in records of some Islamic banks. Yet, when these cases are investigated you discover that it is not more than Mudaraba by name or you may say "synthetic Mudarba".

legislations, friendly central banking regulations, and suitable monetary policy[30], would allow for a better role of Islamic banking. Internal factors which handicap Islamic banking, as explained in previous pages, constitute more no less, or even more, serious challenge to future of Islamic banking.

On strategic grounds dealing with internal problems should be given priority. In fact, removal of external handicaps needs work which is beyond Islamic bankers and economists. All Muslims, not only Islamic economists and financiers, who have zeal towards revival of Islamic Sharia and culture have to work for reformation of their society. Once a favorable climate for an Islamic economic is established, the climate for an Islamic financial system would be favorable.

At present, for sake of better future, Islamic banks have to work hard for correcting and improving their competence from within. Internal imbalances have to be corrected and with respect to external handicaps Islamic banks have to find practical solutions to minimize their effect or to go safely and successfully around them. The magic solution to both internal and external problems is financial innovation. Everything has to be done without violating Sharia and its tenets[31].

Innovation in Islamic Banking

Innovation is built on human creativity[32]. It is ability to introduce something new in practice. In banking it means offering new product, adopting new operational method or devising new mechanism for same products, or opening new markets.

Most important in financial innovation is: (1) to target efficiency and competitiveness of Islamic banking. This is quite important in financial markets, which are up till now dominated by conventional banking. (2) To give due considerations to innovative

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30) External factors that affect Islamic banking are not only confined to these. A truly better climate for Islamic banking is dependent on institutional changes that have to take place in Muslim countries; in education, judicial system, and macroeconomic policies. Changes have to take place under enlightened understanding of Islam. All this may be achieved in the long-run by the will of Allah, through continuous and sincere efforts of people who are keen to serve the Islamic cause.

31) This has to be emphasized. Innovative products, and innovative mechanisms have to be done without misusing Sharia by some tricks that only maintain fiqh rules at the surface while violating the core of Sharia and its Maqasid (tenets).

32) Globally, the banking industry has evolved over time through the process of financial innovation.

products that are most suitable to the development of production sector, and innovative mechanisms that help in financing highly productive investment projects. (3) to take into account particular kinds of risk that are associated with innovation[33] such as (a) "Sharia compliant risk" which would arise if innovative products or mechanisms appeared later on to be Sharia incompliant, (b) "Partnership investment risk" which is likely to emanate from Islamic profit/loss sharing financing if possible costs and loss are not, ex-ante, estimated rightly.

For Islamic banking, on the supply side, innovation is vitally important to correct:

1- Imbalances which resulted from neglecting, or insignificantly practicing partnership in employment of banks financial resources.

2- Structural imbalance in trade conducted operations, which resulted from assigning most of the finance to durable consumption goods, instead of production goods and services..

3- Errors in allocation of resources that resulted from using the interest rate in bench-marking their costs and profit rates in all operations.

On the demand side Innovation in banking, as in all business, is mostly related to demand conditions as revealed by market. The problem with Islamic banking is that it cannot simply follow needs of customers and overlook Sharia. "Organized Tawaruk" has been innovated by Islamic banks to fit the need of some customers' category. But such innovative product is not but Bai-Eina (disguised Riba). Besides, "Organized Tawaruk" from purely financial point of view is an inferior product if compared with interest-based loans because of its relative higher cost. Calling "Organized Tawaruk" Islamic product is surely misnomer.

To be consistent with Sharia Maqasid, financial innovation has to be beneficial to economic development which is most important economic target in all contemporary

[33]) Besides standard risks associated with banking activities, such as credit, liquidity, market and operational risks.

Muslim countries. Hence Islamic banks have to be ready with innovative products , methods and mechanisms to finance : (1) manufacturing firms which have competitive or comparative advantages, (2) enterprises which are estimated to develop potential comparative advantages in the long-run, with special consideration to small and medium scale entities, (3) enterprises in the manufacturing or services sector, which are introducing innovative products , and (4) primary and agricultural activities which are important for domestic market or for exportation.

Only in this way Islamic banking would not only correct its path but also gain strength , popularity among Muslim savers and investors, ability to get larger share in the banking industry, and competence to push economic development.

6- Towards New Promising Islamic Banking

First: Urgent Corrections!

