IN THE NAME OF
ALLAH, THE BENEFICENT,
THE MERCIFUL

O ye who believe Fear God and give up what remains of your demand for usury if ye are indeed believers. If ye do not, take notice of war from God and His Apostle. But if ye turn back ye shall have your capital sums. Deal not unjustly, And ye shall not be dealt with unjustly.

SURA AL BAQARA II
VERSE 278-279

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### CONTENTS

1. Editor’s Note ................................................................................................................................. 11

2. Examining Theories of Growth and Development and Policy Response based on them from Islamic Perspective
   By Salman Ahmed Shaikh ........................................................................................................... 15

3. Shariah Governance Model (SGM) and its Four Basic Pillars
   By Imran Hussein Minhas ........................................................................................................... 30

   By Dr. Ahmed Saeed, Mohammad Shahid, Quaiser Imtiaz ......................................................... 35

5. Factors that affect the Profitability of the Conventional bank and Shariah Bank in Indonesia
   By Muhamad Nadratuzzaman Hosen ........................................................................................ 55

   By Fadzlan Sufian & Nor Halida Haziaton Mohd Noor ............................................................. 69

7. Sukuk as an alternative avenue for infrastructure development and job creation
   By Oladokum Nafiu, Abdel Ghani Echachabi,
   Mohammad Fany Alfarisi ............................................................................................................ 78

8. Global Financial Crisis and Ethical Concerns in Financial System: Any Lessons from Islamic Finance Services Industry
   By Mobolaji Hakeem Ishola ........................................................................................................ 89

9. Note To Contributors of Articles ............................................................................................. 105

10. Order Form for Subscription/Ad to the Journal ...................................................................... 106
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Editor’s Note

Salman Ahmed Shaikh has authored an article on “Examining Theories of Growth & Development & Policy Response Based on them from Islamic Perspective”. This is based on his study to ascertain whether the role played by IMF and World bank is beneficial to the borrowers and whether their advice to them works to their advantage or only favors the IMF and World Bank.

Their loans are often tied for utilization in some selected countries which deprive the borrowers from shopping in cheap market. They also prescribe such actions like privatization which is against the interest of the borrowing countries. The developed countries indulge in methods which harm the interest of developing countries. They subsidize their agriculture which makes competition with their products a very tough job. In short the loan granted by IMF and World Bank are a trap for developing countries who once they are ensnared, find it impossible to free themselves from their tentacles.

Many African countries availed of these facilities but they are now toiling under the burden of debt and find it difficult to meet the demands of the budget as heavy chunks of revenue go to these institutions on account of interest.

In short none of their activities works to the benefit of the borrowers who only suffer from heavy indebtedness which leaves no margin in budget for development.

Pakistan is under heavy debt of these institutions and its development has immensely suffered and its economy is in a bad shape.

Some countries foresaw the future scenario and avoided falling in their trap. They worked on their own resources and have reached the height of prosperity like China.

The study also presents the difference between capitalism and Islamic system. Capitalist system is based on interest and it believes that enough resources are available and it is only man’s ingenuity which can utilize them by developing technology. In spite of this belief, poverty is still rampant in a greater part of the world because it is not the lack of resources but unequal distribution of wealth and prevalence of interest which causes concentration of wealth in a few hands and ultimately results in wide-spread poverty.

Religion provides a panacea against all these ills as it warns against punishment hereafter for sinful behavior and acts which cause harm to people to provide benefit to a handful of the privileged which is not a righteous action.
Lastly Islamic system has been analyzed to check if it has the capacity to foster growth and development on its own principles.

Islam encourages equity financing in which profit and loss is shared. Finally Islamic system of inheritance prevents concentration of wealth in a few hands.

Zakat acts as a means of prevention of concentration of wealth in a few hands. Thus it performs the equitable distributing function of wealth and creates stability. Islam ensures against exploitation and also discourages imposition of excessive taxes beyond Zakat. Thus Islamic system can redress the malpractices of the capitalist system

This article on “Shariah Governance Model (SGM) and its Four Basic Pillars” by Imran Hussein Minhas defines governance and the adjuncts of good governance. It further elaborates the qualifications of a business to merit the title of corporate governance which is also a term for good governance.

It further goes on to explain the Shariah governance and its various requirements which have to be observed. It also gives a synopsis of phenomenal growth of Islamic banking which works under Shariah system in its entire operations.

The article describes the various organs and personnel of Shariah organization which advise, guide and supervise the functioning of Shariah compliant organizations and check their drifting from Shariah rules and principles. Lastly the article specifies in brief echelons of various Shariah governing hierarchy to be formed and its beneficence.

This study by three authors Dr. Ahmed Saeed, Mohammad Shahid and Qaiser Imtiaz captioned “Bankers Perception and Performance in the Frame of Marketing in the Islamic banking Industry of Pakistan” has been undertaken to find out the bankers’ perception and performance in the matter of marketing ethics in Islamic banking. For this purpose, questionnaires were framed and answers sought from junior officers of Group 1 and senior officers of Group 2 working in Islamic banks which appear under appendix I. Appendix II carries the analysis of the data culled from the answers. The finding is that there is no significant difference between perception of junior and senior officers about the level of satisfaction among the customers in respect of marketing ethics practiced by Islamic banks.

The article has reiterated the significant principles of Shariah which are binding on the Islamic banks. Islam enjoins its adherents to obey the Commandments of God and Traditions of Holy Prophet (p.b.u.h). It is also compulsory for them to comply with the principles of Shariah which cover every aspect of human activity. In the practice of Islamic banking and personal behavior there are definite instructions to be followed. Islam does not recognize differences of status between different categories of employees who must be polite and respectful to one another and those occupying higher positions are not to flaunt authoritarian behavior. The article has quoted a plethora of Islamic injunctions on this subject. All these edicts must be followed.

The aim of this research paper by Muhamad Nadratuzzaman Hosen is to find out, as stated in the caption “Factors that affect the Profitability of the Conventional bank and Shariah Bank in Indonesia”. It says that the banking industry in Indonesia has been developing fast, the number of banks is multiplying and their assets are also growing. It classifies profitability to be basic factor which leads to an all-round
success of the bank; it improves the trust of its clients and consequently attracts more depositors etc. It also opines that the yardstick for assessing the level of profitability is returns on ROA and ROE. The paper also expresses the hope that there is bright future for Islamic Banking in Indonesia as the majority of the population who have also been warned by religious edict (Fatwa) against Riba are enthusiastic to have Islamic banking. The factors that adversely affect profitability inter alia are internal factor (Micro) and external factor (Macro). The paper analyzes these factors and also compares profitability between Islamic Banking and commercial banking to instil competitiveness between them and to foster growth of economic system.

