“Are Islamic bank promises delivered or failed? Evidence from cross country Islamic banks”

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Abstract

This paper examines the balance sheet of 28 Islamic banks to see whether and to what extent the fundamental premises that led to the establishment of Islamic banks were delivered. The empirical evidence shows that, while profit and loss sharing (Mudaraba) and equity sharing (Musharaka) modes are distinguished products of Islamic banks, they are, in reality, nominal – ranging between 0.03-6.34 percent and 0.015-14.94 percent of total assets, respectively. Banks that participate in Mudaraba and Musharaka financing are only 28 and 50 percent, respectively. Banks' participation in Qard al-hasan financing is in the range between 0.017 and 0.93 percent of total assets. All banks calculated Zakah but only a few banks distributed it directly. This paper finds that Islamic banks' participation in conventional debt-type banking product is overwhelming.

Keywords: Islamic bank, conventional bank, Riba, profit and loss sharing (PLS), Mudareba, Musharakha.
JEL Classification: B19, B29, G21.

Introduction

Once, even three decades ago, financial institutions without interest were unthinkable. Today Islamic financial institutions (IFIs) are in reality with $1 trillion assets and spread all over the world including European countries and the United States. In particular these have their significant presence in all Muslim majority countries like Pakistan, Malaysia, Sudan, Iran, Saudi Arabia, Bahrain, United Arab Emirates, and other GCC countries.

A growing number of western financial institutions are now offering Islamic investment products to Muslim investors because of the successes of IFIS. For example, Citi Islamic Investment Bank, is a wholly owned subsidiary of Citi Corp opened in Bahrain in 1996. Chase Manhattan has an Islamic "window" in Frankfurt, Germany. Multinational corporations like IBM and GM have raised funds through the US based Islamic leasing fund at the United Bank of Kuwait. In mortgage financing there are now two mortgage companies (LARIBA of Pasadena, California, and University Bancorp of Ann Arbor, Michigan) operating in North America on Islamic principles (Samad, 2006).

Recent economic crisis reveals a large number of bank failures during 2008-2010. All failures are from among the conventional banks. Performances of all conventional banks are affected during the crisis whereas it is a folded report that claim that Islamic banks are not affected and their performances are stabilized. "As the contemporary financial crisis unfolded, the voices of the IBFs have shown increased confidence in the industry and even boldness to claim superiority of Islamic system, and then some went even a step further to suggest to the West that they should also consider Islamic finance" (Farook, 2009, p. 3). There are numerous studies including Samad (1999), Samad & Hasan (2000) that shows that the performances of Islamic banks are better than those of conventional ones.

Given IFIs phenomenon growth and superior performance, questions arise asking, what makes IFIs superior? What are those unique principle (features) and product characteristics that make IFIs superior and distinguish them from the conventional banks? Are those theoretical founding premises, objectives and product characteristics unique to IFIs delivered and to what extent they are delivered? This paper examines these issues.

The major contribution of this paper to the Islamic Finance Institutions' literature is two-fold. First, it identifies countries and the number of individual banks that participated Mudaraba, Musharaka, Qard al-hasan financing as well as that paid by Zakah directly. Second, the paper identifies each bank's amount of Mudaraba, Musharaka and Qard al-hasan financing as well as the magnitude in terms of total assets.

The paper is organized as follows. Section 1 explores the unique principles, products, and characteristics of IFIs. A brief survey of literature is outline in section 2. Data and methodology is described in section 3. Section 4 provides empirical evidences by examining cross country Islamic banks' records i.e. the balance sheet of Islamic banks in determining the extent of participation of Islamic principle and products; and whether they are delivered. A short analysis is also provided for their failure of delivery. Conclusions will be provided in the final section.

1. Islami bank principles and goals

Islamic banks (Islamic Financial Institutions (IFIs)) are banking firms and they maximize profits toward promoting a "just and equitable" society. IFIs are subject to Quran and Sharia law. In addition, Islamic

banks are subject to the laws of the countries where they operate. Thus, Islamic banks are subject to twine constraints. The first and most important feature or constraint of Islamic banks is the prohibition of interest[1] (riba), regardless of its form or source. Since "Riba" is considered as interest, Islamic banks become synonymous as interest free banking (Warde, 2000). Interest free transaction is the foundation for the establishment of Islamic banks. The rationale is that the credit system involving interest leads to an inequitable distribution of income in society. In Islam, interest rate, reward for risk taking, is considered unethical as it benefits the lenders. All businesses have potential risk. By fixing a predetermined rate of return (interest), lenders (conventional banks) do not share the risk of losses in business. Interest provides assured income to lenders and it is the life and blood of conventional banks. They charge interest when loans are advanced and pay interest when deposits are issued. The difference between the interest rate charged and interest rate paid constitutes the fundamental source of income for conventional banks and Islam prohibits the practices of interest.

