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ISLAMIC BANKS AND WEALTH CREATION

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ISRA الأكاديمية العالمية للبحوث الشرعية
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1. INTRODUCTION

One of the primary objectives of the Sharīʿah (famously known as Maqāṣid al-Sharīʿah) is to ensure the preservation and growth of the community's wealth.[1] Since that wealth is an aggregate, it is protected by establishing appropriate rules for its management both at public (such as regulatory and supervisory agencies) and private levels (such as Islamic financial institutions). The protection of the community's wealth as an aggregate depends on the protection of the property and wealth of its particular individuals. In other words, the wealth owned by individuals benefits both its respective owners and the whole community, for its utility is not restricted to the immediate beneficiaries handling it.

Maqāṣid al-Sharīʿah also aims at a fair and equitable distribution of economic resources, wealth and income. Islam discourages concentration of wealth in a few hands; rather, it promotes its circulation among all the sections of society, thus enabling the poor and destitute of the nation to also take benefit from it.[2] Thus it is of the utmost importance for the Islamic banking system to bridge the gap between the rich and the poor by modifying the distribution of wealth and economic resources in favor of the less fortunate.

A study of these issues is important for three reasons. First, it will address wealth creation in the Islamic banking system. Second, it will demonstrate that the Islamic

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[1] The views of jurists such as al-Shāṭibī (no date), Ibn ʿĀshūr (1966) and al-Ghazālī [see Ismail (2010)] are closely related to this case.

[2] Refer to Sūrah al-Ḥashr (59):7; Allah says: "That which Allah give as spoil unto His Messenger from the people of the townships, it is for Allah and His Messenger, and for the near of kin, orphans, the needy and the stranded traveler—this is so that it does not just circulate among those of you who are rich."

economic system ensures fair and equitable distribution of wealth through positive as well as negative measures.[3] Third, it raises the question: Will abolishing the use of the interest rate mean that Islamic banks will be able to distribute income more equitably?

Both the issues of the creation and distribution of wealth will be addressed in this paper. It aims to examine how wealth is created by Islamic banks: how customers as depositors invest their money through the banks; how the banks invest the funds at their disposal; and how economic agents such as individuals, firms and government use these funds. It also examines how this money generates profit, which is then distributed to Islamic banks and depositors, and hence preserves and develops the wealth (*māl*) of economic agents. It also raises the larger question of whether Islamic banks contribute to the well-being of society by focusing on return to depositors and to shareholders.

The remaining discussion of the paper is organized into five sections as follows: Section 2 discusses prior studies. Section 3 describes methods for measuring inequality. Section 4 will produce findings, and Section 5 concludes the discussion.

2. HOW CAN WEALTH BE CREATED IN ISLAMIC BANKS?

A significant development of the present century has been the rapid expansion of Islamic banking in Muslim countries as well as major non-Muslim countries such as the United Kingdom, Australia, and China (especially in Hong Kong). The fundamental departure of Islamic banking from the conventional banking system is the avoidance of *ribā*, which includes interest in general, while promoting profit-loss sharing (PLS) as a viable alternative. PLS would assign the Islamic bank the role of an intermediary. In eschewing interest as their central allocation tool, Islamic banks have developed an impressive range of transactions, primarily based on PLS, that could appeal to a variety of customers. These include two major modes of financing, *muḍārabah and mushārakah*, which the Sharīʿah considers desirable because

[3] The preservation of *māl* is promoted by measures such as *zakāh* and *ṣadaqah*, the laws of inheritance and bequests; the identification of things that threaten *māl*, such as payment of interest; the prohibition of earning wealth by *ḥarām* (unlawful) means; and the prohibition of hoarding.

profit/loss and risk are shared fairly between the contracting parties. As Nik Hassan et al. (2004) highlighted, by offering these modes of financing, the Islamic banking system should promote social and economic justice by creating an environment that promotes cooperation within society. The adoption of PLS modes of financing by Islamic banks acting as intermediaries would lead to fairness by serving the interests of the community as a whole and is expected to promote value creation to depositors and shareholders and, eventually, to the economy as a whole.