The paper outlines research methodology. The data for research consists of financial reports of Indonesia’s Islamic banking and commercial banking for the period 2002-2010. The analysis has been undertaken using quantitative method. Nine tables showing the details of the research and also the results appear in the article.

The article on “Financial Sector Liberalization, Foreign Banks Entry and Domestic Banks Performance: Malaysia’s Initial Post-Liberalization Experience” is the joint output of Fadzlan Sufian and Nor Halida Haziaton Mohd Noor. Its aim is to find out the effect on Malaysian Banks of entry of foreign banks in the Malaysian market which was permitted by Malaysia due to pressure of developed countries to open home market for foreign players and its obligation under GATS agreement provided by WTO. In the first instance three Middle Eastern Islamic banks were allowed to operate in Malaysia on condition of maintaining paid-up capital of RM 10 M and paying RM 50,000 as license fee. Further in terms of Financial Sector Master Plan issued in 2001 the Central Bank of Malaysia issued licenses to two new Islamic Banks and five Conventional banks of foreign origin. Its also raised foreign equity limit in domestic Islamic investment banks from 40% to 70%.

This permission of foreign participation in the domestic market was expected to bring in some advantages to home banks like more efficiency, stability etc. However this has exposed the local banks to severe competition from foreign banks, while the former are only a small fry in this vast field. This paper therefore to provide empirical proof of the impact of foreign banks entry on the performance of local banks undertakes a study in which a series of parametric and non-parametric invariant tests have been employed.

It presents table I listing the foreign and domestic Islamic banks in Malaysia. It is followed by figure 1 which marks the growth of Islamic banking assets as a percentage of Malaysian banking assets during the period 1996-2007. In 1996 it was 1.2% but in 2007 it rose to 12.00%.

Lastly it illustrates the performance of De NOVO banks relative to incumbent banks in table 2 and the impact of foreign banks on the performance of incumbent banks in table 3.

To arm the Malaysian Islamic banks to face the stiff competition from foreign Islamic banks, Central Bank of Malaysia has encouraged them to open their wholly owned subsidiaries.

This study on “Sukuk as an alternative avenue for infrastructure development and job creation” has been conducted by three Ph.D students viz Oladokum Nafiu, Abdel Ghani Echachabi, Mohammad Fany Alfarisi of the International University of
Malaysia whose aim is to find out the possibilities of utilizing Sukuk methodology for raising funds for building, maintaining and improving infrastructure in Islamic countries. It also proposes to use this method for poverty alleviation through encouraging small business which results in poverty reduction and employment generation. However the renting of stall is a great problem for small business men as the owners claim several years rent as advance which they can ill afford. Therefore it is proposed that the difficulty can be surmounted by using Sukuk for financing small business. Scarcity of funds and huge amount of advance are other difficulties in the way of development of small business while microfinance banks charge heavy interest on loans. In these circumstances the issue of Sukuk can solve the problem.

The paper then gives details of six models of Sukuk based on the different methodologies of business prescribed by Shariah and explains their use through illustrative figures towards the end. The paper has proposed a model based on Ijara, which is represented by a figure followed by explanatory notes for its understanding and utilization.

In conclusion, the paper asserts that the proposed model will foster growth of small business as they will be rid of the exploitative demand of advance for a stall.

The article on “Global Financial Crisis and Ethical Concerns in Financial System: Any Lessons from Islamic Finance Services Industry” By Mobolaji Hakeem Ishola has analyzed the causes of the recent worldwide financial crisis which in a nutshell appears to be due to malpractices in which the conventional banks indulge in there operation with only one aim to earn profit without the least concern for morality and ethics. In the literature several other causes have also been identified for the frequent visitation of these financial crises for the last three centuries culminating in the recent recession which played havoc with all economies of the world and the Govts of the countries had to inject huge amounts as bailout packages to save the economy from total collapse. To be specific financial greed speculation and interest based system are the causes for eruption of this tragedy (Chapra) and according to Hasan non-observance of moral and ethical norms lead to frequency of these crises.

However the Islamic banking system was the least affected by this crisis as Islam strictly bans interest and other immoral and unethetical activities. Thus exploitation is reined which insulates the system against the onslaught of such storms.

The article concludes that the conventional banking should learn from the Islamic banks the advantages of moral and ethical behavior in business to avoid future turmoil in their system.

The Islamic banking can also learn innovation from the conventional banking.

Disclaimer

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We invite our readers not to hesitate in communicating to us their opinion which will be welcomed. This will help us in improving the standard of the Journal.
Examining Theories of Growth & Development & Policy Response Based On Them From Islamic Perspective

By Salman Ahmed Shaikh*

Abstract
Poverty and inequality around the world has been rising over the last three decades and the attainment of the Millennium Development Goals (MDGs) seems a far fetched goal. In explaining underdevelopment, Classical Economics has offered many theories and models including but not limited to Rostow’s Stages of Growth Theory, Harrod-Domar Model, Solow’s Growth Model, Dependency Theory, Lewis Two Sector Model, Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis etc. This study analyzes the theories of development proposed in classical literature in the light of Islamic Economics and investigates whether policy response influenced by some of these theories had been effective or not in selected countries and regions. In light of recent developments in growth literature, the last section of the paper also analyzes whether Islamic economics principles have the capacity to ensure that determinants of growth suggested by ‘new growth theory’ will exist in an Islamic economy and together with these, do Islamic economic principles have other distinctive mechanisms and institutions that can help in the development process.

Keywords: Interest free economy, Public finance, Taxation, Inequality, Income redistribution, Islamic economic system, fiscal policy, deficit financing.

JEL-Codes: L38, I31, O10

1. Introduction
The major problems in economic development of any country include poverty, inequality and unemployment. All other problems are more or less a result, or a

* Mr. Salman Ahmed Shaikh is a researcher in Islamic Economics & pursuing PhD in Economics from IBA. He has authored 20 papers on Islamic Economics and has authored “Proposal for a New Economic Framework Based on Islamic Principles.” (salmanahmed_hyd@hotmail.com)
symptom of these three problems. Problems like violence and political turmoil that on the surface seem unrelated to economics are also caused by poverty, inequality and unemployment.

