

Title: Islamic Finance Needs a New Paradigm. By Dr Saad Al-Harran (February 1996).

Título: Necesidades Financieras Islámicas, un Nuevo Paradigma. Por Dr. Saad Al-Harran (febrero 1996).

Note: This article details the argument that the world economy is undergoing rapid financial revolution, dominated by the stock market rather than productive investment in agriculture and manufacturing activities. This has led to an increase in the rates of unemployment in the Western world, and is inflicting its social consequences Western societies. In these economies (and through the speculation in the stock market), the elite in the corporate sector have suddenly become richer through gambling in order to acquire quick profits. If the culture of speculation and manipulation dominates over physical labour and hard work, then the West is in a real crisis; not only economically and financially but socially as well.

The article suggests that the same situation will apply to the property market and the experience in South East Asia, and needs to be examined carefully. A large number of financial institutions are providing credit to the developers while at the same time these organisations are investing in the property market. It puts forward the notion that free trade is myth and an illusion in the mind of the developing world, as their economies are controlled by multinational corporations (MNCs). The article deals with the question: Is there a way out? Can Islamic finance, with a new paradigm, be an alternative?

We would like to thank the Islamic Microfinance Website for the use of this article. For more information, please visit www.islamic-microfinance.com.

Nota: Este artículo desarrolla el argumento de que la economía mundial está experimentando una rápida revolución financiera, dominada por la bolsa de valores en vez de la inversión productiva en la agricultura y en las actividades manufactureras. Esto ha llevado a un incremento en los índices de desempleo en el mundo occidental y está teniendo consecuencias sociales en sus sociedades. En estas economías (y a través de la especulación en el mercado de valores), las élites en el sector corporativo se ha vuelto de pronto más ricas a través de apuestas para adquirir ganancias rápidas. Si la cultura de especulación y manipulación domina sobre el trabajo físico y duro, entonces Occidente está en una crisis real; no sólo económica y financieramente, sino socialmente también.

El artículo sugiere que la misma situación será aplicable al mercado de la propiedad y a la experiencia del sudeste asiático, y necesita ser examinado detenidamente. Un gran número de instituciones financieras se encuentran otorgando créditos a quienes compran para vender inmuebles mientras que al mismo tiempo dichas organizaciones están invirtiendo en el mercado de la propiedad. Desarrolla la noción de que el libre comercio es un mito y una ilusión en los ojos del mundo desarrollado, ya que sus compañías son controladas por corporaciones multinacionales (CMNs). El artículo se hace la pregunta: ¿Existe una salida? ¿Puede el financiamiento islámico, con un nuevo paradigma, ser una alternativa?

Quisiéramos agradecer al Sitio de Internet del Micro-Financiamiento Islámico por el uso de este artículo. Para más información, favor de visitar: www.islamic-microfinance.com.

Keywords: Islamic, musharakah, partnership, multinational corporations (MNCs), banks.

Palabras clave: Islámico, musharakah, asociación, corporaciones multinacionales CMNs, bancos.

Countries: Sudan, Malaysia.

Países: Sudán, Malasia.

ISLAMIC FINANCE NEEDS A NEW PARADIGM

Dr Saad Al-Harran

Dr. Al Harran is an international Business Consultant.
He is the Managing Director of Global Horizon Limited, a New Zealand-based company.

[More About the Author](#)

Contact : Fax: +64 3 3831451

Email: salharran@hotmail.com

The contemporary financial system is fragile, and retail investors are worried about the future. Their worries are justifiable due to various factors, mainly because the world financial markets are not solely governed by economic and financial fundamentals, rather on speculation in the stock market and short selling through derivatives.

The Barings fiasco supports the above analysis; in that one broker, Nick Leeson has played an important role in the collapse of the oldest merchant bank in England. The episodes of the Orange Country financial disaster in the United States, and the Mexican peso problems are further evidence pointing to how and why a new breed of high-flying traders can exert the kind of influence that no one would have dared even to suggest ten years ago.