Unlike PLS, interest-based instruments are prone to favor the rich and work against the interests of the common people. Banks prefer to loan money to those who have money. When entrepreneurs borrow huge amounts of money from a bank, they utilize depositors' funds for their project. When they earn profit, they will pay nothing to the depositors. Loss, on the other hand, may lead to the bankruptcy of the bank itself, and ultimately depositors will have to bear the whole loss. This is how interest-based systems create inequity and imbalance in the distribution of wealth in the economy. Generally, in PLS, both depositors and entrepreneurs would be willing to share the results of the project in an equitable manner. In case of profit, both will share at pre-agreed ratios, and in the case of loss, all financial loss will be borne by the capital provider (the Islamic bank) while loss of labor is borne by the entrepreneur (*muḍārib*). This would build a link between capital providers and parties that have business skills but lack capital. PLS financing instruments could develop the role of Islamic banks in providing or channeling funds to skilled entrepreneurs in an effort to encourage economic growth.

According to Matthews, Tlemsani and Siddiqui (2004), the Islamic economic principles of sharing risks and rewards, as well as joint involvement in wealth creation through equity financing by investors and entrepreneurs, have the potential to induce creativity and productivity in an economy. In addition, PLS contracts promote fairness and subsequently create value for each of the contracting parties involved. However, experience shows (Abalkhail and Presley, 2000; Ahmed, 2002) that there are some inherent problems (asymmetric information, moral hazard and adverse selection) that might hinder the application of PLS. Despite that, al-Jarhi (1999) proposes that Islamic banking needs to develop an equilibrium combination of mark-up modes and profit-sharing modes of financing.

Based on the above studies, it is understood that the adoption of PLS contracts might lead to value creation for Islamic banks, their shareholders, customers and the economy as a whole. Besides that, it would drive the financial system to a different agenda that would create a balance between material and social objectives in an effort to provide fairness and justice. However, the success of the application of profit-sharing modes in financial systems will depend heavily on the resolution of the imperfections associated with their use.

3. THE ECONOMIC CONTRIBUTION OF ISLAMIC BANKS

From the above discussion, an Islamic bank can act as a partner or as a *muḍārib*. The actual facts show that Islamic banks also act to clear and settle payments; to pool and apportion wealth and channel the flow of funds for the financing of both large-scale and small-scale projects; to transfer economic resources over time, locations, and sectors; to accumulate, process and disseminate information for decision-making purposes; to provide ways of managing uncertainty and controlling risk; and to provide ways of dealing with risk and return issues that arise in financial contracting. These activities will be discussed in the following subsection.

3.1 Law and Finance

Commercial law and finance are primarily concerned with contracts. These contracts are defined—and made more or less effective—by legal rights and enforcement mechanisms. From this perspective, a well functioning legal system (with its origin in the Qur'an and Sunnah) is expected to facilitate the smooth operation of the Islamic banking system. The Sharīʿah law, as mentioned in Ismail and Tohirin (2009), allows the enforcement of contracts, which is intended to produce a better-developed Islamic financial system. The overall level and quality of financial services—as determined by the legal system—can improve the efficient allocation of resources and economic growth. However, some countries might also prefer to choose among the following four legal families descended from Roman law: French, English, German, and Scandinavian.

3.2 Pooling Savings

In the economy, financial capital can be directly or indirectly invested. Financial capital (via savings) can flow to Islamic banks or when the owner himself establishes a *shirkah* (partnership). Savings can come from individuals, institutions and government. This section explains the relationship between savings and investments (via indirect channels) and the important difference between individual savings and aggregate savings.

Individual savings means spending less on consumption than what is available from one’s disposable income. What an individual saves can be held in many ways. It can be deposited in a bank, put into a pension fund, used to buy a business, pay debts, or be kept under the mattress, for example. The common element is the claim on assets that can be used to pay for future consumption. If there is a return on the saving in the form of profit, dividend, rent, or capital gain, there can be a net gain in individual savings and, thus, in individual wealth.

Suppose an individual decides to increase savings by consuming less. His cutback in spending necessarily means a reduction in income to others. They in turn might cut their consumption to match the loss of income, but then others, too, would lose income. Most people do not reduce consumption equal to the loss of income, so there will usually be a net reduction in savings. Thus the net saving may individually decrease more than the original increase, which would result in a decrease in aggregate savings.

Aggregate savings do not increase as a result of individuals acquiring pieces of paper like ringgit *ṣukūk* or stock. That merely swaps one type of financial asset for another without affecting the total. Aggregate savings occur when the nation acquires real domestic assets, such as new housing, new machinery, new factories and offices, additions to a firm's inventory of goods, or new claims on assets overseas. And that is precisely what is meant by investment.

*Aggregate savings equals investment***.** Investment is what provides for growth in aggregate wealth. However, we cannot increase investments without increasing aggregate savings. Therefore, measures taken to increase individual savings will not necessarily increase aggregate savings. This will only happen if individual savings increase investments. If this doesn't happen, they may actually bring down the income of others, and thereby reduce both aggregate savings and investments. For example, if investment increases by RM10 billion, aggregate savings must have increased by RM10 billion. That means the aggregate income must have increased by RM10 billion more than the increase in aggregate consumption.