When one looks at recent development statistics, a very dismal picture appears. In 2001, there were 1.1 billion people living in poverty. But in Africa, the number of people in extreme poverty rose to 313 million. As people living in extreme poverty increased in number in Africa, they also became poorer. The average daily income or consumption of those living on less than $1 a day declined from 64 cents in 1981 to 60 cents in 2001. In the rest of the developing regions, it inclined from 72 cents to 83 cents. In Africa, the median share of income going to the poorest 20 percent of the population is 4.9 percent, almost 2 percent points less than in other developing regions. Only in Latin America and the Caribbean, do the poorest 20 percent fare worse. (Source: UN Development Research Group). Therefore, the question is that how the broad based development would be achieved let alone reducing fiscal deficits as faced by most developing countries at the moment.

In mainstream development economics literature, several theories and models have been proposed in explaining the multidimensional problem of poverty and underdevelopment. These include Rostow’s Stages of Growth Theory, Harrod-Domar Model, Solow’s Growth Model, Dependency Theory, Lewis Two Sector Model, Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis etc.

In this backdrop, this study analyzes the theories of development proposed in classical literature in the light of Islamic Economics and also analyzes the policy response based on these theories and its impact on selected countries.

2. Brief Analysis of Classical Development Theories

The assumptions and supposed stages in Rostow’s Growth Theory are highly simplistic and evidence is against the suggested linear progression to each higher stage. Definition of a traditional society in Rostow’s Growth Theory is incongruent with Islamic principles, especially when it comes to the role of religion in a society. In an Islamic society, religion is the core, whereas, Rostow’s Growth Theory assumes religion to be a source of primitiveness just like Marx who opined that religion is opium.

Structural transformation, which is considered as a pre-requisite in that theory for the take off stage had been proved to be flawed in many countries whenever it was forced upon by developed countries extraneously with no regard to peculiarities in individual regions.

In Harrod-Domar and Solow’s Growth model, the emphasis is on increasing savings and investments and that is supposed to lead to increased productivity corresponding to lower ICOR in Harrod-Domar model and hence higher rate of growth and to higher steady state level of output in Solow’s Growth model. But, the savings are much less dependent on real interest rates in LDCs as the empirical evidence shows. Savings feature despite the negative real interest rates.
Plus, in all Structural Adjustment Programmes, IMF and WB insisted on increasing indirect taxes and freeing trade barriers which increased imports, resulted in depreciation of currencies and together with indirect taxes, fueled inflation. Hence, real interest rates in almost all of the developing regions have been negative for quite some time.

Kuznets’s inverted U-hypothesis also seems to be missing support from empirical data. Inequality in USA, China and India increased even after the economies experienced continuous rise in per capita incomes. In fact, the empirical data supports the view that inequality is the cornerstone of economies following maxims of neoclassical counter-revolution. The result is best described by Stieglitz who calls this kind of economics, the ‘trickle up’ economics than ‘trickle down economics’.

Neo-colonial Dependence Model, False-Paradigm Model, and Dualistic-Development Thesis are all effective political economy explanations of underdevelopment, especially of South Asian, African, Latin American & Middle East countries.

In the next section, we take a brief look at some of policies which were tried taking inspiration from some of these theories and we try to see the impact of these policies in dealing with underdevelopment.

3. Development Programmes & their Impact

3.1 Case of Pakistan

After its independence, Pakistan followed the policy of import substitution. Haq (1963) gave the concept of functional inequality in 1960s. Based on his praise for Harrod-Domar and Solow growth models, he reasoned:

“The road to eventual equalities may inevitably lie through initial inequalities.”

In 1960s, Pakistan witnessed high growth rate, was able to create an industrial class, but later, it was found that this growth only benefitted a very specific small class and created huge income inequality and disparity which eventually led to the separation of East Pakistan from West Pakistan.

Haq (1995) later on accepted that humans are ‘means’ as well as ‘ends’ of any development process or initiative. He finally accepted that ‘Ends’ cannot be sacrificed for the future, even when benefits are certain, and ignoring ‘ends’ undermines the entire development process.

In the later part of 1980s, Pakistan went to International Monetary Fund (IMF) and World Bank (WB) for Structural Adjustment Program (SAP). IMF and WB recommended privatization, diminished role of government in running businesses, deregulation, liberalization, removal of quotas on international trade, lowering tariffs, expanding list of importable items, removing subsidies, increasing indirect taxes and let the currency be floated freely.

Zaidi (2005, p.328) on analyzing the effects of IMF policies and Structural Adjustment Program pursued in Pakistan, reasoned in following words:
“Such programmes have very serious negative impacts on growth, inflation, income distribution, the social sectors, and poverty. In general, Structural Adjustment Programmes have made matters far worse for countries that have followed them. We have examined the philosophy that governs such adjustment programmes, which is essentially one of liberalization, openness, and greater integration with the new economic world order, and we have found that not just the adjustment programmes themselves, but also the thinking behind them does not take account of specific factors and the context of specific countries.”

Anwar (1996) analyzing the SAP in Pakistan and its effect on poverty argued through an empirical research that not only the absolute poverty incidence, but also the intensity and severity of poverty increased significantly by all poverty lines and poverty measures over the period of adjustment. He further noted that SAP created new poor in urban areas amongst the low income groups (mainly clerical and sales workers) whose real wages were eroded over the period. Poverty also increased unambiguously among self-employed and unemployed who seems to have been affected adversely by the overall economic contraction.

Even now, capitalistic democracy in Pakistan is keeping the market in a status quo for the benefit of big monopolists who in collaboration with politicians further their interests and bring barriers to entry for new entrants. ‘Functional inequality’ episode strengthened the elitist class and people of higher financial standing and political influence of this class can get loans and default on them, can bypass red tapism and avoid taxes.

The country’s banks and other financial institutions wrote off over Rs 30 billion during the governments of Muhammad Khan Junejo, Benazir Bhutto and Nawaz Sharif on political basis. (Source: The News, March 13, 2000).

Only 2.75 million Pakistanis, or 1.6% of the country's estimated 170 million people, are registered tax-payers, but the Structural Adjustment Programs only emphasized on removing subsidies, raising utility prices and increasing indirect taxes. The policy to lower and subsequently remove import tariffs badly affected the domestic industrial base. Now, government regularly has to trim PSDP (Public Sector Development Program) to finance fiscal deficit. Elitist class has not yet allowed passing of tax on agriculture, real estate and wealth. Crony capitalism led to selling strategic and important public sector corporations at throw away prices as part of Structural Adjustment Program.

Currently, Pakistan pays around Rs 1,000 billion in debt servicing. Most of the debt is of the nature of deadweight debt. About half of the tax revenue goes to the lenders in paying of interest.

Politicians in this capitalistic democracy too contribute in maintaining the status quo by providing token benefits to their voters (even without providing in many cases) and by creating an environment where the poor have no choice than to join hands and support them to safeguard their private property rights in absence of ruling class fulfilling its basic responsibility of safeguarding private property rights.
Rodrik (2006) explained that when investment is constrained by poor property rights, improving financial intermediation will not help. Security of property rights has been one of the most important determinants of why some countries developed quickly than others. (Acemoglu et al, 2001).

