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Islamic Banking and its Perspectives

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ABSTRACT
In the recent years, the global banking system has experienced large aftershocks. The global economic crisis that began in 2008, and its consequences, succeeded to close down many large banking systems. On the other hand, Islamic banks made a great growth, and their bank assets according to estimates, are worth about 1,800 billion. The secret is not in the big oil reserves, but the system which they called "halal financing". This system is based on several basic premises, which are not of a great philosophy, but are not in compliance with the western system of financial manipulation. The prohibition of interest-based finance through the banking sector, spread the growing economic impact in the contemporary economic, social, political and globalisation area. The relevance of this study is contributing to the debate which concerns the possible relevance of Islamic Banking to the potential development and redefinition of conventional banking. Through analysing the pros and cons of this financial system based on the Islamic principles, it will be determined if it is able to play a leading role in revamping and driving the conventional banking.
Key words: Islam, Islamic Financial System, Income Distribution, Credit Arrangement

INTRODUCTION

With diverse histories and attitudes toward risk-taking, different financial systems have a common aim: ensuring financial stability and efficiency within a geographical region (Suzuki, Barai and Uddin 2013). Nonetheless there are differences between various financial systems and the Islamic is one of them. Islamic banking emerged in 1963 in Egypt and Organization of Islamic Countries (OIC) established the Industrial Development Bank (IDB) in 1974 as the first explicit bank to provide the funds to member countries on profit and loss sharing basis. (Khan et al. 2013). During the last twenty years there has been increased global awareness of Islamic finance and extraordinary growth worldwide (Hussain 2014). Even in the wake of the global unrest currently experienced by financial markets, Islamic financial institutions maintained their stability and showed resistance. However, more important than focusing on its growth, commercial performance and market share is the need for evaluating it in terms of its contribution to introducing and promoting the understanding of the economic and financial aspects of the overall Islamic way of life (Siddiqi 2006).

So, engaging in discussion regarding Islamic banking is practically impossible if there is no preliminary knowledge of the legal structure of Islam - Islamic law or the source of rights and duties that are important in predominantly Muslim countries. Because Islam makes no distinction between secular and religious law, it follows that any Islamic Financial Institution must practice in accordance with the Islamic principles (Roy 1991). This structure of the Islamic or Shari'ah Law is based on the primary sources, such as the Quran and the Sunna, the sayings and actions of the Prophet Muhammad transmitted orally in the form of the hadeeth (the stories of the Prophet's companions) (Di Mauro, Caristi, Couderc, Di Maria, Ho, Grewal Masciantonio, Ongena and Zaher 2013). Such discretion leave room for various interpretations of the Islamic values which are not immutable, however, but rather part of a dynamic process subject to evolution and change (Dunnin 2015).

Islam has well-established business, economic and social systems and its influences are interwoven with the daily life of Muslims (Yousaf 2016). The Islamic finance industry has grown considerably over the last two decades and Islamic financing transactions today often have a global reach (Bälz 2004). Research centers, academic journals, seminars, conferences, introduction of teaching courses, even establishment of departments of Islamic economics in universities and writing of hundreds of doctoral dissertations, in the western universities as well as in the Islamic world (Siddiqi 2006). (Kettell, 2010; & Sudin and Wan Azmi, 2009) opine that there are some fundamental rules that must be employed and considered in every activity of Islamic banks: The prohibition of interest (Riba), prohibition of unreasonable uncertainty and speculation (gharar), profit and loss sharing Prohibition of making money out of raw money, all contracts must be approved by the Shari'ah, and provision of shariah advisory committee. (Yunusa and Nordin 2015).

