

Successful Development of Islamic Banks*

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The Islamic banking system is currently spreading fast through many Arab and Muslim countries. The success of this new system is indicated by the rapid growth in number of banks, branches, accounts, and sums of money it handles. This enormous success has caused some Western style commercial banks, in Sudan for example, to consider changing to the Islamic banking system. It is also drawing the attention of the governments of some Muslim countries to seriously supporting the system.

Although the main reason for these successes is believed to be the Islamic beliefs of the people of these countries, an empirical study conducted with the customers of Faisal Islamic Bank of Sudan (FIBS) identifies other more important and entirely non-religious factors. Surprisingly these factors not only focus on the reasons for the current success of Islamic banks but also highlight the dangers that future operations of the Islamic banking system might encounter. This paper presents these factors and discusses their managerial implications to the successful development of Islamic banks. A brief summary of the principles and operations of Islamic banks is presented first.

Principles Underlying the Islamic Banking System

It has been explicitly stated in the Qur'an that trading is permitted but that usury is forbidden (2:275 and/or 3:130). These Islamic principles are aimed at the betterment of mankind in all economic and social spheres of life. The following basic rules are outlined:

- (i) Business and trade activities should be undertaken on the basis of fair and legitimate profits.
- (ii) Monopoly, gambling and certain forms of speculation are to be prohibited.
- (iii) Usury and interest (interest being a special type of usury) are to be prohibited for all types of transactions.

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The third is the most fundamental of these principles and is also significant to the operations of the banking system. Many reasons have been advanced as to why usury has been forbidden, but perhaps the most important is the belief that capital should not generate profit unless combined with human effort or unless risk is involved. Interest on loans is thus an inequitable payment since under conditions of uncertainty no borrower can guarantee that enough profit will be made to pay the interest due. Uncertainty about the future therefore makes it unjust to guarantee return on capital or loan and when no human effort has been exerted. Notwithstanding this rationalization, the ultimate reason is that the Quran lays down a clear and unambiguous order against all types of usurious transactions. The reasons presented in the foregoing discussion, therefore, may only be interpreted as illustrating the type of arguments currently advanced.⁽¹⁾

The chief alternative to interest, consistent with the Islamic principles, is the various forms of profit-sharing. This it is believed will bring justice and equitable distribution of the profits as well as sharing of the risks of investment. This principle is followed by all Islamic economic institutions, and forms the basis of the operations of existing Islamic banks.

Business Operations of Islamic Banks

Like any other commercial financial institution, an Islamic bank may be established along the principles of Joint-Stock Companies Act to render services for the purpose of making profit (or any other objective). But its activities should be *consistent* with Islamic principles. In terms of these principles it may perform the following:

- (a) acquire funds from the public,
- (b) render chargeable services, and
- (c) use the acquired funds in profitable activities.

Profits realized from these operations may then be distributed according to predetermined profit-sharing ratios. These activities and the method of profit distribution are briefly described below.

(a) Acquisition of Funds

In addition to the capital provided by share-holders (equity capital) there are a number of methods which a bank may use to secure more capital. Current, saving and deposit account may be used without any interest dealings as explained below:

i. *Current Accounts*: Current accounts may be offered in the conventional Western banking tradition. Customers are supposed to give their explicit approval to the bank to use their funds, without any return. The bank, however, should guarantee payment of these funds on demand.

ii. *Saving Accounts* No return is expected in these accounts and customers may draw their funds anytime without notice. The bank guarantees the return of funds from these accounts on demand. However, since the bank can only keep part of these funds in cash to meet demands and use the rest in other activities, it may also render this service without charge.

(1) Those who may be interested to read more about Islamic Principles underlying the prohibition of interest may refer to S.A. Maududi, Sud Islamic Publications Ltd., Lahore, 1961.

iii. Deposit or Investment Accounts : These accounts reflect a departure from the conventional banking system. Customers will be encouraged to deposit their funds in investment accounts on the basis of a predetermined profit-sharing ratio for a specified minimum period. The profit-sharing ratio is usually predetermined according to the nature of the deposit account, whether the distribution of profits is considered on a short or long-term basis. The long-term deposit accounts usually have a higher profit-sharing ratio because they are more stable and the bank may use the funds for long-term investments. Although depositors (of short or long-term) can demand their funds whenever they like, to share in the profits (or losses), they must keep their money in the bank at least for the contracted period. So, for example, no profit-share would be given for a six month deposit account if the depositor withdraws the fund after only five months. This feature exposes the bank to even higher liquidity risk if losses are expected, and to alleviate this risk the bank may require that notices be given before withdrawals are allowed.