### 3.2 Case of Africa

Just to put the issue in right perspective, consider these facts. Africa’s debt stock in 1970 was $11 billion and Africa’s debt stock in 2008 stood at $215 billion. Furthermore, Sub Saharan Africa receives $10 billion in aid but loses $14 billion in debt payments per year (Africa Action, 2008).

Currently, Africa’s total external debt stands at $300 billion. Many African countries spend more on debt than either on health or education. For example, Cameroon, Ethiopia, Gambia, Guinea, Madagascar, Malawi, Mauritania, Senegal, Uganda and Zambia all spent more on debt than on health in 2002. GNP per capita in Sub-Saharan Africa is $308 while external debt per capita stands at $365. Just to cite one example, Nigeria borrowed around $5 billion and has paid about $16 billion, but still owes $28 billion. Regrettably, 7 million children die each year as a result of the debt crisis.

To cite another example, Zambia was unable to employ 9,000 qualified teachers because of a public sector wage freeze imposed by the IMF in 2004 as a condition of receiving HIPC (Heavily Indebted Poor Countries) debt relief. Half of African population in Africa doesn’t have a meal a day.

Habisso (2009) analyzing the impact of aid on development in Africa commented:

“The continuing failure of official international aid to encourage the emergence of a self-sustaining growth in agricultural and industrial sectors, geared to local needs, has led many to question the appropriateness of aid per se. A number of problems with the current system of aid assistance have been identified: (i) Since some of the aid is in the form of loans rather than direct grants, poorer countries may find themselves getting into increasing debt; (ii) A considerable proportion of any aid package is swallowed up in payments to technical experts, the field-staff of the donor countries, or on the costly housing, transport, and diet arrangements made for them in the host country.”

Habisso (2009) further notes that aid often increases dependency by being loaned to a country on condition that it must be used to purchase goods from the donor country, i.e. aid tying. Almost 70% of British aid is loaned on these terms, which means in effect the main beneficiaries of aid are the capitalists in the developed world.

McCord et al. (2005) discussing the effect of SAP on the development of Africa revealed that Africa was the only major developing country region with negative per capita growth during 1980 to 2000; its health conditions are by far the worst on the planet; its soaring population is exacerbating ecological stresses; and despite the policy-based development lending of structural adjustment, it remains mired in poverty and debt.
3.3 Case of China

China made progress because it could not be lured into taking excessive debt. Most of the growth owed to localized and indigenous efforts and an active role played by public sector with discretionary intervention when and where necessary. The sustainability of the growth momentum also owed to the fact that China did not allow fiscal bleeding unlike the mantra favored by IMF and WB for developing countries to take on debt and develop infrastructure with it. Indigenous and uncompromising leadership made the growth possible and to keep it sustaining.

Rodrik (2010) explained that there has not been a greater instance of poverty reduction in history than that of China in the quarter century since the late 1970s. Interestingly, he points out that western economists or their piece of research did not play an instrumental role in China’s reforms. He mentioned that South Korea, Malaysia and Vietnam all achieved success in development with their own set of reforms and policies. He argued that in none of these Asian cases did economic research, at least as conventionally understood, play a significant role in shaping development policy. The same is true of other long-term successes elsewhere, such as Botswana and Mauritius.

Chang (2006) explaining the role of institutions and governments to steer development efforts successfully cited that countries like France, Austria, Finland, Norway, and Taiwan have extensively used state-owned enterprises (SOEs) in steering their impressive economic developments after the WWII. Citing an example of Korea, he argued that the famous Korean steel producer, POSCO, was set up in the early 1970s as an SOE in a country that did not even produce the raw materials (iron ore or coking coal) at a time when such act was a clear defiance of comparative advantage, but it went on to become the most cost-efficient steel producer in the world within a decade of its establishment.

3.4 Case of Ecuador

Working over there, Perkins (2004) revealed that for every $100 of crude oil taken out of the Ecuadorian rain forests, the foreign oil companies receive $75. Of the remaining $25, three-quarters must go to paying off the foreign debt. Most of the remainder covers military and other government expenses which leaves about $2.50 for health, education, and programs aimed at helping the poor. Hence, out of every $100 worth of oil pinched from the Amazon, less than $3 goes to the people who need the money most. With resources taken away from debt servicing, human capital, which is cited as engine of growth and development cannot possibly be given due importance.

3.5 Case of Transition Countries

Zawalinska (2004) noted that the most painful effect of SAPs in Transition countries was a high and persistent unemployment resulting from restructuring and privatization processes. Many countries experienced a jump in unemployment from the level close to zero to about 20% over first 5 years.

He further noted that the most immediate influence of SAPs on households was a burst of inflation which occurred as a result of prompt liberalization. This
unquestionably heavily hit all the households as their private savings immediately lost value and only higher income households could shift the rest of their savings from the bank to fixed assets. The poor households had to face the substantial decrease in value of their purchasing power without much security.


In this section, we will analyze that has the lacking on implementation front or inadequate institutional framework contributed to underdevelopment and shortcomings in development progress. We will present analysis of why this argument is weak and mention several possible reasons responsible for the underdevelopment which have nothing to do with poor governance and institutions. While poor governance and inadequate institutional framework may have worsened matters, they are not the only factors behind shortcomings in development progress. The policies themselves and the lack of commitment on other ancillary fronts by developed countries have also resulted in underdevelopment of the developing countries.

Coming out of a debt and poverty trap requires consistent growth for a sustainable period. But, international trade restrictions take much of the ability to grow from developing countries. Tariffs charged by high-income countries on goods important to developing countries, such as textiles and agricultural products, remain high. Subsidies of $350 billion a year to agricultural producers in Organization for Economic Co-operation & Development (OECD) countries are another barrier to developing country exports. Global trade is not yet a level playing field.

Other than tariffs, high-income countries accuse developing countries of not following environmental standards, Technical Barrier to Trade (TBT), Sanitary & Phyto-Sanitary Barriers to Trade (SBT), Kyoto Protocol etc and thereby further reduce the ability and capacity of developing countries to gain from exchange and get out of debt and poverty trap. High-income countries account for half the world’s Carbon Di-Oxide (CO₂) emissions (Source: Carbon Dioxide Information Analysis Center data). Furthermore, High-income countries account for 36% of emissions of organic water pollution (Source: World Bank).