Firstly; Islamic banks are called, for previous mentioned reasons, to drop once and for all "Organized Tawaruk" financing. This in itself will restore lost repute to many Islamic banks' and is likely to release in many cases between 20% - 40% of financial resources that can be assigned to more efficient and more productive employment[34].

Secondly; Islamic banks are required to remove imbalances caused by excessive dependence on debt-based Murabaha finance, particularly its use in retail trade of consumption goods. This target would be achieved gradually by more employment of resources in profit/loss sharing products, as will be suggested below. But the said target can also be achieved by two means;

(1) Using Murabaha increasingly in financing promising small scale (or medium scale) projects. The example of Faisal Islamic Bank (Omdurman Branch) in this regard has been remarkable and successful. It can be imitated to the benefit of developing small enterprises which comprise a large section in the economies of Muslim countries. The profit margin (mark-up) on Murabaha, it should be emphasized, has to be bargained

[34]) Based on my own estimation, through personal observations and contacts.

between the enterprise and the bank and not to be bench-marked by some interest rate or fixed on all operations like a post stamp. Readiness of the enterprise to pay higher mark-up would, under normal conditions, indicate its expectation of higher returns from the operation. This mechanism would promote efficiency in financial resource employment on one hand and help economic development, on the other hand, by giving priority to promising enterprises. Islamic banks in practicing Murabaha by this mechanism have to collect as much as accurate and sufficient information as possible about small enterprises and refrain from financing cases where financial situation or market performance of the enterprise proved to be unsatisfactory.

(2) Using Murabaha in financing whole sale trade. This would open door to benefit from economies of scale, by reducing operational costs involved in purchasing and selling to large number of customers. The Bank can make large deals with companies involved in import and domestic trade of cars or other durable consumer goods. The bank would import for them by their order (Murabaha to the orderer of purchase), finance operations on its own risk, bear all risk involved in carrying goods from foreign manufacturers until delivery is made (better) at customs house to companies. The Islamic bank, in order to succeed, has to follow efficient procedures, making sure to benefit from economies of scale by importing commodities for more than one orderer company, and doing its best to to minimizing its administration costs by eliminating unnecessary procedures.. The market would be highly competitive in such Murabaha operations, since home companies are ready to import directly by getting credit facilities from conventional banks. In the contract the commodities are specified, and promise to purchase is given in advance. The bank is performing a proper Sharia Murabaha sale, bearing its risk, getting benefit from foreign manufacturers when buying in large quantities for more than one purchase orderer and in becoming steady customer to manufacturers. The bank would be able to get the price of the deal from companies or big domestic dealers in one or two installments. Murabaha in wholesale trade would benefit the domestic companies by

saving all efforts, costs and risk of importation,[35] while allowing better use of bank resources and wider share in the financial market.

Thirdly; Islamic banks should stop using the interest rate in bench-marking their profit rates in all operations. This has been explained above for Murabaha.

In practice of Leasing/ownership (Ijarah wa Iqtina) Islamic banks, as well known, are using interest rate as bench-mark, unlike mortgage companies which are using it explicitly in doing almost the same operation. For better future performance and for sake of pristine Leasing/ownership activities Islamic banks should adopt Sharia compliant criterion in determining the leasing/ownership installments. Firstly, the price of the asset (house or apartment) should be determined when signing the contract on bases of deferred payment sale arrangement. This price which is fixed on such bases, will be divided on total number of installments which is agreed upon. The rental which is an amount paid or collected from the lessee as rent (now entirely separated from the price installment) should be determined according to market rental of same or similar asset. Practice of LIBOR or any similar bench-mark in determining the rent should be absolutely terminated. Dependence on market rents means that rental of an apartment in city center should be different than an apartment of the same quality in an urban area, or rent of a Toyota car is not determined by same method as rent of an airplane. This will be consistent with principle of best allocation of available financial resources, since leasing which is more rewarding will be given priority. The rule of the rental of the equivalent is well known in Islamic fiqh (أجرة أو إجارة المثل). Accordingly, the rental should be adjusted periodically as the ownership of the asset is gradually transferred to the lessee with every payment he (she) makes in the price of the property. In other words the customer would be renting only what he does not own.[36]

Second: New Mudaraba Contract based on Sharia Compliant Restriction and Mechanism

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[35]) The idea of this Murabaha product been derived from Frank Vogel and Samuel, Islamic Law and Finance: Religion, Risk, and Return, PP.242-244, Published by Kluwer Law International, The Hague, The Netherlands, 1998. Vogel and Hayes proposed using Murabaha internationally in more diversity.