The question to be asked is why investment in the productive sector is declining at the same time when non-productive investment has become the language of operation to most financial institutions (such as investment in the stock market, and property and real estate development). In the United States, the stock market is much more volatile than the economy even under the best of circumstances because only an inordinate minority of people usually participate in the market. It is also true in that country that 50% of total stocks is owned by just 1% of families. The other half is in the hands of pension funds, small businessmen, and professionals, as revealed in Prof. Ravi Batra's book, *Surviving the Great Depression of 1990*.

The above episode will support the argument that the world economy is undergoing rapid financial revolution, dominated by the stock market rather than productive investment in agriculture and manufacturing activities. Such an unhealthy situation has led to an increase on the rates of unemployment in the Western world, and inflicting its social consequences on their own societies. In these economies (and through the speculation in the stock market), the elite in the corporate sector have suddenly become richer through gambling in order to acquire quick profits. If the culture of speculation and manipulation dominates the mind of people rather than physical labour and hard work then indeed the Western world is in a real crisis; not only economically and financially but socially as well.

The same situation will apply to the property market and the experience in the South East Asia region is indeed unique and need to be examined carefully. A large number of financial institutions is providing credit to the developers while at the same time these organisations are investing in the property market.

The primary argument for such investments is the security aspects and the risk aversion. It is also sad to observe that in these economies some of the giant financial institutions have started to use Islamic finance terminology such as Musharakah Financing (Partnership) to justify their main motive in investing in the property market. The main idea behind it is clear (and this no different from the conventional banking system philosophy) profit maximisation to suit the needs of the corporate elite who are keen to control more of the wealth of the nation.

In a recent study published in England on the problem of poverty in the developing world, it was revealed that one over-populated African country's economy is run and controlled by 15 families. These people are controlling the wealth of that country while the masses are suffering from the high cost of living, inflation, and unemployment. The gap between the 'haves' and 'have nots' is widening which will lead to economic and social crises in the economy.

If the above scenario is true, then Professor Ravi Batra is correct in his analysis on the contemporary international financial system. He believes that it is on the brink of collapse and this will come about by the end of 1995. A statement in which he has proclaimed in his article 'World Economic Meltdown Begins' published by *Asian Business* (June 1995). This article should be examined very thoroughly by economists and bankers. His 1978 work, 'The Downfall of Capitalism and Communism' had accurately predicted the collapse of Soviet communism, and forecasted a shakedown for capitalism towards the year 2000 due to its concentration of political power in the former case, and for capitalism, it is due to an extreme concentration of wealth.

Furthermore, the dollar is being hammered at from all sides. From the West, the assault is led by the Deutsche Mark and Swiss Franc. From the East, the Yen is the aggressor and recently, the International Monetary Fund (IMF) criticised the Japanese government's forbearance in allowing its institutions to slowly write off their bad debts and non-performing loans. It warned the

government that this was "potentially disastrous" and could "snowball" to bring about a disastrous crisis. The IMF is correct in showing concern for if the World's biggest banks fold, the repercussions will be felt worldwide.

One may say that free trade is myth and an illusion in the mind of the developing world. Their economies are controlled by multinational corporations (MNCs). A good example is Africa where the masses are suffering from many a dilemma, mainly poverty and unemployment. Professor Batra's assessment is that free trade has already shrunk the purchasing power of pay cheques in the US and is about to hurl the globe into a depression.

The question is: Is there a way out? Can Islamic finance, with a new paradigm, be an alternative? Time and history alone will tell.

CURRENT PRACTICES OF ISLAMIC FINANCE

It is sad to observe that most of the Islamic financial institutions are heavily involved in short-term (Murabahah and Bai Bithaman Ajil) rather than long-term investment (Mudarabah and Musharakah) financing. The former is a sale contract whereas the latter is a financing contract.

From the Islamic point of view, Murabahah contract (which is dominating the current practices of all Islamic financial institutions, with the exception of the Sudanese Islamic Bank that operates on the basis of Mudarabah and Musharakah financing) should be restricted only to cases where Mudarabah and Musharakah are not applicable.

A recent research by the author entitled 'Proposal for an Integrated Marketing Model of Musharakah Financing to Help Disadvantaged Fishing People in Malaysia' was presented in an international workshop '*Islamic Partnership Financing For Small Enterprise*'. It was organised by the Enterprise Development Centre, Cranfield School of Management of England in Egypt on 10-13 July 1995. The author has shown in Table 1 that (for example, Bank Islam Malaysia Bhd (BIMB) Mudarabah financing represented less than 1% throughout the 1985-1991 period with the highest rate at 3.1% in 1984. Similarly, Musharakah financing was at 1.2% in 1994 to 2.2% in 1986. Since then, it has declined to 0.01% in 1991.