Due to this, most developing countries are going through a perpetual debt trap which takes away resources that could have been used on development, but instead are used to service compounded debt. Interest payments take up most of the resources of the government. It must be kept in mind that principal amount of debt remains same even if debt is serviced each year. Even if only debt is serviced each year, the debt servicing amount would continue to increase each year with compounding effect.

Total external debt of low-income countries stands at $523 billion. Total debt service being paid every day by low-income countries amounts to $100 million. For every $1 received in aid, low income countries pay at least $2.30 in debt service.

Theory of Comparative Advantage states that resources should be allocated to the efficient sectors of the economy. If U.S.A has a comparative advantage in
producing cars and if Pakistan has a comparative advantage in producing wheat; then, Pakistan should allocate its resources on producing wheat and U.S.A should allocate its resources to produce cars. Both Pakistan and U.S.A can gain from exchange and specialization.

But this will only work when the trade is fair and when both countries do actually allocate their resources to their efficient sectors. Instead what happens is that developed countries have absolute advantage in producing most goods over developing countries. Developed countries allocate their resources in producing goods that they can produce most efficiently and use the proceeds from sale to provide subsidies to their inefficient sectors and virtually paralyze the developing economies by depriving them of their chance of gaining through exchange and specialization.

The export subsidies provided by developed countries to their inefficient sectors enable the inefficient sector to become efficient artificially and crowd out the developing countries by overproducing and then dumping these goods in the third world countries. If the supply exceeds demand, developed countries have not been reluctant to dump their production in sea if they can’t do it in the developing countries! It is just to fulfill ‘get the prices right’ mantra espoused from Washington Consensus.

By providing export subsidies to their inefficient sectors, developed countries create distortions in trade and misappropriations in resource allocation. The export subsidies paid by the developed countries to their inefficient agriculture sector are funded through the proceeds of exports. Hence, these are in reality cross subsidies. Therefore, effectively these subsidies are paid by the developing countries. Developed countries charge huge premium for value addition that is not in line with their out-of-pocket costs. The difference is especially huge in information technology products, software and pharmaceuticals. Once software or medicine is made, the capacity is virtually unlimited. Unlimited copies can be sold provided there is enough demand. Cost per unit is spread over larger output. At higher levels of output, marginal cost is negligible and constant in these products.

Therefore, developing countries are denied gains from comparative advantage in agriculture through export subsidies provided by developed countries to their comparatively inefficient agriculture sector. Subsidies of $350 billion a year to agricultural producers in OECD countries are a barrier to developing country exports (Source: World Development Indicators 2005). This creates unemployment and poverty in the developing economy. Agriculture is still the most important sector in Less Developed Countries (LDCs) in terms of achieving growth, and sourcing funds for development and redistribution efforts as the evidence from Table 1 shows.

Table 1: Share of Agriculture (%) in GDP and Employment in LDCs

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<tbody>
<tr>
<td>In Employment (%)</td>
<td>79.5</td>
<td>76</td>
<td>70.8</td>
<td>68.6</td>
</tr>
<tr>
<td>In GDP (%)</td>
<td>30</td>
<td>29.5</td>
<td>30.2</td>
<td>28</td>
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Source: World Development Indicators 2008, World Bank
Brown (2002), former head of the United Nations Development Program, estimated that farm subsidies cost poor countries about $50 billion a year in lost agricultural exports. He concluded that this amount is the equivalent of today’s level of development assistance.

Eventually, a developing country will have to submit itself before the international financial institutions that are able to exert extraordinary influence - not limited to economic but also political - in the developing country. Therefore, the role of IMF, WB, World Trade Organization (WTO) and the adaptation of SAP and Free-Float exchange rate systems are all interrelated in their objectives to maintain the status quo of supremacy of developed world over developing countries. Mercantilism stands completely opposite to Free trade theory, but, the former was supported when Europe needed it.

Higher tariffs are levied by developed countries on products involving a higher degree of value addition. In the European Union (EU), processed foods are subjected to a higher tariff than unprocessed foods, and fabrics to a higher tariff than thread. In addition to that, many finished textile goods were not allowed under quantitative restrictions, which is a clear violation of WTO. Even if they can produce processed products more cheaply than the developed countries, tariffs tilted the balance against them.

Through ‘Tariff escalation’, developing countries are discouraged to enhance their industrial base and capacity and move from their traditional colonial trading pattern of exporting raw materials and simple manufactures to be exporting value added goods.

To summarize, in this section, we analyzed that lacking on implementation front or inadequate institutional framework is not chiefly responsible for the underdevelopment. The policies themselves and the lack of commitment on other ancillary fronts by developed countries with regards to biasness in international trade, tariff escalation, biased and inconsistent resort to environmental excuses etc have also resulted in underdevelopment of LDCs.

5. Flawed Theories & Prescriptions Lead to Undesirable Outcomes

The term “Washington Consensus” refers to development strategies centered on privatization, liberalization, and deregulation and built upon a strong belief in free markets and aimed at reducing the role of government. These policies were prescribed for developing countries through various programs including Structural Adjustment Programmes.

Below, we review literature which critically analyzes the prescriptions put forward under “Washington Consensus”.

Stieglitz (2004, p. 1) commenting on Washington consensus remarked:

“If there is a consensus today about what strategies are most likely to promote the development of the poorest countries in the world, it is this: there is no consensus except that the Washington consensus did not provide the answer. Its recipes were neither necessary nor sufficient for successful growth.”
Woo (2004) reasoned that the Washington Consensus runs the danger of denying the state its rightful role in providing an important range of public goods.

Stiglitz (2004) contrasting the development experience of East Asia with Washington consensus wrote that Washington Consensus inspired development strategy stands in marked contrast to the successful strategies pursued in East Asia, where the development state took an active role. He reasoned that there is no theoretical underpinning to believe that in early stages of development, markets by themselves will lead to efficient outcomes.

Commenting on trickledown economics, Stiglitz (2004) noted that the notion that somehow everybody would benefit is flawed as the evidence against trickledown economics is now overwhelming.

In late 1999, to enhance the contribution of their interventions to international poverty reduction efforts, IMF and the WB adopted a new strategy for their assistance to low-income countries. The main features of this strategy were (a) both institutions were to base their concessional lending and debt relief to low-income countries on Poverty Reduction Strategy Papers (PRSPs) prepared by the countries themselves; and (b) IMF concessional lending was to be provided through a revised lending facility, the Poverty Reduction and Growth Facility (PRGF)—with a stronger poverty reduction focus.

In PRSPs, broad based participation is a well orchestrated desire, but, how this could be made possible with so much direct and indirect political interference of Donor countries and International DFIs in the developing countries is a big concern.