(b) Chargeable Services

These are services which the bank could render on fee, commission or fixed charges which are not tantamount to interest charges. These include:

1. Safeguarding jewelry and other valuables.
2. Transferring funds.
3. Acting on behalf of clients to purchase or deliver goods.
4. Offering advice and consultancy services.

These constitute the least profitable kind of investment and will require cash and other liquid holdings (e.g. balances with clients and other banks). These holdings henceforth, are referred to as "funds for bank services".

(c) Profitable Business

A bank's real investment activities constitute the main source of its profits. There are three kinds of short-term investments which are usually of medium return and risk:

1. Investments on commodities and stocks not subject to monopoly speculation or any of the forbidden kinds of investment.
2. Financing to customers on a participation or profit-sharing basis. Profit-sharing ratios are usually contractually predetermined, and the higher portion of return goes to the partner who undertakes management of the business.
3. Long-term investments are usually the bank's own projects or other long-term joint projects undertaken with individuals or other financial institutions. These require enormous funds and may be the most profitable, greater risk is also involved.

To guard against any hidden form of interest or other unlawful transactions, in any type of business mentioned above, Islamic banks may establish supervisory banks to ensure conformity with principles of Islamic *Shari'ah* (as is the case with FIBS and other Islamic banks).

Subjective Reasons for the Success of Islamic Banks

The Islamic banking system is argued to be ideal for all Muslim believers. It is claimed that the funds of those who might not want to support the interest banking system are brought to Islamic banks. Those who deal with interest banks, mainly by having current accounts, are forced to do so in the absence of an Islamic banking system. Once the system has been founded most of these funds are believed to have moved to Islamic banks. These reasons were claimed to explain the inherent success of Islamic banks.⁽²⁾

These ideological reasons might have been the ultimate cause for the success of the system in its early days. That line of argument is unlikely to be the main reason since the system has expanded and Islamic banks have come into competition with each other. Muslims who supported the system at the beginning must have formed some expectations, meeting of those expectations could be a strong reason for their continuing support of the system. Similarly, fulfilling the objectives of profit maximization may also be a strong reason that attracts funds to Islamic banks. A closer look into the objectives of bank dealing is therefore necessary.

In a research study⁽³⁾ undertaken by this writer it was found that fulfillment of specific objectives are the main reasons for the success of Islamic banks. These objectives and their managerial implications are discussed in the rest of this paper.

Reasons for Success of Islamic Banks

An empirical survey was conducted on customers of Faisal Islamic Bank of Sudan (FIBS). A special questionnaire designed to determine the factors that affect supply of funds of Islamic banks was distributed to 1200 customers and 496 (41%) replies were obtained. Summary results from the survey reveal that fast flow of funds to Islamic banks leading ultimately to their success is mainly caused by four factors. These factors are connected with the ideological factors presented above.

It is identified that funds supplied to current and saving accounts are mainly determined by volume of bank services and volume of funds that the bank invested on a participation basis. Funds supplied to deposit and investment accounts, on the other hand, are affected by expected return to depositors and level of risk involved. Return to depositors are of course determined by the profitability of the bank and the predetermined profit-sharing ratio. These findings reveal that the effective reasons for the success of Islamic banks are:

1. High and efficient bank services.
2. Cheap and less risky advances on a participation basis.
3. Higher return to customers on their investments.
4. Low risk in returns.

These factors seem similar to the usual expectations of any bank's customers.

The only difference between the two is related to the kind of loans to customers. While interest-based banks offer loans on a fixed return (interest) Islamic banks offer

(2) FIBS conference report August 1979 (in Arabic).