Islamic banks have to abide by the revealed doctrines in Islam in conducting their business and financial transactions (Karim 1995). They employ in-house religious advisers—often referred to as Shari'a Supervisory Board (SSB)—who issue a special report to inform users of financial statements whether or not the bank has adhered to the Islamic principles. Islamic financial system seeks to evenly allocate the social and moral dimensions in order to ensure the wellbeing of the society. Its fundamental principles are derived from the basic principles of Shariah under which, the lending in Islamic countries is based on a complete coverage of all deposits by the population and is without interest. Identifying the impact of the interest rates upon Islamic banks is a key to understand the contribution of such institutions to the financial stability (Ergenc and Arslan 2013), designing monetary policies and devising a proper risk management applicable to these institutions. Namely, in Islam, trade is permitted, but not usury. Accordingly, Islamic banks offer financing without obligation for interest to their customers. In XX century a doubt appeared in some Islamic economists, whether the notion of "Reba" which is Arabic word for interest, is the same as the English term "interest", i.e.whether any type of interest is prohibited, because it breaks the bonds of natural relationship between human beings leads to inequality between borrower and lender, enables rich to continue to dominate the poor and inevitably leads to social unrest (Roy 1991). According to Abu Hamid al-Ghazali (Zaher and Hassan 2001) interest prevents the money to perform their proper function as means for performing value measurement and as a medium for exchange, while he considered the function of money as means for accumulation of fortunes bad and undesirable for the society.

The essence of Islamic banks is mediation between those who have surplus funds and have no placement, or do not know how to place them and those who do not have enough money to meet their investment or consumer needs. In fact, it is a nature of the conventional banks. But unlike them, Islamic banks do not pay their depositors interest but offer them, through investment deposits, to participate in business ventures of the bank, and thus proportionally through their share to participate in the distribution of profits and the loss of that business venture. It should be noted that besides being forbidden to be paid, it is forbidden to receive any kind of interest. It is also important to note that these banks operate for profit, so together with customers they participate in distribution of profit or covering of loss, but also take a commission to perform some banking services. Because Islam prohibits interest ("Interest Rate"), but allow and encourage trade and commercial transactions (“rate of return"), which is a big difference. In the Islamic-interest system, those who can borrow money can make a "rate of return" on their money if they participate in the risk of making a profit.

This restrictions further includes prohibitions on: (1) investments in businesses whose practices are in conflict with Islamic teachings, such as those that engage in gambling or pornography, or the sale or consumption of alcohol and pork; (2) investments offering fixed interest-based return; (3) investments in indebted companies paying interest on servicing their debt; and (4) speculation in derivative transactions on the stock exchange (Vahed and Vawda 2008).

Considering the above, Islamic banks have two options: To work together with the customer, to enter the investment and share the profit or loss, or goods, equipment, etc., bought together with the client and later, given to the client for lease or sale with deferred payment. In both cases, apart from the conventional banking, the bank engages in investment and trade by sharing the risk with the client. Hence, it may be concluded that the Islamic bank cannot grant a non-purpose loan.

1. Financial structures in the non-Islamic financial systems

The conventional credit (debt) financing to non-Islamic financial systems constitutes only one of the modalities of financing which has its own alternative in the various forms of ownership financing. Thus, this form does not represent an imposed solution, but a variety of free parties, so it is unclear why is contested its ethical basis. Not only the credit financing is one of the possibilities, but in the conventional systems is also gladly sought and selected possibility.

In the theory of the corporate financing is estimated that the shareholders are faced with extremely aggravated protection of their rights, if they do not have concentrated position. Due to that the interest in share investments in such systems depends on the conjuncture of the stock market, it intensifies when is expressing the trend of growth of the share price and it suddenly disappears when it comes to reversing the trend.

Despite that, many of the transactions refer to the privatization and the trade of shares blocks where essentially it is not a matter of investments due to financing, but it is about forced shareholding and change of the control over the corporation.

2. Islamic proposals of the financial structure

The ban on rate of interest, as promoted in the Islamic concept is basically a ban on the conventional credit arrangement. Thus the financial structure is reduced to solely equity financing. In the concepts and the practice of the Islamic financing are known certain modalities for credit financing, but from a theoretical aspect they have no great importance, because they are based on concepts known in the conventional financing (natural loan, lease, concession, etc.) and the general assessment is that according to their characteristics it does not preclude the fixed contribution to the financing, the nominal value of the liabilities, nor providing a further refund.