[36]) Such an arrangement would be similar to what some Islamic banks practice- at present- under so-called Musharaka Mutanakisa.

No way to remove the influence of the interest system except by developing "Islamic Partnership Finance"

The two–party Mudaraba contract remained since the 1970s without any reformation with respect to employment of the Islamic bank resources, in spite of its high importance. The nature and mechanism of the classical two-party Mudaraba show high reliance and full trust in Mudareb (fund user). Trust is based on subjective bases, i.e. trust in the Mudareb's personal character, sincerity, honesty and experience in business. In the past, such trust was strongly supported by the strength of Islamic culture, and enforcement of Sharia rules in courts. Besides, information about personal character of the Mudareb was naturally available in communities of limited population such as tribes, villages and small societies[37]. Modern societies have grown in size and population, characterized by large size towns and cities and large financial markets. Businesses have grown in size and financial intermediaries have to deal with hundreds or thousands of persons at national and international levels. All these changes would extremely raise risk of Mudaraba if carried on subjective bases as in the past.

The new two-party Restricted Mudaraba which is proposed here is a revised version of the classical "restricted Mudaraba" contract[38]

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[37]) It can be deduced from these observation that the classical Mudaraba contract could stand a fair chance of success if applied, even with minor modifications in small villages and towns of contemporary Muslim countries. Mudaraba finance through Small size Islamic Banks, therefore, could stand a good chance to succeed in villages and small Towns ! In fact, analysis of the first experience of an Islamic bank which was established in Egypt in the early 1960s at Mit Ghamr shows that success achieved was due to small scale banking enterprise operating in a town to which the entrepreneur and the manager (late Amad Al–Najar) belonged. Close personal relations were established with known figures in the town, who were funded successfully by the classical two–partner Mudaraba contract. [Source:Lectures by the author at Faculty of Islamic Studies, Hamad Bin Khalifa university, Qatar]

[38]) Maliki and Shafei schools of fiqh are against restriction of Mudaraba. Their logic behind this is that Mudaraba is a company in profit, the Mudareb is not paid in any way for his work, but only working in expectation of getting a share profit (when this is realized). Thus his effort should not be restricted. Hanafi and Hanbali fiqh schools accept restricted Mudaraba in principle. Restrictions, however, are not to intervene with Mudareb' mobility or decisions but only to avert general kinds of risk, such as do not trade in such place where war or troubles are expected or do not carry trade in such product. The capital owner in fact, by such restriction, is protecting himself from expected loss or making Mudaraba more liable to yield higher profit. This is in his interest because he is the one to bear loss if realized, as well as in the interest of the Mudareb who will share profit. If the Mudareb accepts such general kind of restriction, he has to be committed to it. He is unrestricted after that in all actions or in taking any decision to make

The Mudaraba contract will be restricted by legal conditions and terms of finance based upon, and derived from, detailed feasibility study of the prospective project that have to be submitted by the customer (Mudareb) and approved by the bank. Conditions and terms of finance, as such, are part and parcel of the contract, to secure best possible use of finance at minimum possible risk. In case if Mudareb infringed conditions that are endorsed in the contract he (she) will have to bear loss or compensate the bank. To manage the risk in practice some innovative methods and mechanism have to accompany the new restricted Mudaraba contract. (First step) Evaluating the prospective user of fund (Mudareb) on objective bases, i.e. his enterprise faculty, achievement motivation, managerial skill, pervious experience, personal record and reputation. Sufficient information of this sort should be gathered.

(Second) An examination of the feasibility study which the customer (Mudareb) has to submit to the bank. Careful evaluation of the investment project that need bank finance should be done on sound economic criterion to estimate its viability. Preference should be given to project which help economic development directly as well as promising higher profit rates at reasonable or acceptable degree of risk.