Levinsohn (2002) noted that the suggestion that more open trade is good for the poor is based more on faith than evidence. Although the PRSP documents are peppered with references to molding the particulars of a poverty alleviation program to the details of the country, the discussion of trade policy (as well as some of the macroeconomic prescriptions) seems to come from a one-size-fits-all mentality.

Rodrik (2006) contrasting the perceptual differences regarding security of property rights argued that presumably, investors felt more secure when they were allied with local governments with residual claims on the stream of profits in China than when they had to entrust their assets to private contracts that would have to be enforced by incompetent and corrupt courts in Russia. Whatever the underlying reason, China’s experience demonstrates how common goals (protection of property rights) can sometimes be achieved under divergent rules.

To summarize, we can say that the uniformity of problems does not necessitate the use of same remedies as the dynamics of each region and their peculiar context is different.

6. Need for a Paradigm Shift in Development Focus

Such unanimity in shortcomings in underdevelopment in varied regions and after so many policies have been tried for so long, hints us towards understanding that merely the lacking in implementation could not have led to such a happening. Governance in less developed countries has been no less poor or better than
developed countries. Hence, the inclusive approach envisaged in PRSPs put forward by WB seems a reasonable way to approach development after Millennium Development Goals (MDGs) are increasingly appearing to be underachieved in entirety.

Rodrik (2010) argued that successful countries achieving development identify sequentially the most binding constraints and remove them with locally suited remedies. He favored diagnostics which require pragmatism and eclecticism, in the use of both theory and evidence.

Fundamentally, there is also a need to revisit the indicators and barometers of progress and development. Stieglitz has also been very critical of Gross Domestic Product (GDP) as a sole measure of growth. GDP per Capita cited as a measure of economic development is also not devoid of problems as it is based on GDP and cannot take into account distribution of income, resources or wealth.

7. **Normative Divide Between Islamic & Capitalistic Development Philosophies**

Resources are scarce as compared to unlimited wants. But, the economics of non-rival ideas creation has proved that resources are ample and that physical resources could be used in ways that keeps fulfilling the basic needs of society through the creation of ideas that augment and bring multiplier effect to the availability of given physical resources.

In simple words, the development in science and technology by developing human capital base has enabled the societies through each level in history to make best use of physical resources and avoid resource exhaustion for the basic requirements.

Despite that, problems like poverty have persisted and even got severe in some regions in last century than in the past. Problem is not with resource scarcity, it is with distribution of resources which require an equitable and egalitarian socio-economic system. What is needed is a system that consists of institutions working towards fulfilling this objective.

Capitalism, the way it is practiced as an economic system, has largely allowed and promoted certain institutions and their operations based on free market philosophy and such institutions have been chief reasons behind much of distributional inequity in the world today, both in developed as well in developing regions.

Interest based financial intermediation in theory and in practice has exhibited increased concentration of wealth in the world. A system is not an end in itself; rather it is meant to serve the needs of society at large amicably.

Indeed, when we glance over statistics of poverty on one hand and rising inequality on the other, we ought to question the merits of such institutions. Indeed, even in free market philosophy, we do not allow certain institutions which bring harm to the society and individual liberty. But, yet, so far, we have turned limited
attention towards critically evaluating the intricate system of interest based financial intermediation.

Islamic economic system is a blend of natural features present in Capitalism i.e. right to private property, private pursuit of economic interest, use of market forces etc used along with some distinct features derived through Islamic economic teachings i.e. interest free economy, moral check on unbridled self-pursuit and provision of socio-economic justice to achieve the goals of Socialism as far as is naturally possible without denying individual freedom and incentives.

Another aspect of resource scarcity is completely psychological rather than physiological. Humans compare themselves relatively to their contemporary peers. Indeed, we, as individuals have much more facilities and better standard of living in material terms than even the kings of the past. But, even that does not satiate our hunger and sense of deprivation.

Religion provides such meaningful conditioning which makes us bring the right balance between our aspirations and physical limits. Religion also promises salvage from the limitedness of this worldly life in heaven which will be awarded to the most righteous people. This, in turn, provides a permanent incentive to choose righteous behavior as an end with the hope and fear of deterministic results in life hereafter.

Schematically, we present the two models below:

**Capitalism Microeconomic Model**

<table>
<thead>
<tr>
<th>Scarce Resources</th>
<th>Pursuing private benefit</th>
<th>Unlimited Wants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indifferent between right &amp; wrong</td>
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**Islamic Microeconomic Model**

<table>
<thead>
<tr>
<th>Scarce Resources</th>
<th>Seeking Allah's pleasure</th>
<th>Unlimited Wants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Differentiate between right and wrong</td>
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8. **Development from Islamic Perspective**

In neoclassical growth theories, the emphasis is on increasing savings and technological progress which brings about increase in capital per worker and eventually output per worker and enables an economy to reach the steady state level of output. In ‘endogenous growth theory’ models, more sophisticated work has been done by endogenizing the technology, human capital and savings.

To summarize their findings, these theories and models help explain the differences in per capita across countries and conclude that countries with high savings and investment rate, having people spending more time in learning new skills and with better social infrastructure in the form of strong private property rights are able to have more per capita income than countries which lack in these characteristics.

Below, we try to analyze whether Islamic economic principles have the capacity to help build these elements for sustainable growth and development.
8.1 Boosting Investment in Islamic Economy

With a lenient rate of Income Zakat, the productive sector is provided with incentive to ensure achieving potential output with lenient fiscal levies and no scarcity of capital through prohibition of interest. This could itself bring about increase in output per person in economy and could bring stability in prices. Tax on cash and capital will force the people to invest their money in productive uses. With prohibition of interest, this money will only go in business either with the start of one's own business or equity participation in Mudarabah and stocks etc.

Besides this, a consistent and credible low tax rate policy with broader Zakat base ensures minimum distortions, boosts aggregate demand and encourages investment by decreasing costs of doing business and this could also simultaneously solve microeconomic problems of imperfection in markets by increasing competition and helping to reduce market power.

8.2 Improving Income Distribution in Islamic Economy

If we study the classical and neo-classical literature on growth and development, the theories and policies based on them have felt short to improve income distribution.

Islam economics has many non-state mechanisms to ensure income redistribution without interfering with individual freedom and market mechanism; we discuss three main mechanisms below:

8.1.1 Prohibition of Interest – Interest as a system of allocation of resources ensures a fixed return for one and variable and uncertain for another. In contrast, Islam encourages equity financing in which the loss/profit would be shared. This ensures better results from the perspective of redistribution and better co-operative behavior since payoffs for all parties are linked with productive sector of the economy. Consequently, markets will not have to produce speculative surplus output just to service exorbitant amount of debt and that could stabilize business cycles.

