Recent Developments in Banking Organizations with Special Reference to Islamic Banking and Finance

During the last two decades more than 120 countries of the world have faced some or the other form of banking crises. Many a times these crises were such of large scales that it virtually threatened the international payment system. The governments and monetary authorities, to avert these crises and to stop the contagion, had to intervene but only at the enormous public costs to the national GDP ranging up to 40-45%.

Several studies have been conducted by various world bodies like IMF, World Bank, Bank for International Settlements (BIS) and national institutions apart from various reports and studies by the ailing governments. Many theories have been postulated about the causes and their solutions. However, the situation remained where it had been. The frequency of these crises has been an increasing trend in spite of several measures taken at the national and international levels.

Major theories put forth about the causes of these crises discovered inefficiency, underdeveloped economy and un-regulated capital market as the main causes of the crises. These findings, however, faltered when some of the most efficient, developed and highly regulated capital market countries like US, Japan, Switzerland and Malaysia faced severe banking crises during the recent past. Sometimes countries faced with the crisis were so diversified in their economic strength that it was almost impossible to find a common cause leave alone their solutions.

Muslim economists (mostly called Islamic economists) saw these problems from another angle. Though initially basing their arguments on
religious, moral and ethical considerations, over a period of time, to prove their thesis, they came out strongly with more contemporary experiences. They also tried to seek support in scattered western writings. However, a major support to Islamic economists came in the form of recent financial theories which suggested that the value of a firm is independent of its capital structure. Besides, an earlier incident that gave unprecedented boost to their concept, was the fall of Philips curve that had hypothesized a stable trade off between inflation and unemployment. As Professor Norman of the London School of Economics observed, “The most crucial change that has occurred in my own lifetime about our way of thinking about the working of the macro-economic system was the shift from a belief that the Phillips curve remained downward sloping, even in the longer term, to the belief that it would become vertical”.

Islamic economists, in their diagnosis, attributed major reason of these crises to collateral based fixed pay mechanism (i.e. interest). They tried to prove that it is the ‘interest’ which is at the root of all economic crises. For them, it is the interest that leads to uneven business cycle resulting in boom and recession. It is the interest that, using the tolls of debt and speculation, de-links the financial economy from the real one. It also leads to widening the gap between the rich and the poor bringing social unrest and hatred in the society. Islamic economists’ attack on interest revolved around several aspects:

▪ Theoretical justification of interest as a price for capital.
▪ Moral justification of interest; as all the major religions, philosophers and philanthropists had proscribed or deplored the practices of interest (usury).
▪ Empirical justification; has interest been able to perform its assigned task efficiently, justifiably and led to growth and stability?

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2 A predetermined fixed payment to one of the constituents of the production irrespective of the actual outcome of the business.
Islamic economists point out that all the theories of interest, time preference; liquidity; and abstinence; have failed to justify the existence of interest as price for capital when other factors of production are not assured of their fixed positive return. Another reason deploring the practices of interest is moral which says that it is unjustified when risks of the business are not distributed equally on all the factors of production. Other factors are, in fact, exposed to more risk when one of them is insured. This unnecessarily puts a restriction on entrepreneurial capabilities and innovations, apart from raising the cost of production. Few of the very desirable investments are abandoned only because of not being able to cover the cost of interest. On the other hand, some of the undesirable economic activities, including speculations and gambling are freely undertaken because they carry a high-expected return.

The Islamic economists are more scathing against the empirical justification of interest. How a system can be efficient when the criteria for selecting a project is not based on its merit but on the financial worthiness of the proposer. For Islamic economists, the most efficient way of financial intermediation is that which ensures most efficient distribution of financial resources, according to the merit of the project itself and not the one who proposes it. As far as the stability is concerned Islamic economists argue that interest, debt and speculation together have evolved one of the most vulnerable financial systems where public money to the order of thousands of billion dollars is diverted to maintain the stability. For growth, Islamic economists scoff that an inefficient, unjustified, and unstable system can only create a myth of economic growth.