3.3 Channeling Funds

It is known that investment is the foundation of economic activity in any society. However, not every individual is capable of directly investing his own savings. Accordingly, Islamic banks play an important role by acting as a vehicle to attract the savings of individuals and investing those savings for the benefit of the individual and the society.

Islam clearly encourages investment and spending. Indeed, when Islam imposed *zakāh* it provided an impetus for the investment of wealth; for wealth that sits idle would be exhausted by *zakāh* over a period of time.

The ways in which Islamic banks channel funds may create a closer working relationship between the bank and the fund recipient than the corresponding relationship in conventional financing. The relationship could be that of *rabb al-māl* and *muḍārib*. This form of relationship might affect the screening and monitoring of potential entrepreneurs and the allocation of capital in the economy.

However, the relationship could also be in the form of *murābaḥah* (mark-up financing). The mark-up scheme has similar features to debt contracts and involves similar screening and monitoring processes. Nevertheless, it has several differences that make it uniquely Islamic: (i) it is commodity-based financing, (ii) no penalty (interest) is imposed for past-due payments, (iii) there is no compounding of the interest rate for past-due obligations, (iv) there is no floating interest rate during the whole period of the contract, (v) in case of bankruptcy, only the initial debt (including the mark-up) is recovered.[4] Nevertheless, this mark-up scheme has similar features to 'standard debt contracts' in that it has the advantage of being an optimal contract.

In equity financing, an Islamic bank funds a project totally or in the form of a partnership with an entrepreneur on the basis of profit-and-loss sharing (PLS). Islamic banks may require the entrepreneur to maintain a minimum holding of certain assets relative to the business size, thus keeping its net worth high. When an entrepreneur has a higher stake of his net worth in holding, his tendency to be dishonest will be reduced because he has a lot to lose. Screening and monitoring remind the entrepreneur that he will be held responsible for his actions, and the process also helps Islamic banks predict the expected outcome from the entrepreneur. Thus, the entrepreneur will make management decisions that would bring monetary returns to both partners. As a result, this would enhance the level of investment.

Allocation of capital: Islamic banks can minimize the costs of acquiring and processing information about investments, which are costly for individual savers to attempt to obtain for themselves. The ability to acquire and process information leads to higher economic growth because Islamic banks are capable of allocating funds to the most promising firms. In addition, Islamic banks can stimulate the rate of technological innovation by providing funds to entrepreneurs with the best chances of successfully initiating new goods and production processes. Here, the specialty of the Islamic banks is to manage the deposits and at the same time allocate capital to entrepreneurs.

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[4] Constraints (ii) and (iii) are applied in case the customer is unable to pay.

If the allocation of capital is based on the sharing of risks and profits, then the actual performance of the project, enterprise or the economy as a whole determines the return on capital.[5] Therefore, in this profit-sharing arrangement, capital and profit share are directly linked to productivity. Accordingly, the actual realized return on capital is the price of capital, which will determine how it is allocated.

3.4 Custodian, Payment System Access and Accounting

In Islamic banking operations, the Islamic bank has the authority to use deposits in savings and current accounts and gives a guarantee to return the deposit to the depositor upon request. Depositors will periodically obtain a share of the profits earned by the bank when it utilizes their money to invest in business ventures. The portion of profit to be shared is at the absolute discretion of the bank. This arrangement is based on the Islamic principle of *al-wadīʿah (yad al-ḍamān)*, i.e., guaranteed safe custody, in which Islamic banks, acting as custodians, guarantee the safety of deposits without guaranteeing any return on them.

At the retail level, most transactions use cash in the form of notes and coins. However, checks and plastic cards dominate in volume because they are typically used for more expensive purchases. Islamic banks can provide access to payment systems such as cash payments, payments by check, Giro payments and plastic cards like charge cards, credit cards, and debit cards. However, Islamic banks also transfer a large volume of funds electronically using various systems like EFPOST, CHIPS and the Automated Clearing House.