The arrangements that are in the paradigmatic concept of the financial Islamic financing are prescribing to the most significant potential of the reforms of the financial structure basically represent something like a modified version of the familiar modalities of the ownership financing. For isolation are two arrangements with common characteristics, to include the division of profits and losses between the financiers and the entrepreneurs.

The agent arrangement (Mudaharaba) involves a contracted relationship in which one party; the financier provides all the necessary capital, while the other party is dedicated to the project with their management skills and successful realization. The manager of business development and strategy describes the emergence in the object of service and explains how this affects the service practice.

In mudarabah leasing we invest money in fixed assets of businesses [object of service], if the customer inform us about any new type of assets [emergent object] he want us to invest in. (Ullah 2015). We evaluate the new opportunity and restructure our service to adjust for such opportunity (Ullah 2015). We send such design to headquarter for approval, where the result could come as approval of our recommended service design or disapproval with recommended changes….This practice broadens the scope of our service…As recently we did for financing imports of CNG pumps… IFSP1 (Ullah 2015).

The two key resources receive a prize which depends on the joint realized results in proportion to the pre-defined key for distribution. The financial loss will go exclusively on the financier, while the entrepreneur (the agent) will remain without reward for the labor and the efforts, so each party will lose what they invested in the project.

In contrast to the above mentioned, at the joint venture arrangements (musharakah) both sides provide the necessary funds, so here the entrepreneur appears in the role of co-financiers. In other words, musharakah refers to a contract in which two parties agree on the capital shares that both confer to a project hence both parties are involved in the implementation and management of the project and profits are divided according to the terms agreed in the contract and losses are allocated in proportion to the capital contributed (Di Mauro, Caristi, Couderc, Di Maria, Ho, Grewal, Masciantonio, Onega and Zaher 2013). In this case the economic outcome is shared on the basis of pre-defined key, which provides part of the entrepreneurial activities and part of the engaged capital in proportion to financial investments.

3. Structure of the distribution in the Islamic and the conventional financial arrangements

The ethical background of the financial arrangements which are characteristic for the Islamic banking led to a direct relationship between the yields of the capital invested in entrepreneurial projects with a result of financing the project. The ethical aspect of such a system of distribution is subject to analysis of many authors.

In the conventional credit arrangements the creditor agrees for themselves a yield, which is not directly determined by the result of the project, but by the risk of the project, while the residual belongs to the entrepreneur. In other words, conventional banking is based on a pure financial intermediation model, whereby banks generate profits from the margin earned from savers' deposits and demand deposits on the one hand and the funds lent to enterprises or individuals (Ryu et al. 2012). Because of the simplicity, let’s suppose that the yield of the financiers is defined by a fixed rate regarding the complex capital and that the project is financed with equity investment of the entrepreneur and a credit. For all future conditions that satisfy the condition liquidation value of the funds invested in the project in order to maintain a claim over the loan, the yield of the financiers will remain nominally unchanged. However, for the future conditions which include the liquidation value that does not reach a value of the claim, the financier should note it as a loss proportionate to the negative difference between the liquidation value of the assets and the value of the claim. Certainly the creditor will try with the help of timely intervention to prevent to come to such an unfavorable trend of the development of the circumstances. The entrepreneur (the debtor) on the other hand will bear all the differences between the liquidation value of the assets and the nominal value of the debt, while due to the limited liability shall be released from covering the loss in the future situations in which the value of the assets does not reach the value of the debt. So both sides are at risk, but the positions are not completely symmetrical. In the Islamic version of a joint venture (musharakah) the position of the parties would be symmetrical so that engagement does not involve a fixed rate of participation in the distribution on the basis of the entrepreneurial commitment. A certain asymmetry comes from the fact that the key division of the positive result differs from the key by which the negative result is charged to the position of the parties. However, in Islam, the labor and the capital are seen as equal economic resources, taking equivalence between the actual loss of the capital and the omission of reward for engaging work. Therefore, the change in asymmetry exists only if it remains in position of the conventional judgment basis.