The present work, ‘Recent Developments in Banking Organizations with Special Reference to Islamic Banking and Finance’ tries to examine and analyze the above-mentioned issues. The basic problem, which has been identified, is to find out the causes of the growing and recurring financial crises and also to analyze the steps taken to avert these crises. One important aspect in this regard is the emergence of Islamic financial institutions during the last
couple of decades. In this study greater emphasis has been given to this aspects of developments not only because this is a new concept but also because of the tremendous attention it has received not only among Muslims but also among the secular, western and other non-Muslim experts. The work proceeds with the following chapterization;

- Chapter One: Modern Banking: A Historical Perspective.
- Chapter Two: Recent Banking Crises, Reforms, and Restructuring Efforts.
- Chapter Three: Bank Reorganization: An Islamic Way.
- Chapter Four: Models of Islamic Banking.
- Chapter Five: Islamic and Conventional Banking: A Comparative Analysis.
- Chapter Six: Problems of Islamic Banking.
- Chapter Seven: The Future of Islamic Banking.

**Chapter One: Modern Banking: A Historical Perspective:**

This chapter briefly describes the history of modern banking. How the modern banking has developed from the practices of moneychangers, goldsmiths, and Lombardy Street to the present day. Discussion starts from the word ‘Bank’ itself and proceeds to a brief historical overview of the modern banking. It has been explored how the modern banking came to evolve in the present form from the Italian moneychangers, ‘argentarry’ and the British goldsmiths.

Subsequently a country-wise discussion of the development of modern banking is taken. The beginning is made from the Italy since it is regarded as the mother of modern banking where during 1270-1584 banking was entirely in the private hand, however, after 1584 effort was made to create public sector bank, which was not encouraging in the beginning. Another country, which has played no less important role in the development of modern banking is Great
Britain. Modern banking in Great Britain began during Elizabethan age when growth of the foreign trade led to influx of gold in the country. These golds were kept at the goldsmiths who started the first practices of deposit banking and loaning. Germany follows a different kind of banking which in present day is often known as the investment banking. Banking developments in Germany are described briefly. In the same order banking developments in France and United States are taken. Among the commonwealth countries banking history of India is taken for some description.

After the country-wise development of modern banking, an important constituent of the modern banking, i.e. Central Bank that had started taking shape during the early years of the twentieth century, is described. By the first half of the twentieth century almost every country had developed a kind of bank with special powers of note issue and as a supervisor of the countries monetary policy. After a brief discussion of the evolution of central banks, some of the later developments in modern banking like regional development, industrial development and International Monetary Fund and the World Bank's brief account is given. Present day modern banking is carried out mostly through Internet known as virtual banking is also included in the chapter. Some important features of the unit and branch banking are also mentioned in the work to highlight the distinguishing feature of the US and the British banking systems.

Chapter Two: Recent Banking Crises, Reforms, and Restructuring Efforts:

The chapter revolves around the basic question of the study. It analyses the recent banking crises in several countries and the steps undertaken to resolve these crises. Chapter starts with genesis of the crises then moves on to measure the costs of the crises in selected countries. This subsection briefly touches upon the recent trends in the financial markets highlighting major
issues related with globalization, innovation, and speculation accompanying large-scale deregulation in financial markets across several countries of Europe, Asia, and America. An effort has been made to analyze the causes of these crises from various viewpoints. Blurring distinction between domestic and foreign market along with voluminous trade in foreign currencies, derivatives, swaps etc. are examined to find out the real causes behind these crises. Certain tables have been given for proper empirical understanding of the issue. International efforts in this direction to resolve the crises in the form of Basle Committee and its recent guidelines in the form of Basle Core Principles for Effective Banking Supervision are mentioned in some detail.