Mudarabah and Musharakah financing are not popular with the BIMB due to the following three main reasons.

1. There is a lack of honest and trustworthy entrepreneurs. Some of them did not declare their profits while others did not possess the skill to engage in business
2. There is a lack of medium and long-term funds which is one of the conditions for Mudarabah and Musharakah financing. The major portion of BIMB's funds is in the short-term with the remainder, at best, in the medium term.
3. Long-term financing involves higher risks and there is a lack of qualified personnel to undertake the operation. Subsequently, BIMB is partial towards short-term investment financing. To overcome this problem, the author is suggesting an Islamic investment company is set up as well as an Islamic consultancy house. These companies will firstly identify the potential sectors such as manufacturing, agriculture, services, and small-and medium sized industries. They will then evaluate each project based on its economic and financial viability, and propose it to the bank for funds.

The short-term approach adopted by most Islamic financial institutions by investing in Murabahah and Bai Bithaman Ajil (BBA) has made these institutions face the problems of surplus funds rather than the mobilisation of resources. A research conducted by the *New Horizon* in UK (a magazine which deals with Islamic Banking and Insurance) has shown that by the year 2000, the surplus funds problems facing Islamic financial institutions will be more acute when the total assets of these organisations reach US \$100 billion.

The above scenario supports the argument why these institutions have not really made any developmental impact in the economies where they operate. This has led many Muslims to be unaware how Islamic banking works because these institutions have dealt only with the people in the urban rather than in the rural areas. The only unique exception is the Sudanese Islamic Bank (SIB) which has implemented the Musharakah financing concept to small-time farmers in rural areas of Sudan.

The experience of SIB in Musharakah financing was recently analysed by Professor Malcom Harper of Cranfield School of Management, UK. Entitled '*Musharakah Partnership Financing - An Approach To Venture Capital For Microenterprise*', it discovered that providing a reasonable return for the investment of both parties (the bank and the small farmers) can lead the way to a self-sustaining banking system. Such an experience in terms of its developmental impact has undoubtedly brought some benefits to the rural community in Sudan, especially the women and small farmers.

But the main problems of the Sudanese government are the internal and external factors that will have an adverse effect on the economic and financial situations of the country. Nevertheless, the SIB experience has proven without any doubt that Musharakah financing is applicable and is capable in bringing benefits to the rural community. It proves that more rural development projects based on Musharakah financing need to be financed elsewhere in the Muslim World.

WHY ISLAMIC CREDIT FOR THE GRASS-ROOTS LEVEL

The world economic system has to look for structural changes. A plausible option is Islamic finance to be established at the grass-roots level to achieve long-term goals. Its ultimate objectives include the maximisation of social benefits, as opposed to profit maximisation, through the creation of healthier financial institutions to serve the needs of the masses, rather than just a handful.

However, many question the Islamic bank's ability and willingness to take up the responsibilities of safeguarding humanity from exploitation, unemployment, and the concentration of wealth in the hands of a few. This is particularly so because during the last twenty-five years, Islamic banks (with the exception of SIB) have concentrated their investment portfolios only on short-term financing.

It is the opinion of the author that Islamic finance needs a new paradigm to approach the 21st Century. The main challenges facing Islamic financial institutions are many. Let us highlight a few of them.

A proper utilisation of resources so as to meet the demands of the grass-roots people in the rural areas in the Muslim World. The focus should be directed to the youth that lacks the credit to start his own small business, especially those in Africa and Asia. The poor have the right to get credit so as not to depend totally on the money-lenders and the middleman where the interest rates are exorbitant. Many rural people believe that obtaining credit through the payment of interest is unlawful from the Islamic point of view, and thus, it should be avoided.

In the Islamic belief, every individual has the right to live in dignity and respect so that he is able to pursue his purpose in life as a vicegerent of Allah on earth. Such a guarantee should not only be confined to Muslims; non-Muslims should also be considered. Protecting people from hunger, and ensuring security of life and honour are essential elements of the social order in which man is entitled to in this world.