Profit and loss sharing (PLS) is the most important cornerstone and the distinguishing feature of IFIs. Since Quran, the Divine book of Islam and Hadith, the practices of Prophet Mohammad, prohibits "riba" (interest), Islamic banks cannot operate on the principle of interest. However, without some kind of reward, Islamic banks could not operate and survive. The avoidance of interest in Islamic financing has led Islamic banks to innovate various products as a viable substitute for conventional products (Samad, Cook and Gardner, 2005) consistent with Shariah principles. Based on the nature of contracts, these Islamic financial products may be classified into two broad categories: (1) equity type contract; (2) mark-up price (debt) type contract. 'Musharakah' (partnership) and 'Mudaraba' (trust financing) are the only two products that fall into equity type contracts (Hamwi and Aylward, 1999). They are based on the profit and loss sharing (PLS) principle. These two products are very special to Islamic banking[2] and provide the most distinguished characteristics of Islamic banks.

1.1. Musharakah (partnership). Under this equity type contract, Musharakah (partnership), both parties provide capital. Profits and losses are shared (PLS) by contracting parties. Risk and rewards are shared by both contracting parties (Dar and Presley, 2003; Usmani, 2002). The key element is that both parties – banks and entrepreneurs – provide capital and share profits. Profits of the projects are shared by prearranged agreements, not necessarily in proportion to capital. The return of investor (bank) is, thus, not guaranteed and fixed. In case of losses, both parties share them in proportion of capital.

1.2. Mudaraba (trust financing). Under Mudaraba contract, one party (investor) provides capital (maal) for a project and the other party (entrepreneur) provides labor to run the project. Profits and losses are shared by both parties. Profit and loss sharing (PLS) mode is a key feature of Islamic banks (Abdel Karim, 2001; Samad, Gardner and Cook, 2005. In case of profits both the investor and entrepreneur share the reward of the project. Profits are shared by both based on pre-agreed arrangements. In case of failure of the projects there are losses and all financial loss is borne by the capitalist and the entrepreneur loses his labor (Iqbal and Molyneux, 2005, p. 28). Risk is fairly distributed in IFIs. The investor (supplying capital) loses capital and the entrepreneur (providing labor) loses his entire labor.

The key elements of the Mudarba contract is that the lender is not guaranteed a predetermined and specific return (Samad, Gardner, Cook, 2005). This is in direct contrast to interest based lending of the conventional banks. The second key element is that "The financier or investor is not liable for losses beyond the capital he has contributed, and the entrepreneur or trustee does not share the financial losses except for the loss of his time and efforts" (Maniam, Bexley and James, 2000, p. 4).

1.3. Zakah. Zakah, a compulsory poor due, is one of five pillars of Islam and an integral part not only for an individual Muslim but also for Islamic financial institutions (IFIs). IFIs are considered as instruments towards establishing a "just and equitable" society. IFIs are obligated to pay "Zakah" from its profits to the poor. When Islamic banks were in philosophical concept and in an embroidery stage, it was expected that Islamic banks would be an instrument for ensuring the "just and equitable" society not only by paying Zakah (the poor due) from its profits but also financing small businesses, trades, and agriculture. Toward establishing a "just and fair" society, the interest of small traders, businesses, and agriculture must be supported and financed. They should not be neglected while serving big businesses, corporation, and industries. That is, laying an emphasis on microfinancing is one of the objectives of Islamic banks.

1.4. Qard al-hasan. Qard al-hasan is repeatedly emphasized in Hadith and Quran. Support the needy and feed the poor – is the basic message of Islam. 'Spending out of what God has provided' has been frequently instructed in the Quran. The "Qard-al-hasan (benevolent) financing is a cornerstone of Islamic finance" (Samad, Gardner and Cook, 2005).

[1] Although "riba" is usury not interest, they are considered equivalent by most Islamic scholars.
[2] Please see Samad, Cook and Gardner (2005) for details.