Bank reforms and restructuring undertaken in several countries like Japan, Sweden, United States, Korea, Thailand, Philippines, China, and India have been discussed in some detail. It was found that in all the countries special emphasis was given to higher capital adequacy, prudential regulation and assets classification. It was also found that higher capital is now considered as public good. A major constituent of the present commercial banking i.e. deposits insurance is also critically analyzed. It is also found that deposit insurance, (explicit or implicit) more often, has resulted in moral hazard and increased public cost to maintain the stability of these financial institutions. Some of the recent studies are also cited in the favor. At the end a table comparing the structure of bank income in some western countries along with developing countries is given to highlight that as a country advances towards industrialization its non-interest income in comparison to interest income increases.

Chapter Three: Bank Reorganization: An Islamic Way:

This is another very important chapter as far the basic question of the thesis is concerned. It introduces the Islamic banking into the thesis. Several important aspects related with introduction of Islamic banking are discussed in
detail before describing the evolution and development of Islamic banking. The chapter has been subdivided into theoretical preparation and practical efforts. In the beginning, prohibition of interest is discussed in detail and the reasons that make Islamic economists feel uncomfortable while dealing with interest. Islam and financial intermediation is discussed to find out whether Islamic economists consider it necessary or not. Economic reasons for financial intermediation, not sustained by fixed pay up, are also discussed. In between, some of the distinguishing features of Islamic economics are compared with the conventional economics.

Theoretical preparations of Islamic banking are further subdivided into early writings on Islamic banking which discusses all major writings on the issue. This is accompanied with a table mentioning some of the early efforts. Another subhead of the section is a brief introduction of some of the important seminars, conferences, committee reports and institutional efforts.

The practical efforts in the field of Islamic banking are looked under two broad subheads (1) those Islamic banks established before 1980 and (2) those that were established after 1980s. Some of the earliest and prominent efforts have been specially highlighted. An important aspect, which has been brought to the fore, is India’s contribution in this arena. An attempt has been made in this study to examine this aspect. It, however, appears to have hitherto been ignored by researchers in India.

Some countries have initiated to Islamize their whole economy. This issue is briefly discussed in the chapter apart from introducing some of the topmost Islamic financial institutions of the world. Islamic banking in South Asia along with India is especially examined. Islamic banking practices by Western financial institutions are mentioned at the end of the chapter.
Chapter Four: Models of Islamic Bank:

This chapter is specifically devoted to the models of Islamic banking. Since the Islamic banking models are based on Islamic financing techniques, a detailed description of Islamic financing techniques is given prior to the discussion on Islamic banking models. These financing techniques are grouped under: Contracts of Partnership; Contracts of Exchange; and Contracts of Charity. These contracts are further subdivided for some detail elaboration.

It is contended that the basic idea of Islamic banking is to devise an efficient and equitable system of profit and loss sharing (PLS). Efficiency property derives from its insistence on the linkage between the financial and the real sectors of the economy, while equity property is based on maximizing the rates of return on deposits. Islamic banking, in the sense of its linkage between the financial and the real economy, is contrary to the fixed payoff system of the conventional economy. Therefore, all the banking models devised under Islamic framework are based on PLS principles.

Since the idea of Islamic banking is derived from the Islamic legal concept of Shirkah (partnership) and Mudarabah (profit-sharing), all the major models of Islamic banks revolve around these partnership contracts. Islamic bank mobilizes savings from the public on the basis of Mudarabah and advances it to the entrepreneurs on the same principle. The first and foremost model discussed in the chapter is Mudarabah model propounded by M.N. Siddiqi. Some other models given by Mohammad Baqir al-Sadr, Mohammad Muslehuddin, Abdul Gafoor’s Commercial Banking model and Shaikh Mahmood’s Time Multiple Counter Loan (TMCL) have been discussed in some detail. At the end, some of the more recent and refined models of Islamic banking are briefly described. These models deal with some of the more intricate issues like credit creation, seigniorage and monetary policy etc. At the end some modifications in Siddiqi model are mentioned in the words of Siddiqi himself.
Chapter Five: Islamic and Conventional Banking: A Comparative Analysis:

The financial sector is a major player in modern economies, as a producer of financial services and as an employer. Banking system fulfills essential functions in intermediating between savers and investors. To ensure the proper allocation of financial resources, it is must that the banking system is sound and efficient enough to effectively play this role. Profit-sharing finance synchronizes payment obligations of firms with its revenue accruals, thus removing a great source of instability in the system. Interest based finance subjects the firm to a rigid schedule in which the amounts due for payment as well as the due dates of payment do not take into account the current status of the project. Conventional banking lend money to earn interest while Islamic banks provide finance to share profit. This fundamental difference leads to many other important differences between functioning of the both.