The Prophet (PBUH) is reported to have said that Fuqr (poverty and destitution) has the propensity to lead one towards Kufr (infidelity and rebellion against religion). The significance between infidelity and poverty, paucity and humiliation, need to be addressed by the policy makers of the Islamic financial institutions to safeguard humanity from exploitation and Kufr. The only way out is through Islamic credit at the grass-roots level to build a solid foundation, rather than a shaky one.

Surely banking for the poor has great potential to alleviate some of their suffering. Undoubtedly, the experience of Grameen Bank (GB) of Bangladesh has shown that credit made available to the poor can generate an increase in the household income easily. The GB has been successful in providing credit for the landless without collateral and retain a repayment record of 98%. Despite the fact that there is a 16% interest imposed by the bank, it has been proven that the trust reposed by the bank in them has not been negligible.

Although, the GB experience has met with some success in terms of empowering the poor through credit, some Islamic bankers have reservations about the mode of the bank's operation. The GB method is based on debt financing; charging interest on money loans is viewed as usury and is strictly forbidden in Al-Quran.

Alternatively, the experience of Sudanese Islamic Bank (SIB) needs to be replicated in view of the relative success it has enjoyed since its inception in 1983. Some of the Islamic financial institutions, which are currently suffering from the problem of surplus funds, need to learn from the SIB experience. The main reason for SIB's success is simple.

The management of the bank has adopted a long-term vision to assist the rural farmers and productive families (defined as the ability and readiness to provide some of the day-to-day needs by applying means of production to raise their standard of subsistence) to improve their standard of living. The uniqueness of the experience is the implementation of Musharakah and Mudarabah financing in the rural areas of Sudan, bringing hope to the people.

In regards to the SIB's productive families programme, it remains as one of the most appropriate interventions that promotes self-sufficiency and initiates various rural/urban socio-economic linkages. The main objective of the productive families is based on the notion that the family is a functional unit in overlapping social networks, the household, and extended units. The family is initially entrusted with the promotion of self-sufficiency which could perpetuate self-reliance. Also it helps to create a new productive sector by transforming the Sudanese family into a productive unit.

One of the modes of financing involves a contract whereby the bank becomes a partner in the clients' business. The bank contributes to the total capital of the new venture as well as the running of the business. Partnership financing can be categorised according to the duration of the project in two forms.

Firstly, short-term partnership contracts of a three-to-twelve month duration usually involve the financing of working capital for one production period.

TABLE 1

BANK ISLAM MALAYSIA BERHAD: MODELS OF FINANCING (% TO TOTAL FINANCING)

YEAR	1984	1985	1986	1987	1988	1989	1990	1991
BBA	49.1	68.4	77.0	78.7	76.0	75.8	70.8	73.7
Murabahah	37.2	22.8	15.5	15.0	18.9	20.9	17.9	13.2
Ijarah	9.3	5.9	4.9	3.4	2.9	3.1	11.2	13.0
Murabahah	3.1	0.9	0.3	0.3	0.3	0.06	0.04	0.04
Musharakah	1.2	2.0	2.2	2.1	1.8	0.01	0.01	0.01
QH	0.1	-	0.1	0.5	0.4	0.06	0.07	0.07
TOTAL (%)	100	100	100	100	100	100	100	100

BBA (Bai Bithaman Ajil) : QH (Qard al-Hassanah)

[Sources: *BIMB Annual Reports, 1984-1991*]

While the other partnership is of a long-term duration involving the financing of capital assets, it is usually for a period of more than one year. It can be continuous or diminishing. A diminishing partnership is one where the bank's share in the partnership diminishes gradually through repayment, leaving the venture to be wholly owned by the client.

Ms. Nawal Adam's (of the Faculty of Economics, University of Gezira, Wad Medani, Sudan) research on five representative cases of partnership financing selected from amongst the bank's productive Families Branch in Wad Medani (based on partnerships with working capital for a period of three months) deserves serious consideration. These cases are SIB's involvement in financing the production of ready-made clothes with a total investment of LS321,017; production of cooking oil with a total investment of LS761,825; production of shoes with a total investment of LS543,880; and the production of ready made clothes with a total investment of LS150,000.