IFIs are expected to practice and enhance Qard al-hasan in the society.

1.5. Shariah approved transaction. Islamic bank lending, borrowing, buying, and selling are required to be Islamically permitted called Sharia approved i.e. halal. Currently these products are Murabaha, Ijara, Istansa, and they are Sharia approved. That is, bank transaction for permitted (halal) businesses and goods must be approved by Sharia law.

2. Literature survey

A brief survey of Islamic bank literature shows that there are many studies on the Islamic bank financing. However, these studies do show any evidence of study relating to what Islamic bank promised to deliver and to what extent they have delivered.

Earlier studies on Islamic banks (Ahmed, 1981; Karsen, 1982) primarily focused on the conceptual issues dealing with interest free financing.

Institutional issues were discussed by Siddiqi (1983), Khan (1987), Kahf (1989), Omr and Haq (1996), Khan and Mirakhor (1987) and Mannan (1968, 1998).

There are relatively large literature dealing with Islamic bank performances and efficiencies. Samad (1999), Samad and Hassan (2000), Ariff (1989), Hassan (1999), and Choong, Thin and Kyzy (2012) primarily focused on Islamic bank performance and the comparative performance of Islamic. Noor and Bt Ahmed (2011), Bashir (2000), Onour and Abdalla (2011) and Ali and Sghaier (2012) used different measurement criteria and focused on estimating the efficiencies of country specific Islamic banks.

3. Data and methodology

Data from twenty-eight banks' annual reports were obtained from the online bank. Percentages are calculated by the author. Variables used are:

1. *Mudaraba financing.* Muderaba financing as a percentage of total assets. The closer the Mudaraba financing to 100 percent of total assets the higher the delivery of the promises of Islamic financing.
2. *Musharaka financing.* Musharaka financing as a percentage of total assets. The higher the percentage of Musharaka financing to 100 percent of total assets the higher the delivery of the promises of Islamic financing.
3. *Zakah payment.* Zakah distribution by the number of banks as a percent of total banks under the study. The higher the implementation of Zakah to 100 percent the higher the delivery of Islamic practices.
4. *Qard al-hasan.* Qard al-hasan financing as a percentage of total assets. The higher the percentage of Mudaraba financing to 100 percent of total assets the higher the delivery of the promises of Islamic financing.
5. *Debt-type[1] financing as a percentage of total assets.* The debt type financing is basically a mark-up pricing contract and is very similar to conventional modes practiced by conventional banks. Critiques of Islamic complain that debt-type financing is nothing but interest based financing, although it is approved by Sharia Boards. The higher the percentage of debt-type financing, the higher the Islamic bank's standing, and it is closer to conventional bank practices.

Percentages of all variables are calculated by the author for determining the extent of Islamic bank participations and the delivery of Islamic products.

4. Empirical evidences of cross country Islamic banks[2]

The empirical evidences from the examination of the cross country bank balance sheet are presented in Table 1.

Table 1. Cross country Islamic bank allocation of funds

Bank name	TA	Mudarabah finance	Musharaka finance	Qard al-hasan finance	Zakah payment by bank	Debt-type finance***
Abu Dhabi Islamic BK	51,210,056	642,886 **[1.25]**	–	–	BCSH[3]	Overwhelming
ABC Bank, Bahrain	1,461,345	803 **[0.054949]**	3,616 **[0.247443]**	–	260	Overwhelming
Al-Baraka Islamic Bank, Bahrain	1,001,461,410	12,989,281 **[1.297033]**	23,900,235 **[2.386536]**	–	BCSH	Overwhelming
Al-Salam Bank, Bahrain	554,480,558				529,087	Overwhelming
Bahrain Islami Bank, Bahrain	873,967	55,436 **[6.343031]**	80,526 **[9.213849]**	–	264	Overwhelming
Ithmaar Bank, Bahrain	5,380,426			–	BCSH	Overwhelming
Unicorn Bank, Bahrain	978,770			–	BCSH	Overwhelming

[1] This includes Murabah, Ijera, Istansha, and other Sharia-approved financing.
[2] List of all banks under the study are available upon request.
[3] Bank calculates Zakah for its shareholders but does not distribute directly.