(3) B. Bashir, "Portfolio Management of Islamic Banks", Ph.D. thesis, Department of Account & Financing University of Lancaster, 1982.

funds on participation basis. Although this might be more expensive than the fixed interest (in case of high profitable uses of the loan), it is much safer and less risky than the interest loans. The customers' objectives are similar but the Islamic banks have a better chance of offering higher returns. The fact that they have to invest in real investments gives them the chance of obtaining more profits and hence pay greater returns to their customers. This might be at the cost of higher risk, but the risk can be substantially reduced through diversification. Having these high returns at a reasonably low risk would enable the Islamic bank to generate higher volumes of funds and hence to render more bank services, which will in turn attract more funds.

These factors are found to be the main reason for the success of FIBS, as well as the reason for the foundation of the other (two) Islamic banks in Sudan and the shift of some of the interest-based banks to the Islamic system.

FIBS, for example, is found to offer all kinds of banking services that any other bank is offering. It utilises almost half of the funds it generates in cash and other liquid holdings for bank services. It is also found to offer a large portion (45%) of its total funds as short and medium-term advances on a participation basis. Although these are the lowest or second to lowest profitable investment they enable the bank to use huge volumes of funds and reduce the total risk. In addition to that, the bank manages to earn substantial profits and secure higher returns to depositors compared with those offered by the prevailing rates of interest. For the period 1980-1982, return to depositors were between 14.5%-16.5% which is very high compared with the maximum reported interest rate of 10%. The same advantages are deduced from the existence and the performance of other Islamic banks in other countries (e.g. Egypt, Bahrain and Kuwait).

Successful Development of Islamic Banks

To ensure future success of Islamic banks, they must be well managed to fulfill customer's objectives as identified above. But if achievement of high returns to equity share-holders of the bank is also an important objective (which might well be the case of all Islamic commercial banks), then the customers' objectives contradict or at least conflict with maximization of returns to equity-holders.

To achieve high returns to equity-holders would require more profitable investments (which are long-term investments) and a low profit rate to be offered to depositors. That would imply less banking services and short-term investments and lower returns to depositors. But lower depositor returns will cause the withdrawal of funds and possibly lead to failure of the bank. Thus, an optimal policy must be selected to fulfill the customers requirements, to achieve sufficient returns to equity-holders, and to ensure future successes of the bank. A brief demonstration is given below as to how such optimal policy might be achieved.

From the above discussion, the following three objectives seem to be the most important for any commercial Islamic bank.

1. Maximization of returns to equity share-holders.
2. Achievement of sufficient returns to depositors.
3. Minimization of the bank's risk of loss.

In a special questionnaire designed for the management of FIBS, these objectives are confirmed to be of tantamount importance to its Islamic business operations.

To achieve the first two objectives would require constructing a highly profitable portfolio and an optimal profit-sharing ratio for the distribution of these profits. These seem to be two independent decisions, but they are not. The profit-sharing ratio that will determine the return to depositors, affects the volume of funds to be deposited for investments and hence the bank's capacity of investment. The bank cannot use funds in its current accounts for long term investments. Thus unless there are sufficient funds deposited for investment the bank cannot invest in high profit business and make sufficient profits. Therefore, these two decisions, the optimal portfolio mix and optimal profit-sharing ratio are mutually dependent.

A reasonably low profit-sharing ratio with a highly profitable portfolio or a higher profit-sharing ratio with a less profitable one may sufficiently satisfy the requirements. But the optimal policy might well be in between these two cases. To offer a low profit-sharing ratio with a highly profitable portfolio would require huge investments on long term projects and less in banking services and short-term loan investments. Such a policy might be very risky on the one hand and on the other may reduce the volumes of funds supplied to the current accounts due to reduction in banking services and short-term loan investments. Offering a high profit-sharing ratio and holding a less profitable portfolio may be less risky and could bring huge volumes of funds to the bank (in both current and deposit accounts). But such a less risky portfolio would reduce the profitability of the bank and also the return to equity and deposit holders (equity-holders may be greatly affected). Neither of these two policies fully satisfies the requirements, and an optimal policy has to be found using an optimization technique.

The third objective (risk minimization) stands as a constraint to the achievement of the first two. High profits to satisfy the return objectives can only be achieved at high risk. In the case of Islamic banks, high risk could simply lead to bank failures. This is because depositors can simply withdraw their funds from these investment accounts before losses occur, leaving the bank with the burden of these losses. Most customers will prefer to move their funds to personal use rather than to current or saving accounts if losses are expected. This will subject the Islamic bank to an even greater risk of funds withdrawal which might possibly lead to its failure. In the conventional theory of portfolio selection, risk is usually treated as a constraint to a maximization problem. However, in Islamic banks minimization of risks below certain maximum accepted level is an objective in itself and is to be treated as a third objective rather than a constraint.