In fact, the fixed elements are not excluded also in the arrangements which are based on the division of profits and losses. At the agents key arrangement is specified the share of the managerial work in the distribution (the total income or profit), while the rest belongs to the financier. At the Islamic arrangement, the joint venture is also fixed, determined as the share of the managerial work, while the rest belongs to the financier in proportion to the investments. The reward for project management can be seen as management earnings, which in general is composed of variable part. The variability of this reward is calculated as an effect of the application of fixed, predetermined rate of export of the business outcome, which is inherently variable. The part that belongs to the party which invests exclusively capital, is determined by a rate in all cases. In the case of conventional credit financing, the rate is applied to the amount of the investment, while in other cases is applied to the amount of outcome. But the business result is far from directly determined by the entrepreneurial endeavors, and if the business result is observed as a result of the management engagement, it remains unclear why the financier reward would be determined regarding the element for which it is not directly credited.

The key for distribution of the profit implicitly recognizes that the participant, who is not involved in the project management, claims the right to the result. The question now is how to justify the investor's participation in the profit? If it's exposure to risk, then, basically, the Islamic concept differs from conventional concept, i.e., the result is divided according to risk exposure.

In the Islamic arrangements the division of the profits and the losses, the percentage share of the managerial work in the distribution of the results of operations remains fixed during the life cycle of the project, with the manager staying tied to the project, which can be realized only with the voluntary liquidation. Unlike, at the established credit arrangement, the reward of this economic resource completely varies directly with the results of the project. Whether because of that position of entrepreneurs the credit financing of the project is inconvenient, demonstrates the fact that the debtor-creditor arrangements, the financier yield would depend on the quality of the resources that he himself invested in the project. Such structure of distribution according to the Western standards of business ethics has been challenged because of its ethics. The rate of yield would not depend on the quality of the resources invested in the project.

If the position of the manager of the project is perceived, one may see that in both systems the amount of the reward for the invested resources is variable and depends on the achieved business result, except that the conventional credit financing, the reward of the managers of the project is uncertain and in terms of the participation rate, while at the debtor-creditor arrangements, it is a pre-defined key that is valid during the life cycle of the project.
The relative contribution of the two economic factors in the results over time can radically change. There is no basis to increase or decrease of results that may occur over time and to be prescribed as a contribution of the invested capital, but only the management efforts. Nevertheless, to the capital will belong part of the increased result on the reward of the project manager. Due to that also the yield of the financiers of the same invested amounts in different projects would drastically differ.

In case of substantial equity investments this is not so unnatural relationship of things because the risk of investing can also radically differ. But if the debtor-creditor relationships include some elements that reduce the risk of the financier, such as collateral then the position of the financier approaches the position of the creditor and the risk is significantly reduced, while the whole system of distribution falls under more criticism of ethics.

If the problem is set as follows: the increasing of the income of the financier aroused due to the application of the inadequate key with which the development of the described circumstances made incorrect and unfair reward rule. Then arises the question with what the financier has earned increasing of the reward, obviously with a good investment choice.

In the non-Islamic financial systems, for managing with the investment funds must be taken into account the rights for compensation in a fixed amount of the value of the investment, which means that the choice of investments without participation in the management of the projects represents an economic value that is recognized in Western economic systems. When in this way is performed decomposition, it seems that the Islamic and the conventional concept does not differ enough that they do not even deserve separate names. This means that the key for distribution is determined so that it leads to overflow of the reward from the entrepreneur to the financier. This can be assessed by the main reason why even in the Islamic financial systems the entrepreneurs-beginners who believe in their projects would resort to the conventional credit arrangements. The determination which was applied also among mature companies, the ultimate effect is that the quality entrepreneurs and ideas go round the Islamic modalities of ownership financing, and the whole system becomes very sensitive to manipulation.