Table 1 (cont.). Cross country Islamic bank allocation of funds

Bank name	TA	Mudarabah finance	Musharaka finance	Qard al-hasan finance	Zakah payment by bank	Debt-type finance***
Khalleeji Commercial Bank, Bahrain	464,993		13,278 **[2.855527]**	–	BCSH	Overwhelming
Kuwait Finance House, Bahrain	1,284,675		17,257 **[1.343297]**	–	BCSH	Overwhelming
Islami Bank Bangladesh, Bangladesh	230,879,135,344		34,782,229 **[0.015065]**	2,150,986,743 **[0.931651]**	132,429645	Overwhelming
Social Islamic Bank, Bangladesh	29,808,880,564			–	16,655,675	Overwhelming
Shahjalal Islamic Bank, Bangladesh	45,216,968,653			–	BCSH	Overwhelming
Brunie Islamic Bank, Brunie	4,754,080,978			–	30,685,277	Overwhelming
Dubi Islamic Bank of Pakistan, Dubi	32,050,073		1,183,750 **[3.693439]**	–	BCSH	Overwhelming
Emirates Isalmic Bank, Sharjah	26,400,450			–	13,866	Overwhelming
Muamalat Bank, Indonesia	12,610,852,548.00	1,906,653,010 **[15.11914]**	3,045,839,065 **[24.15252]**	2,223,188 **[0.017629]**	7,379,140	Overwhelming
Jordan Islamic Bank, Jordan	1,848,373,078		13,946,342 **[0.75452]**	11,194,937 **[0.605664]**	BCSH	Overwhelming
International Islamic Arab Bank, Jordan	906,311,975			267,972 **[0.03]**	BCSH	Overwhelming
Muamalat Bank, Malaysia	14,415,669			27,491 **[0.190702]**	215	Overwhelming
Bank Islam Malaysia BHD Malaysia	23,559,424	9,249 **[0.039258]**		–	5,998	Overwhelming
Maybank, Malaysia	26,924,720	30,986 **[0.115084]**	78,505 **[0.291572]**	–	7,120	Overwhelming
Mizan Bank, Pakistan	85,276,070		9,622,864 [**11.28437**]	–	BCSH	Overwhelming
Emirate Global Islamic Bank, Pakistan	16,537,387		2,471,518 [**14.94503**]	15,652 **[0.094646]**	BCSH	Overwhelming
Qatar Islamic Bank, Qatar	33,543,158			–	BCSH	Overwhelming
AL Rajhi Bank, Saudi Arabia	163,255,693			–	935,199	Overwhelming
Faisal Islamic Bank, Sudan	1,549,316,005		1,448,853 **[0.093516]**	–	BCSH	Overwhelming
Al Barak Bank, Tunisia	10,920,288	638,858 **[5.850194]**	159,100 **[1.456921]**	–	10,961	Overwhelming
Islamic Bank Britain, UK	180,799,300			–	BCSH	Overwhelming

Note: *** Debt-type finance are Murabaha, Intansa, and Ijara. [ ] presents the percent of TA[1].

Column 3 of Table 1 shows that only eight out of twenty-eight banks i.e. twenty-eight percent of the total banks issued Muderaba financing only during 2008. These banks are: Abu Dhabi Islamic BK, ABC Bank, Al-Baraka Islamic Bank, Bahrain Islami Bank, Muamalat Bank, Jordan Islamic Bank, Bank Islam Malaysia BHD, Maybank, Malaysia, and Al Barak Bank. The Mudaraba financing of these banks ranges from 0.03 percent to 15.11 percent. If Muamalat Bank of Indonesia is excluded, Muderaba financing ranges only between 0.03 and 6.34 percent.

Column 4 of Table 1 shows that fourteen banks out of twenty-eight i.e. 50 percent of the total banks participated in Musharaka financing during 2008. However, if 24.15 percent of the Muamalat banks of Indonesia are excluded, the Musharaka financing of cross country Islamic banks range from 0.015 percent to 14.94 percent.

If banks are ranked based on percentage of participation, Islamic bank (Mumaalat Bank) in Indonesia has the highest participation both in PLS (Mudaraba) and Musharaka financing, 15.11 percent and 24.15 percent, respectively. The second is Pakisatan Islamic bank. The total financing of Musharaka mode by Mizan Bank and Emirate Global bank in Pakistan is 11.28 percent and 14.95 percent, respectively.