Islamic banks have their own conceptual mainspring, defining objectives, procedures and practices that make distinction with conventional systems of banking. The thrust of the chapter revolves around comparing the Islamic banking vis-à-vis conventional banking from the point of view of efficiency, stability, growth and justice.

At the end, an empirical comparative study of Islamic and conventional banking is presented where it can be noted that Islamic banks have performed better than their counterpart conventional banks (Table No. 5.3). The rate of growth of total equity for Islamic banks, during 1990-97, was substantially higher as compared to the conventional banks. As far as the total investments is concerned Islamic banks leave their counterparts far behind. And almost similar is the scenario for growth in total assets for Islamic as well as conventional banking, where again Islamic banks have maintained their lead by a fair margin.
Chapter Six: Problems of Islamic Banking:

In this chapter, the main focus is on the problems and obstacles that Islamic banks are facing in various ways; ideological, theoretical as well as the practical. These difficulties mainly stem from the circumstances created by their existence in places and regions where they operate in an economic, legal, administrative, cultural and social atmosphere, which is not best suited to them. Islamic banks have been facing a number of problems which can be evaluated on various grounds. Some of the problems faced by Islamic banks stem from the nature of their businesses. Another kind of problems can be evaluated from the point of view of the treatment Islamic banks receive from various governments, Muslims as well as non-Muslims. A set of problems is specifically associated with the institutions concerned. Several problems faced by the Islamic banks have been overcome by their past experience while new problems are still hindering the performance of Islamic banks at various stages. Some of them are related to their internal structure, which has grown unplanned and instantaneous to the demands of the community. Some of the inherent theoretical contradictions still haunt the business of Islamic banks.

Early models of Islamic banks, which were supposed for financial intermediations only, have taken precedence by the Islamic banks engaging themselves in the actual businesses. Since Islamic banks have largely concentrated on actual business, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. Because of the same they are facing problems in financing consumer loans and government deficits. Second, the risks involved in profit sharing seems to be so high that almost all the Islamic banks have resorted to those techniques of financing which bring them a fixed assured return. As a result, there is a lot of genuine criticism that these banks have not abolished interest but they have, in fact, only changed the nomenclature of their transactions. Third, the Islamic banks do not have the legal support of the Central Banks, which seldom have the necessary expertise and trained manpower to appraise, monitor, evaluate
and audit the projects that are financed by the Islamic banks. Various issues are yet to be resolved before Islamic banks could really expand their spheres outside their small religious clientele. Few suggestions are given at the end of the chapter.

**Chapter Seven: The Future of Islamic Banking**

This is the last and concluding chapter of the thesis which deals with the future of banking organizations in general and Islamic banking in particular. It is observed that the present financial system, which is based on fixed pay, is inherently weak in comparison to a system based on equity and partnership. Therefore, the desirable banking form is that where financial intermediation is carried out on equity principles and not on debt which has rendered the present financial system obsolete and vulnerable. It is also observed that Islamic banking is not an insignificant or a temporary phenomenon and that it is here to stay.

In the beginning ‘the overview’ section briefly reviews the Islamic banking development and the factors responsible for it. This is followed by a brief review of the present financial crises under the subhead ‘the fault line’. Some of the western scholars are quoted. The third and fourth subheads of the chapter express that Islamic banking has the potentials to remain viable on its own and there is a large demand for Islamic banking products. And finally, the future of Islamic banking is looked in the light of statements of Islamic as well as conventional economists.

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