(Third) The contract will state that Mudaraba fund shall not be delivered in one single payment, as in old days. The Mudareb will receive total amount of finance that is agreed in the contract in several payments. Payments shall be scheduled in accordance to the progress of the project at successive stages as outlined and described in the approved feasibility study (Fourth) the bank will keep full rights to get periodical progress reports from the Mudareb, to examine the accuracy and transparency of these reports and to halt or stop the flow of finance if terms of finance are violated,

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Mudaraba successful. If he infinged upon the contract he has to guarantee return of Mudaraba capital intact. Suggested new contract and mechanism for Restricted Mudaraba in this article means endorsing standpoint of Hanafis and Hanbalis. It should be noticed that though restrictions will be intensified in the new suggested contract but will not intervene with freedom of action that the Mudareb should have, as will be explained. The conception of new contract and new mechanism for restricted Mudaraba was presented by the Author first time in " Islamic Banking Modes of Finance : Proposals for Further Evolution", within "Islamic Perspectives on Wealth Creation", Conference organized by the Center of Islamic Studies, Durham University, U.K, July, 2002. Later on the Conference paper was published in "Munawar Iqbal and Rodney Wilson (editors), "Islamic Perspectives on Wealth Creation, Edinburgh University Press, 2005.

(Fifth) the Mudareb will undertake to pay back intact to the bank, funds that he (she) received, in case if he has violated terms of finance stated in the contract. This is in compliance with rules of restricted Mudaraba. In some cases, e.g. new firms or enterprises expanding their business, or introducing new product, the bank may ask for third party (of known goodwill) to guarantee the fulfillment of the Mudereb's undertakings in case of contract violation.

The new Restricted Mudaraba contract would be suitable for financing industrial development in Muslim countries. Yet, when finance is extended by to large industrial entities, it will be normally large and of long-run nature. This needs further care in procedures and in risk mitigation because bank resources in investment accounts, though are supposed to be suitable for long-run projects, are only of short or medium term nature in practice[39].

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

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

[39]) This is because right of account holders to withdraw from their investment accounts at any time.

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

Third: Employment of resources through non-bank financial companies:

The dual nature of the Islamic bank in carrying financial intermediation alongside with trade and investment activities is not helping the institution to have market competitiveness. Islamic banks showed efficiency in collecting funds directly from the market, but they could not prove same thing in practicing directly trade and investment activities. They imitated some products that are well known in the conventional market, such as hire purchase, and mortgage, enveloped them within Sharia tailored contracts to suit Islamic banking practice[40]. According to the devised contracts, selling such products involved banking procedures, documents, and much more time than matching products that are sold directly by companies in the conventional market. All that meant higher costs in practicing trade finance by Islamic banks, and consequently inability to be market competitive. Islamic banks business in selling durable goods or houses is in fact going on in practice because of keenness of their customers to avoid transaction that is based on Riba. It is fear of sin more than anything else.

Islamic banks would, in fact, be able to employ their resources in trade and investment activities in more efficient and competitive manner *indirectly* through non-bank financial companies NBFCs. Non-bank financial institutions are well known in the liberal secular system. They facilitate bank-related financial services[41] Islamic banks can either establish

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[40]) Mohamed Ariff (Ibid)writes ""The current Islamic banking products are mirror images of conventional products, shari'ah compliance being the main differentiator."

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

relations with some existing NBFCs, or take the initiative to establish NBFCs within existing legislations of the country[42].

The Islamic banks have to adopt a strategy in establishing NBFCs. They have to comply with secular laws and central banking regulations until an Islamic financial and economic system is established. In a proposed long-term strategy, a group of Islamic banks can cooperate in establishing large Islamic NBFCs to carry different trade and investment activities by help of their finance. This would minimize capital required from each bank in the group while allowing each bank to gain from economies of scale realized by a large size entity. A single Islamic bank may, however, establish a company on medium scale size. In compliance with central banking regulations it would be only keeping the allowed stake in the company's capital, but making sure at same time to keep seat in the company's executive board. After establishing the company, bank will work for growing its size by means of Musharaka finance and by encouraging its customers (holders of investment accounts) to buy shares of the company.

NBFCs whether having agreements Islamic banks or established by them, would undertake carrying trade and investment activities as required by the bank *strictly within Sharia rules.* The NBFC would not be subject to procedures, restrictions or limitations which Islamic banks face in practicing trade or investment activities, and it would naturally, for market competitiveness, price its product according to demand and supply conditions. This will actively help in pushing economic development on Islamic lines. Establishing these companies through the capital market will also help in developing a secondary market for Sharia compliant shares in Muslim countries.