If countries are ranked based on Mudaraba and Musharak financing, the Pakistan Islamic banks totaling Mudarabah and Musharaka financing is 26.22 percent. The third is the Bahrain Islami Bank. Its Muda-

[1] Assets of all banks are in local currencies and in 000 except for the following banks: ABC bank of Bahrain (US $000), Ithamaar Bank in Bahrain (US$000), Unicorn Bank in Bahrain (US$000), Al-Baraka Bank in Tunisia (US$000), Isalamic Bank Bretain (Pound). The following banks have their assets expressed not in thousand: Faisal Islamic Bank in Sudan, Jordan Islamic Bank and all three Islamic Bank of Bangladesh.

raba and Musharaka financing is 6.34 percent and 9.21 percent, respectively. The fourth bank is the Al Barak Islamic Bank in Tunisa with a participation rate of 5.84 percent and 1.4 percent in Mudaraba and Musharaka, respectively. Interestingly, the Islamic Bank Malaysia Berhad which once had the highest participation in Mudaraba and Musharaka during the 1980s showed no record of financing in these modes during 2008.

The examination of the percentage of participating banks (out of the total banks) and the percentage of their financing (out of their total assets) reveals that Islamic banks, financing under Muderaba and Mushraka, the most distinguished differentiating pillar of Islamic banks, is hopelessly inadequate and far short of delivering Islamic principles, in practices. The finding of this paper is that Islamic bank Muderaba and Musharak financing is marginal and is supportive of previous studies (Samad, Norman and Cook, 2005; Farook, 2007; and Dar and Presley, 2002).

There are various reasons why the financing under the Mudaraba and Musharaka mode is trivial and unpopular. The inherent weakness of partnership business, asymmetric information, and agency problems are a few of the basic reasons why banks do not participate significantly in the delivery of these products[1]. A detailed discussion is provided by Farook, (2007) and Caggiano (1992).

Column 5 of Table 1 shows only six banks, out of twenty-eight cross country Islamic banks i.e. 21 percent of total banks issued Qard al-hasan (benevolent) financing and the magnitude of Qard al-hasan is basically zero. Qard al-hasan financing ranges between 0.017 and 0.93 percent of the total assets. The finding dictates that Islamic banks' participation both in terms of percentage of participation and the percentage of their financing is very trivial. Islamic banks fail to highlight Qard al-hasan financing, and are in failure of delivering the third distinguishing principle of Islamic financing.

The basic reason for non-participation i.e. non delivery of Qard al-hasan product of banks is the lack of financial incentive. Under this mode of financing, banks are not allowed to charge any fee for financing the customers.

Column 6 of Table 1 shows that thirteen banks out of twenty-eight i.e. 43 percent of the total banks distributed Zakah directly from their profits. The rest of the banks i.e. 57 percent of the total banks simply calculated Zakah for their shareholders. The distribution of Zakah was left with the banks' shareholders. We are not sure about the shareholders' distribution of Zakah but it is certain that 43 percent of Islamic banks paid Zakah directly on bank profits during 2008. The delivery of Zakah, the fourth distinguishing feature of Islamic banks, is considered to be real.

Column 7 of Table 1 shows that the overwhelming percentage of total assets of cross country Islamic banks are allocated to the debt-type mode of financing which the critiques of Islamic banks doubt about its Islamization or Islamic validity. The delivery of debt-type financing is the highest and in most cases (100 percent).

The main reason is the popularity of this financing is the high return of investment in short periods with almost zero risk.

Conclusion

This paper examined twenty-eight Islamic banks of fifteen Muslim majority countries to determine whether or to what extent the promises (Islamic principles) are delivered. Mudaraba and Musharaka financing, the most distinguishing pillar of Islamic banks, are trivial and far short of promises. Financing under Mudaraba and Musaharaka is in the range between 0.03-6.34 percent and 0.015-14.94 percent, respectively. Qard al-hasan, the third most distinguished feature of Islamic banks, is also nominal. Only six banks out of twenty-eight banks participated in Qard al-hasan financing and its financing is very trivial and in the range between 0.017 and 0.93 percent of total assets. The participation and the distribution of Zakah are far more real than other principles/promises of Islamic banks. The overwhelming percentage of total assets is allocated for debt-type financing which the critiques of Islamic bank doubt about its Islamic validity.

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[1] Umar Farook (2007) provided detail description why these financing are unpopular.

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