It can be concluded that due to the specific problems with which the Islamic debtor-creditor concept is encountered in the implementation of care to establish equality in the distribution of two key economic resources, led to the disruption of a ratio between the value of the reward and the efforts of those resources whose status in the Islam is especially interesting. The above mentioned arguments show that the fundamental commitments of the Islamic finances does not guarantee harmonization with the interests of the financiers and the entrepreneurs, effective control of microeconomics level, nor efficient allocation of the resources.

4. The Islamic concept and the economic stability

The dominantly proprietorial character of investment which promotes the Islamic concept, but also the debt forms of financing related to specific assets are credited for certain advantages that this concept has when it comes to stability as a quality parameter of the financial system. The arrangements which are derived from the theoretical ideal ensure compliance deadline between the deadline of the available resources and the deadline of tying funds where the liquidity risk is almost excluded. The outflow of the money arising in respect of the ownership financing, appears in the form of profit participation, so therefore the scope of this outflow is directly determined by the gained profit. The outflow from the withdrawal of the role of the financier is excluded and it cannot be the cause but merely a consequence of liquidation of the project. However the specific provisions allow the financier to demand payment of their part with collateral if is established that the entrepreneur does not use the funds in accordance with the contract. However, the main disadvantages of the Islamic concept reveal the problems that will be shown in practice. It is not clear to what extent are neglected the key arrangements that are a consequence of the low interest of the financiers and to what extent they do not match to the entrepreneurs. Certainly in the research are covered also the preferences of the bank customers where it is proven that the problem exists also on the demand side.

At the agent arrangement the problem is in selecting the right projects for financing, but the problem occurs also in the increased propensity to risk that occurs with entrepreneurs whose funded project is extremely intense, which is seen as crucial, that this arrangement remained at the level of theoretical speculation without almost any use. As reason here could be mentioned the declining interest of the financiers.

Characteristic of the joint venture arrangements is that in once established key for distribution cannot be changed until the full project implementation and excludes the reinvestment in the profits as a potentially significant source of financing especially for younger companies. For the same reason, any additional investments in the project are not feasible.

Therefore the initially established financial structure remains in force until the completion of the project. The inflexibility of the financial structure, especially limits the dynamic, i.e. the development-oriented companies. Certain modifications towards the gradual redemption of the participation of the financiers by the entrepreneurs, reduces these problems, but also will be missing the fundamental benefits that come from the permanent character of the investment, because the position of the financiers would gain a characteristic of claim, if the redemption is made mandatory for the entrepreneurs or if defined as his right, would be damaged the interests of the financier because he would have been forced to leave the profitable project.

A special aspect of the problem of the economic stability is derived from the financial stability of the Islamic banks. The Islamic banks differ from conventional in the manner of obtaining the funds. The Islamic concept introduces a specific innovation so called "the Investment deposit". The saving of customers are invested in halal businesses and the profit earned by the bank is distributed between parties according to agreed proportionate of the contract (Langah 2009). Thus, the bank plays middleman role in consumer finances; bank buys assets from halal commodity market and hand over to customers, the customers only invest the labour on this assets then the profit and loss will be distributed between parties on agreed terms and conditions (Langah 2009).

In the theoretical models of banks, the depositors do not have competence nor interest which would be sufficient so that they can more actively get involved in the analysis of economic projects and they transfer this task to the bank. The bank is an investor who specializes in selecting projects for financing. In order to attract funds from individuals who were unable to have insight into the way the bank invests their money, they need to offer a contract which guarantees the right to privileged right of favored role in a moment (often with an additional explicit guarantee of collectability). If these factors are ignored the Islamic concept represents the idea that the investor and the bank's partnership share the risk and the yield of the financed projects, and in this case the conceptual deficiency, suggests confusion in the practical implementation. For example, in Turkey the investment deposits enjoy the treatment of equity investments in applied policy of mandatory reserves in the liquidity and therefore are exception in the calculation of the base, although if as investor appears an individual, they are fully covered by an explicit deposit insurance, which means that in this case they enjoy a treatment of deposit as specific liabilities of the bank.