Islamic banks also play a role in providing maintenance services of the books and records of fund management companies so as to accurately record the assets, liabilities, income, and expenses of funds in accordance with International Accounting Standards (IAS) or US Generally Accepted Accounting Principles (GAAP), and the guidelines of the Securities Commission as well as of local regulatory bodies, which

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[5] Elsewhere it is called Profit-Loss Sharing. Return is based on real performance of the project, i.e., *ex-post facto*, and is not a pre-determined rate or amount for one party.

may issue accounting guidelines from time to time. The investment portfolio may contain a variety of instruments (both OTC and exchange traded). The result of corporate actions (e.g., dividends, stock splits, etc.) will be reflected in the books and records of the funds. Periodically (usually on the valuation date), the portfolio is marked-to-market and, if appropriate, adjusted for foreign exchange in order to provide the basis for issuing a number of accounting statements, the most important being the calculation of the Net Asset Value (NAV).

3.5 Information Disclosure

Information disclosed through Islamic banks' annual reports are a primary source of public information. In the absence of trust in the ability of Islamic banks to invest efficiently and in full compliance with the Sharīʿah, many individuals may refrain from investing through Islamic banks. One of the prerequisites for the development of such trust is the availability of information that assures the investing public of the ability of Islamic banks to achieve their objectives. Among the important sources of such information are the financial reports of Islamic banks, which are prepared in accordance with the standards applicable to them.

The financial reports need to be submitted on a periodical basis to regulators. Such a report covers the Islamic bank's financial position, the results of its operations and cash flows. The information in such reports assists an Islamic bank's management in directing their available economic resources. Accordingly, it facilitates management efforts in planning, directing and supervising the Islamic banks' activities. It also facilitates the roles of regulators responsible for supervising the economy and the stability of the banking system, and for collecting tax and *zakāh* based on the financial information it contains.

Agency relationships: Agency problems as a result of separation of ownership and control are an established aspect of agency theory, which examines the relationship among the contracting agents. In this case, the agent and principals are bonded through contracts. Agents are expected to fulfill their obligations in the best interests of the owner as principal. However, conflicts are likely, as agents and individuals may have their own ideas for maximising funds that may not be what is required in the contracts. Therefore, Islamic banks need a proper procedure to monitor such opportunistic behavior. Disclosures are an important mechanism for monitoring and mitigating agency problems and enhancing agency relationships in contracts.[6]

The contracting agents also create asymmetric information. Unequal access to information may occur among the agents. The application of contracts between shareholders–managers, *ṣukūk*-holders–shareholders, buyers–sellers and employer–employee could result in unequal access to information due to conflict of interests. This may impact management incentives to make disclosure decisions.

Information advantageous to one party may have negative consequences to other parties. For example:

> *Ibn ‘Abbas (may Allah be pleased with him and his father) quoted Allah's Messenger (peace be upon him) as saying, "He who buys grain should not sell it until he has taken possession of it." Ibn ‘Abbas said, "I think it applies to all other things as well."*

The *ḥadīth* is relevant to the imperfect market, in which uncertainty is created when an Islamic bank, for example, sells a house without taking possession of it. This can put the buyer at a disadvantage since he cannot tell who owns the house.

4. WEALTH CREATION

Islamic banks play a valuable and integral part in the development of the national economy. By focusing on sustainable economic wealth, Islamic banks can economically empower employees, shareholders and business partners, and can also contribute to the sustainability of state treasuries and a diverse spectrum of important social development projects. In essence, Islamic banks are able to generate

[6] Other mechanisms such as governance and regulation can also be used to monitor the contracting parties.

employment and to increase the shareholder's and entrepreneur's wealth. The economic contribution of Islamic banks can be seen by looking at the following example.

As reported in Table 1, during our financial year to 31 December 2008, Islamic bank A created wealth of RM20.2 billion, an increase of 14% on the wealth created during the 2007 financial year. While much of wealth generation benefits the employees, shareholders, customers, suppliers and government treasuries, Islamic banks remain focused on contributing to the socioeconomic development of the communities.

Islamic Bank A recognizes and accepts the responsibility to contribute (via *zakāh*) to the broader socioeconomic goals of poverty relief, improved health, better education and general social development, especially in poor communities. Such bank-led initiatives encourage economic development, strengthen civil society and promote the development of democracy.

The benefits of Islamic Bank A's involvement include transferring technology, expanding financial services and providing capital in the countries in which Islamic Bank A operates. These benefits support growth and development.

The primary challenge for Islamic Bank A is to operate successfully in an increasingly globalised environment. At the same time, business is required to go beyond narrow financial considerations and to balance the social, environmental and economic demands of its stakeholders. Islamic Bank A's contribution to the economies in which it operates should be seen in this context.