The main reason for the success is close monitoring and follow-ups that have played important roles in solving the partner-client problems in the running of the operations and the marketing of the finished product. The close proximity of the business location to its own enables close supervision by the bank representative and easier contact on the part of the partner. It also facilitates the regular deposit of sales proceeds.

An effective utilisation of the human resources is also important. It is distressing to say that the current Islamic financial institutions have not succeeded in effectively utilising the human resources at the university level to promote the concept of Islamic finance. Due to this crucial factor, many Muslims are still unaware as to how Islamic banking works.

There is an urgent need to utilise the human resources at the university level to educate the public about the importance of the Islamic financial instruments. This will require some budget allocations (from the institutions that are facing the surplus funds problem) for training the university student to be an agent in promoting the Islamic finance instruments. According to the author's experience, the majority of students in any Islamic universities in the south East Asia hails from the rural areas. Hence, they can be trained as to how they can implement Musharakah and Mudarabah financing in their home towns.

The current Islamic financial institutions have a moral responsibility towards financing student projects for entrepreneurial development. The students need to fully understand the significance of our age, and that is the age of information technology, entrepreneurship, and Islamic finance. Islam encourages us to go into the business arena and manage the risk, rather than avoid it. The basic culture of business - sharing the profits and losses - need to be ingrained into the youth's minds. And that culture can only be learnt from real life situations rather than from the classroom.

Finally, the contemporary economic disorder has propelled mankind to live in an age of crisis - political, social, and financial crises. The question is: Is there any way out from this dilemma? The author is of the opinion that Islamic finance can lead, rather than to be led, to save humanity from exploitation, and the concentration of wealth in the hands of a few.

REFERENCES :

1. Al-Harran, S; ' Protection against bad financial deals', New Straits Times (Malaysian Newspaper) Monday, April 10, 1995.
2. Batra, R; *Surviving the Great Depression of 1990*, Simon and Schuster, New York, 1988.
3. New Straits Times, Malaysia, March 1995.
4. Batra, R; 'World Economic Meltdown Begins', *Asian Business*, June 1995. Hong Kong.
5. Bebett, B; ' Japanese Banking System on Verge of bankruptcy', *The National Business Review*, New Zealand, September 8, 1995.
6. Al-Harran, S; 'Proposal for Integrated Marketing Model of Musharakah Financing to Help Disadvantaged Fishing People in Malaysia'; paper presented in an international workshop on '*Islamic Partnership Financing For Small Business*', Egypt, 10-13, July 1995.
7. Sum, W. C; ' Bank Islam Malaysia Performance Evaluation, 1983-93' in AlHarran, S; *Leading Issues in Islamic Banking and Finance*, Pelanduk Publication, Malaysia 1995.
8. Al-Harran, S; 'Use Surplus Islamic Funds for the Benefit of Society', New Straits Times, 1 May, Malaysia, 1995.
9. Harper, M; ' *Musharakah Partnership Financing - An Approach To Venture Capital For Microenterprise*', Small Enterprise Development, Vol. 5, No. 4, England, December 1994.
10. Ahmad, Z; *Islam, Poverty, and Income Distribution*, Islamic Economic Series-15, Foundation, England 1991.
11. Al-Harran, S; *Islamic Finance: Partnership Financing*, Pelanduk Publications, Malaysia 1993.
12. Abdalla, M; ' Partnership Financing For Small Enterprise: Problems and S u g g e s t e d Improvements' paper presented in an international workshop on the *Islamic Partnership Financing For Small Enterprise*, Egypt 10-13 July 1995.
13. Adam, N; ' The Impact of Partnership Financing on Enterprise Development: The Case of the Sudanese Islamic Bank'; paper presented in an international workshop on the *Islamic Partnership Financing For Small Enterprise*, Egypt 10-13 July 1995.
14. Al-Harran, S; ' The New Role of Muslim Business University Students in the Development of Entrepreneurialship and Small and Medium Industries in Malaysia', *Journal of Islamic Economic Studies* (Forthcoming) Islamic Development Bank, Islamic Research and Training Institute, Jeddah, Saudi Arabia, 1995.