The two main outcomes of efficiency and thereby the stability of the bank are diversification (the sources and the placements) and the superior expertise in the assessment of the creditworthiness of the projects. Beyond the credit mediation these two arguments come into conflict with one another. Otherwise the high degree of diversification cannot be provided if the financier is expected to continuously monitor and participate in the project management. Another aspect of the Islamic concept that is very important for the implication of the economic stability is the negative attitude towards the interest in the financing of the entrepreneurial ventures, where the Islam expands also to the interests of the financial instruments of the public debt. The attitude of the public debt is that feature for which can easily agree the theorists of the western way of working.

In the theory of the financial market is known that the characteristic of adjustment of the interest rates on private and public debt through so-called arbitration relation, the interest rate of the public debt raises the interest rate that the private sector must pay. Only on the basis of variable relationships can be concluded that the irresponsible behavior of the modern states can be one of the main generators of high interest rates. Due to the over-dimensional public spending, the private manufacturing sector is leading to an unfavorable position, either by direct tax liabilities, with pressing out of the financial market through the variable mechanism or distortion of the monetary and even the political stability.

In order to fully realize this problem in the analysis should be included the monetary policy. The expansionary monetary policy, for example, through the operation of an open market has stabilized the price of the deficient budget financing, but as a consequence creates inflation whereupon the monetary intervention in the market of the public debt sometimes gets such proportions so that the question arises whether this way only covers the increased monetization of the public debt. This problem can be reduced if the state is financed beyond the national borders, but then the problem just changes the shape and often gets far larger scale. For example, due to irresponsible fiscal policy, Greece in 2011 based on interest paid around 30% of its total public revenues and led to question its economics and political independence. Due to inefficient control, the authorities of the state in development are still vulnerable to this problem.

Conclusion

The Islamic financial system is based on the principle that prohibits the interest or the interest payment in any form, the obligation of sharing the profit or the loss. Also, this system prohibits earnings without taking risks and investing in pornography, alcohol, gambling and investing in the production of weapons.

Today over 200 different Islamic financial institutions operate worldwide such as, commercial banks, investment banks, in over 50 different countries. This is more prevalent in the Middle East, Africa and Southeast Asia. The largest bank, which operates on this system, is "Al Rajhi Banking & Investment Corp.", with headquarters in Saudi Arabia. Right next to it is "Albaraka & the International Investor Dar-Al- Maal-Al-Islami", based in Geneva, and "Kuwait Finance House" and "Qatar International Islamic Bank".

Given that Islamic banks, invest their assets in the production and trade of material goods is given opportunity primarily to the poor citizens to ensure their existence, and consequently is enabling the economic development in a country level, especially in countries such as Macedonia, where there is a huge gap between the elite and the lowest stratum of society.

The Macedonian legislation does not allow such operations and it is guided by the Western experiences. In this type of banking, basis is the equality and the interest is prohibited. Otherwise, it would not have been respected the equality. Our law does not allow this kind of banking, but is based on conventional banking. In the Islamic banking the equality is the basis; this operating system is stable and does not allow the existence of debtors.

In the world today there are more than 200 different Islamic financial institutions, investment banks and financial and insurance companies in more than 50 countries on all five continents.

The division of profit and loss between the bank and the client, which are seen as partners who cooperate, is one more fundamental principle of the Islamic banks. A survey by the German Institute Stresemann, published in July 2013, concluded that "the Islamic financing" in the European countries collapsed because the Muslim customers due to their low income, did not have sufficient investing potential. For the experts from the ethics committee, which should monitor the Islamic banking, this research shows that are not professional enough, and that they represent too many different points of view.

The experts believe that the reason for the previous failures of the Islamic financial products is primarily due to poor marketing strategy. While, in the Muslim countries, the majority of the population still uses more the conventional banks.

However, IBs are not able to play a leading role in revamping and driving the conventional banking.

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