4.1 Benefiting Employees, Customers and Communities

Islamic Bank A, as shown in Table 1, paid the employees RM8.5 billion during 2008. The amount paid in 2007 was RM7.6 billion. A conservative economic estimate indicates that the number of people who directly depend on Islamic Bank A for their livelihood has increased. Customers received an amount of RM31.2 billion during 2008. It contributed a substantial amount to their wealth.

Furthermore, Islamic Bank A contributes to the economy by providing affordable, effective banking and financial services to diverse individuals and organizations; contributing over RM2.9 billion to the government in the form of taxes in 2008; and promoting economic stability and convenience to local communities through extensive branch networks.

4.2 Islamic Banks and Value-Added Wealth

Value-added wealth is the wealth created by Islamic banks through the provision of banking and other financial services. The Islamic banks' returns in fee-based income have been included in profit, commission and other revenues.

Islamic Bank A also met its primary financial objectives of strong value-added growth. This increased from RM17.6 billion in 2007 to RM20.2 billion in 2008. As a result, the distribution of wealth to employees, government and shareholders increased from RM7.6 billion, RM2.8 billion, and RM1.9 billion, respectively, in 2007 to RM8.5 billion, RM2.9 billion and RM2.3 billion in 2008. At the same time, the retained earnings also increased from RM5.5 billion in 2007 to RM6.5 billion in 2008. The figures above show a significant contribution by Islamic Bank A to the economy during the period of 2004-2008. On the average, as shown in Diagram 1, the employees, government, shareholders (all are economic agents) and **retentions** received about 44.2%, 15.2%, 10.2% and 30.4%, respectively, of the total wealth.

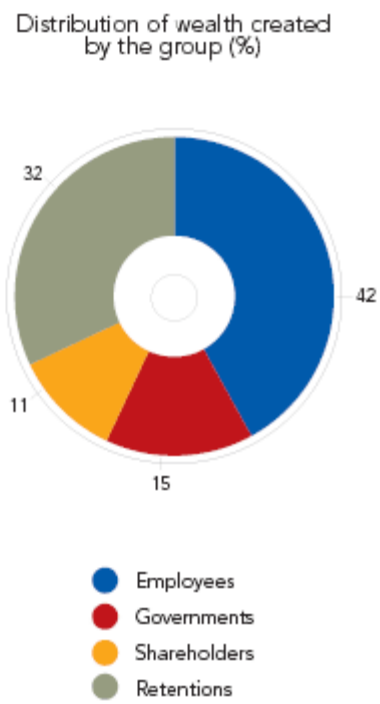
Table 1: Financial Summary of Islamic Banks: Bank A, as an Example

	2008 RM'000	%	2007 RM'000	%
Value added				
Profit, commissions and other revenues	51 391		50 368	
Profit paid to depositors and cost of other services	31 191		32 704	
Wealth created	20 200		17 664	
Distribution of wealth, employees' salaries and other benefits	8 499	42	7 581	43
Governments	2 914	15	2 770	16
Shareholders	2 277	11	1 857	10
Dividends paid to shareholders	2 150		1 753	
Earnings attributable to outside and preference shareholders	127		104	
Retentions to support future business growth	6 510	32	5 456	31
Retained surplus	5 591		4 625	
Depreciation and amortization	919		831	
Wealth distributed	20 200	100	17 664	100

Wealth distribution over five years (%)

	2008	2007	2006	2005	2004
Employees	42	43	46	44	46
Government	15	16	16	15	14
Shareholders	11	10	10	10	10
Retentions	32	31	28	31	30

Diagram 1: Distribution of Wealth to Economic Agents



5. CONCLUSIONS

The role of Islamic banks includes: to clear and settle payments; to aggregate (pool) and disaggregate wealth and allow the flow of funds so that both large-scale and small-scale projects can be financed; to transfer economic resources over time, locations and sectors; to accumulate, process and disseminate information for decision-making purposes; to provide ways for managing uncertainty and controlling risk; and to provide ways for dealing with risk and return issues that arise in financial contracting. These roles can be performed by offering financial transactions, pooling savings and channeling funds. By performing these roles, Islamic banks play a valuable and integral part in the development of the national economy by creating wealth for individuals and the community. Therefore, there are a number of suggestions for future research. First, the adoption of PLS modes of financing by Islamic banks as intermediaries would lead to fairness by serving the interests of the community as a whole, and it is expected to promote value creation to the depositors, shareholders and, eventually, to the economy. Could a higher proportion of PLS ventures create a better distribution? Second, regulation, for instance, of non-performing financing and investment risk allowance might change the distribution of wealth. Third, financial reporting on a contractual basis might produce a more transparent distribution of wealth.

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