What NBFCs financed and supported by Islamic banks can do for economic development? This is what we explain in the following Paragraphs in particular through Leasing/ownership operations as well as through two other contracts, namely Muzara and Salam, that have rarely been used, if at all, by Islamic banks.

[42]) In secular legislations and regulations banking in general are restricted in establishing companies. In case of commercial banks, the risk involved in ownership of companies is high above certain minimum level, as determined by regulations of the central bank. Islamic banks at present except in rare cases are subject to same secular conditions. The problem has to be solved in practice in one way or another.

(a) Leasing (Ijarah) and Leasing/ownership (Ijarah Wa Iqtina) Finance:

Ijarah finance companies would be able to help economic development if they focus directly on serving the production sector. Leasing, apart from purchasing equipment at the end of contract or not, minimizes the upfront investment which enterprise needs to make to perform its activity. Putting aside now our rejection of interest-based finance, we have to benefit from the experience of leasing companies in the western world. In fact these companies are doing excellent job in lease financing to small and medium size enterprises. They practice leasing finance for a wide variety of asset classes that suit for example different types of manufacturing businesses, Medical services, Furniture, Fixtures, Warehouses, and else . Leasing companies are keen to furnish small enterprises with technical advice, offer high-quality equipment to help ensure production of goods that meet customer needs and expectations, help enterprises to upgrade their technology. Thus they help customers to maintain competitive disadvantage and develop their production.[43]

The difference between Islamic and conventional leasing finance should not only remain confined to rejection of interest. Elimination of interest and any other Sharia prohibited practice is necessary condition. Rental of the leased asset should be determined according to market rental of same asset, as previously explained. Islamic leasing finance should serve producers for sake of economic development and should not be less competitive than conventional one by complicated procedures that have nothing to do with Sharia.

(b) Muzara Finance Company:

Muzara has not received any considerations by Islamic banks till now, in spite of its vital importance to agricultural development in most Muslim countries.

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[43]) Quoting advertisement of one of the Leasing companies, it says that it "provides a hedge against technological obsolescence" and at the end of the leasing contract, enterprise "can purchase its equipment, if that makes sense. If not (enterprise) can upgrade by leasing newer, more modern devices in order to stay competitive" [Omni Leasing Corporation in the U.S. state of Colorado, http://omnileasing.net/manufacturing-equipment-leasing/] This is one of several other advertisements of companies involved in leasing finance in the developed world.

It is amazing to find out how conventional banks in many countries have served farms, and farm related business[44]. Islamic banks have almost done nothing in this field. Conventional banks do their business on interest bases, which is prohibited, and it may be said that they would have no mercy if farmers default and become unable to settle their debt. But, is it possible, on the other hand, to attribute the negative role of Islamic Banking in agricultural development, throughout 40 years, to prohibition of interest? Impossible!

Islamic banks have not tried to open branches in villages as specialized conventional agricultural banks do to finance agricultural activities. It is said that Muzara finance, in comparison to loans given by conventional banks to farmers is much risky and requires employment of specialized staff in purchasing production requirements to farmers, as well as in selling crops in the market, besides need to have storage and warehouses for some production requirements as well as crops after harvest. But all what is considered highly costly, risky, or impractical to be done by Islamic banks can be done professionally and at lower risk by specialized Muzara financing companies. These companies have to open branches in different locations, and to employ dedicated and specialized agricultural staff. They can play a really important role in villages through financing farmers, not by giving loans but by buying production requirements, helping them in selecting best rewarding crops, advising them on new crops and new technology. All this will be rewarding to farmers and companies because of partnership in produce. Muzara financing companies should have their own specialists and experts in agricultural marketing.

The classical Muzara contract, as other financial contracts is not a dogma. It ought to be modernized. This can be carried by specialized economists assisted by Sharia experts, to

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

suit farming and new farming business activities. One condition has to be firmly preserved, namely that Sharia is not violated or misused by naïve fiqh tricks. Muzara companies should be able to finance animal farm production,, fisheries, and poultry production,. By close cooperation with Islamic leasing financing companies, Muzara companies can also help farmers in Land reclamation by extending leasing facilities of tractors and other agricultural equipment, digging of wells, and constructing modern irrigation facilities.