Optimal Planning of Islamic Banks

We proposed that the three objectives presented above can be reconstructed in a goal programming technique to solve for the capital policy. The model proposed has an objective function of maximizing the over-achievements of returns to equity and deposit-holders and the under-achievement of risk. To solve for the optimal policy, this objective function is constrained by the management's targets of returns to depositors and equity-holders (to be over-achieved) and the maximum accepted level of risk (to be under-achieved). It would also be constrained by the expected volumes of funds in the different accounts. These in turn would require efficient forecasting models to be built

from the statistical data of the particular bank. If these data inputs can be obtained, then, this suggested optimization model can be constructed simply and the optimal policy easily achieved.

In the research study undertaken, this model is developed⁽⁴⁾ and applied to some statistical data of FIBS. A computer programme (MULTUNCRT), in BASIC to run on Commodore PET machines, was specially designed to find the optimal decision policy. The optimal results obtained from the program runs were compared with the actual performance and some important inferences were made. These findings and their managerial implications are briefly presented below.

1. The results obtained are found to be very close to the actual, indicating that the model is realistic and operational.
2. The priority coefficients of the different objectives are found to be the most important of the model's data inputs, and that the profit-sharing ratio is central to the output. This means that a non-optimal policy might be suggested simply by mis-stating the ranking levels of the three objectives. If the highest priority, for example, is wrongly given to the over-achievement of return to depositors rather than equity holders, then a higher profit-sharing ratio will result and lower returns to equity-holders will occur. Nevertheless, once the optimal policy is reached then any change in profit-sharing ratio might well change its expected outputs. This, however, implies that if the management has to shift from the optimal policy then it is safer to make its changes in decision variables other than the profit-sharing ratio.
3. If shifts from the optimal policy are to occur, then, it is found to be in favour of higher bank services and short-term investments and if necessary also higher profit-sharing ratio (rather than high long-term investments and low profit-sharing ratio). That is to attract more rather than less funds to the bank (specially in the current accounts).

Once the optimal policy is reached, the second and third of these findings has considerable contribution to make to the management of Islamic banks. From the statistical data of FIBS we noticed that the bank's portfolio mix is often changed during the planning period. The second finding clearly states that changes in the profit-sharing ratio should be avoided. It is the most sensitive variable, and changes in it shift the plan from the optimal situation. This leaves the management of the bank with the opportunity of changing its portfolio proportions. The risk factor in this case might prevent any movement toward more long term investments. Thus, the most sensible direction of changes would be toward more bank services and short-term loan investments. This is suggested in finding three and it seems to favour more rather than less funds to be generated in Islamic banks.

(4) The mathematical model is not presented here.

Conclusions

The prohibition of interest under Islamic law is not impeding banks working on Islamic economic principles from flourishing and rapidly developing. The discussion above presented information on the method by which Islamic banks operated. The rest of the paper presents some reasons for the success of Islamic banks and their managerial implications.

Peoples' belief in Islam is acknowledged to be the main reason for the success of the system, but empirical survey reveals that other important reasons exist. Muslim people who supported the system formed expectations and found these expectations fulfilled are identified to have four objectives; (1) high level of banking services, (2) less risky advances, (3) reasonably high returns on investments and (4) low risk of returns. Fulfilling these objectives is the most important way of ensuring the future success of the system (even in non-Muslim countries).

Islamic banks are shown to be capable of fulfilling these objectives. Project financing, which seems to have become an integral feature of Western banking, enables Islamic banks to earn substantial profits and to acquire sufficient returns for its depositors. It is also shown that the Islamic participatory financing method provides relatively low-gear method of obtaining fund for risky projects.

It is further shown that in order to ensure successful development, Islamic banks can be optimally managed in terms of these customer objectives. A goal programming technique to reach such an optimal policy is described and its attributes are presented. These attributes clearly carry strong implications for the management of Islamic banks. The final part of the paper discusses the way in which the result may be utilized by management of Islamic banks.