(c) Salam Financing Company

Slam finance has been practiced at very limited scale by some Islamic banks in the Gulf countries, although it is the perfect Islamic method of borrowing money without paying Riba. In Arabic it is called بيع السلم أو السلف which simply means "Sale based on Borrowing". Someone is borrowing money against undertaking to pay back his debt in "commodity terms".[45] Salam finance when practiced by Islamic banks is likely to be highly risky, in spite of "hedging" that can be done by Sharia compliant "Parallel Salam"[46]. High Risk faced in Salam cannot be mitigated by banks unless having specialized marketing agents and experts to organize hedging and to avoid operations involving storage or marketing of merchandise after delivery is made by the borrower (called Salam Seller), if and when actual delivery dates of the first and second Salam contracts are not perfectly synchronized. Specialized Salam companies would have specialized management and the expertise to perform Salam and Parallel Salam operations with possible minimum of risk.

Salam transactions can help effectively in economic development. To give an example; in many Muslim countries Salam companies can purchase exportable goods from the

[45]) Money paid in advance is called in Fiqh " Salam Price" or Salam Capital. The Salam price may be a quantity of some commodity, i.e. someone is borrowing in commodity terms. In this case, debt can be paid back in terms of money or quantity of another commodity. See details of Salam Contract in " Sharia Standards" published by AAOIFI [Available in internet trusted source of AAOIFI]

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

domestic market, directly or by help of known dealers. On the other hand enter into a parallel Salam contract undertaking the delivery of the same goods to importing firms in foreign markets. Transactions of future delivery are usually well organized at the international level and will allow for much better chance to develop deals based on Salam finance successfully. A successful practice of Salam and parallel Salam can reflect favorably on export development and hence on economic development.

CONCLUSIONS

The role of conventional banking in economic development in Muslim countries was generally speaking insignificant except under some external non-banking conditions. A system that is unable to help in pushing economic development, while based on haram, should not be defended. Call for Islamic banking to replace the conventional system cannot, on the other hand, be based only on Riba prohibition. Riba prohibition is mandatory for all Muslims and institutions in Muslim countries, banking or else. A Riba-free banking system should prove in practice that through profit/loss sharing and Islamic investment criteria financial resources will be efficiently mobilized and employed. Thus the most desirable target for all Muslim countries, that is economic development, will be realized. The paper argues that the performance of Islamic banking in four decades was unsatisfactory. There is a wide gap between what was expected from Islamic banking in theory and what has been achieved in practice. Islamic banks succeeded in collecting funds for investment, and failed in employing these funds in the production sector. Majority of funds have been employed in retail trade of durable consumer goods and services. In fact, conventional banking, in spite of criticism which it faces, is comparatively from purely economic viewpoint, having an undeniable role in financing the production sector, in all Muslim countries with exception of Sudan and Iran. Truly, Islamic banking represents a small portion of the banking system, but it should no significant sign of competition with conventional banking in financing real investment in the modern manufacturing industry, or in other activities in the production sector.

It is undeniable that economic development is the most important target that all institutions have to serve in all Muslim countries. We have to admit that Islamic banking faces many problems in practice because of various crippling external and internal *factors. Financial Innovation can provide a magic solution to most of these problems. Internal factors which are handicapping Islamic banking should be given priority in treatment.*

A better future role of Islamic banking in economic development is expected if, or when: (1) Urgent Corrections of errors and initiating new policies. This can be done through total elimination of non-compliant Sharia products (mainly Tawaruk), and termination of using the interest rate as bench mark. Adopting new production-oriented policy in Murabaha by using it increasingly in financing promising small scale (or medium scale) projects, and raising efficiency of Murabaha operations by giving increasing portion of funds to financing whole sale instead of retail trade. (2) Engineering a New Mudaraba Contract, based on Sharia Compliant Restrictions and Mechanisms. (3) Employment of resources collected by Islamic banks through non-bank financial companies. This will be of particular importance for Leasing (Ijarah) and Leasing/ownership, Muzara, and Salam operations.

At the end, we can say that the role of Islamic Banking in Economic Development, though until now is insignificant but it can be quite promising in future once stern measures are taken to correct wrong practices, better policies are adopted, and innovative products and mechanisms have taken place in practice.

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Shawwal, 1436/ August, 2015

دَعْواهُمْ فِيها سُبْحانَكَ اللَّهُمَّ وَتَحِيَّتُهُمْ فِيها سَلامٌ وَآخِرُ دَعْواهُمْ أَنِ الْحَمْدُ لِلَّهِ رَبِّ الْعالَمِينَ (10 يونس)

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