8.1.2 Family System & Inheritance Distribution – Family system of Islam brings social capital into existence. It ensures empathy and responsibility. It brings a very lasting and durable social safety net. Islamic injunctions about how to treat orphans and polygamy in special circumstances ensure social security for individuals with special circumstances. Furthermore, the inheritance laws ensure that the wealth of the deceased is distributed widely among the members of the family of the deceased and this permanently and systematically ensures doing away with the concentration of wealth in every generation.

8.1.3 Zakat & Infaaq – Zakat is a combination of wealth and income levy. It includes all heads of income and forms of wealth excluding only the means of production, items of personal use and value below Nisab. With a Wealth Zakat, redistribution objective is directly achieved. It reduces confinement of wealth in few hands. The flow (income) and the stock (wealth) both are taxed and hence it ensures appropriate transfer of wealth and transfer of asset ownership.
to the needy. If an economy is in disequilibrium and policies fail to immediately recover and boost incomes, wealth Zakat enables the distributive allocation that works independently of business cycles and help stabilize the extremes of business cycles.

9. Building Social Infrastructure in Islamic Economy

Islam does not disallow private property rights. On the other hand, Islam also educates people that they are not just responsible to fulfill duties set out in a legal framework in a society’s legislature, but are also responsible to Allah. There are several such recommendations in Quran which are not binding in the legal sense of the word, but which educate the people of the desired behavior expected by their Creator.

Second, private property rights are safeguarded by the state after the provision of taxes. Beyond Zakah, Islam also does not give the government the right to fetch people’s money and violate private property rights.

Third, rather than keeping other things as it is, Islam has a very clear view on certain institutions like ‘interest based lending’ which has been chiefly responsible for concentration of wealth, rising inequality and even poverty and is an exploitative form of earning money. Islam by disallowing interest based earnings, exploitative forms of trade and imposition of excessive taxes from the state beyond Zakah ensures individual freedom in a much wider sense.

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Shari’ah Governance Model (SGM) And Its Four Basic Pillars

By Imran Hussein Minhas

Abstract
Governance means ensuring the compliance the rules and regulations prescribed for observance in an organization for efficiency and achievements of its aims and objects.

As Islamic banking is based on Shariah principles and rules, it is necessary that it should be subject to Shariah governance to ensure its working within Shariah parameters and not overstepping its limits. For this purpose a Shariah governance model has been envisaged which will be headed by Shariah advisory board aided by other ancillary departments. Its edifice will be raised on four pillars

Management and Supervision
Shariah Advisory
Shariah Compliance and Review
Transparency and Disclosure

This will strengthen the belief in the system as being truly Shariah compliant. It will also result in Islamic banks’ strict adherence to Shariah principles and reduce the risk of their deviation from the correct path.

Key Words: Shariah Governance Model, Globalization of Islamic Finance, The Mysticism of Islamic Shariah, Transparency and Disclosure

Governance is a method which an organization adopts to ensure that components of the organization follow the set rule, regulation, policies and processes. Governance is said to be good when it primarily ensures achievement of objectives with the existence of effective risk management system, transparency, fairness, responsibility, accountability and independence. Good governance is termed

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as corporate governance when a business entity is operated, regulated and controlled by the well designed risk management policies, processes, corporate regulations, rules and laws that lead the entity to achieve its ultimate goals.

What is Shari’ah Governance?

Shari’ah governance is simply the alignment of corporate governance according to the Islamic principles. Specifically, Shari’ah governance is “the set of institutional and organizational arrangements, policies, processes, procedures rules, regulations and laws which leads the organization towards Shari’ah compliance”. Shari’ah governance applies to Islamic financial institution (IFI) as its compliance is the only reason for an IFI to exist. Shari’ah Governance is based on four pillars, discussed in the subsequent parts of this article, and is monitored, either through Shari’ah board or through a dedicated internal Shari’ah Review Department, working under the Board of Directors.

Why Shari’ah Governance?

Since the last three decades, Islamic banking and finance (IBF) has showed a tremendous growth in all parts of the world. It has reached to more than 70 countries of the world which also includes non-Muslim jurisdictions like London, Japan, China, South Korea, Singapore, Germany and Hong Kong. IBF is getting its share in the financial system with a rapid growth rate of over 20%. According to Ernst and Young the assets of Islamic Finance will grow to US$ 1.1 trillion in 2012 from US$ 826 billion in 2010. The analysts from Deutshe Bank have projected the growth of Islamic banking assets to US$ 1.8 trillion by the end of 2016. This growth is confirming that Islamic banking and finance is a feasible substitution to the conventional financial system.

The globalization of Islamic finance has reinforced the mysticism of Islamic Shari’ah and every business activity which demonstrates growth and involves public interest needs to be regulated by a set of rules and regulations. The growth of Islamic finance demands that IFIs be regulated through such set standards which are capable to raise early warning signals of Shari’ah non-compliance. The standard or Shari’ah governance is also necessary to maintain the trust of clients of Islamic financial institutions in the IBF and to safeguard the interest of investors and other stakeholders in the Islamic financial system. To achieve a certain level of maturity, regulators of Islamic financial institutions need to address the Shari’ah regulatory issues by the legitimate and sound Shari’ah governance model based on the true principles of Islam. A comprehensive Shari’ah governance model is based on the four basic pillars discussed hereunder.

Four Basic Pillars of a Shari’ah Governance Model

It is believed that political support is a driving force to promote Islamic finance in any country. Yet an accommodative regulatory and supervisory framework for effective Shari’ah governance is also imperative for its growth. It would not be wrong to call Shari’ah governance as a brain of Islamic financial industry. It provides a complete system to ensure compliance of Islamic principles of doing business. Ignoring the Shari’ah governance one cannot guarantee that a true and
successful Islamic financial system and markets are in place. I believe a comprehensive Shari’ah governance system is based on following four pillars:

1- Management and Supervision

Management and Supervision is the first pillar of Shari’ah Governance and Board of directors (BOD) comes first in the management. BOD, senior management and organizational structure show a complete set of behavior within the organization. The success of any entity, specifically the IFI, entirely depends on willingness of the management to adopt and implement Islamic principles in the organization. The provision of adequate resources, system procedures, infrastructure and code of ethics for acceptance of business and its legitimacy according to Shari’ah governance entirely depends on the management. Providing proper policies and system will be inadequate if they are not implemented and supervised positively. For better results, bare minimum requirements for management may be prescribed by the regulators, which may include the following:

- Fit and proper criteria for the BOD and senior management;
- Shari’ah risk management policies containing a systematic approach to identify, measure, treat and monitor Shari’ah non-compliance risk;
- Duties and responsibilities of the Shari’ah Board/Advisors;
- Introduction of financing agreements and Shari’ah compliance mechanism to ensure that the operations of the IFI are Halal and free from Riba, Qimar and Gharar;
- Screening process for investment in shares and securities, process of income purification and management of charity;

2- Shari’ah Advisory Board

An Independent Shari’ah advisory board or Shari’ah Advisor is the second important pillar of the Shari’ah Governance model. Preferably the Shari’ah Board is established in two tiers at the regulatory level, the central Shari’ah Advisory Board and the Shari’ah Advisory Committee at the IFI level. The Board ensures that the IFI is complying with Shari’ah principles and policies. The Board’s responsibilities include:

- Establish and implement Shari’ah governance framework;
- Ensure that Shari’ah principles and policies are applied consistently across the IFI;
- Review and approve Shari’ah governance policies and procedures;
- Ensure that the Shari’ah Advisory Board is independent and non-bias;
- Provide guidance and support to the management and supervision in their implementation of Shari’ah governance;
- Monitor the performance of the Shari’ah Advisory Board and provide feedback.

3- Shari’ah Compliance and Review

Shari’ah Compliance and Review is the third pillar of Shari’ah Governance. This pillar ensures that the IFI is compliant with Shari’ah principles and policies. The responsibilities of the Shari’ah Compliance and Review include:

- Review and report on Shari’ah compliance and non-compliance;
- Conduct Shari’ah internal and external audits;
- Ensure that Shari’ah compliance is monitored and reported on a regular basis;
- Provide guidance and support to the management and supervision in their implementation of Shari’ah governance;
- Ensure that the Shari’ah Compliance and Review is independent and non-bias.

4- Transperancy and Disclosure

Transperancy and Disclosure is the fourth pillar of Shari’ah Governance. This pillar ensures that the IFI is transparent and accountable in its Shari’ah governance. The responsibilities of the Transperancy and Disclosure include:

- Maintain accurate and transparent financial records;
- Ensure that the financial statements are prepared and reviewed by an independent third party;
- Ensure that the financial statements are filed with the regulatory authorities;
- Provide guidance and support to the management and supervision in their implementation of Shari’ah governance;
- Ensure that the Shari’ah Transperancy and Disclosure is independent and non-bias.
Body and the other at internal level of the IFI, the In-house Shari’ah Advisor/Board. Role of both the advisory boards are discussed hereunder, separately:

Central Shari’ah Advisory Body (CSAB) – The apex Shari’ah Advisory body of the country, which defines basic structure of Islamic financial system in the country. This body may be assigned the task to approve code of Shari’ah compliant business activities, financing agreements, policies, directions of IFIs in the country as a final authority for Shari’ah matters and disputes.

Shari’ah Advisory Board of IFI – The management of IFIs does not possess the in-depth knowledge of Shari’ah and is unable to interpret the day to day sensitive Shari’ah issues. To cope up the deficiency of the management in the Shari’ah understanding another tier of qualified and independent Shari’ah Board or Shari’ah Advisor is required to be engaged by the IFI for Shari’ah interpretations, ruling, fatwas, product development, review of business process and agreements. The Shari’ah board may also be given the task to conduct research and arrange training program for the IFI’s staff in accordance with the principles of Shari’ah and objectives of Islamic Law i.e. Maqasad Ash-Shari’ah.

3- Shari’ah Compliance and Review

Shari’ah compliance and review is the third important pillar of the Shari’ah Governance Model. Shari’ah review and assessment of adequacy of internal controls is a regular feature of the Shari’ah compliance. For this purpose internal Shari’ah audit department, under the internal audit committee of the Board, is to be established with the objectives to ensure compliance and to develop Shari’ah non-compliance risk awareness culture in the organization.

However, due to various reasons the internal audit is not considered a sufficient and reliable tool by the external users. Therefore, to give a greater confidence to the stakeholders of IFIs, an independent external Shari’ah audit is to be conducted by the statutory auditors, for which they are required to build up their capacity by engaging qualified Shari’ah auditors in their teams.

Till the time the audit firms develop a reliable Shari’ah audit system, Shari’ah review of the operations and transactions of IFIs may be conducted by their in-house Shari’ah board or Advisor on periodical basis.

4- Transparency and Disclosure

The fourth pillar, transparency and disclosure, is a critical part of the Shari’ah Governance Model. Transparency and disclosure always have material impact on the cost of capital, reputation, investors’ decision and stock prices. Stakeholders, shareholder and general public are always interested in correct and timely information of a company for their investment decisions. Information is of two types, financial and non-financial. Positive information on the affairs of the organization makes them a blue chip and it becomes easy for the organization to raise funds from the general public or financial institutions at the lower cost.

A well planned management information system is also essential for the top management. Timely and correct information facilitates the management to take
corrective actions and future decisions which may ultimately affect their business, profitability, competition and growth.

**Major areas of disclosure:**

- Information about the IFI, business strategy, business trends, major business plans, major shareholding, ownership and voting rights.
- Information about the management i.e. composition of board of directors and key executives, compensation.
- Information about Governance structure- good practices, delegation of authority, risk areas, policies, key performance indicators etc.
- Information about the financial position, key financial indicators,
- Material issues affecting employees and other stakeholders
- Foreseeable risk factors
- A Shari’ah compliance certificate duly issued by the External Auditor, Shari’ah Board/ Advisor.

To maintain the confidence and trust of the customers in the Islamic banking it is imperative to introduce and implement the Shari’ah Governance mechanism for the growth and stability of IFIs and to minimize Shari’ah non-compliance risk. A reliable Shari’ah governance system can ensure Shari’ah compliance besides enabling the regulators to regulate the Islamic industry in the least risk of Shari’ah non-compliance.
Bankers Perception and Performance in The Frame of Marketing in The Islamic Banking Industry of Pakistan

By Dr. Ahmad Saeed, Mohammad Shahid, Qaiser Imtiaz

Abstract

This study attempts to examine the bankers insight and performance in the frame of Marketing in the Islamic banking industry of Pakistan. The scope of the study was limited to the employees of Islamic banks of Pakistan. One hypotheses were formulated for bank employees. The hypotheses of bank employees were upheld. In the light of the findings, several concrete recommendations were made for the betterment of Islamic banking system.

The analysis would strengthen the marketing strategy as well as maximize the Bank Officers performance. There is high potential for Islamic banking industry. It is recommended that the Islamic banking industry regulate the marketing as per Islamic principle. The social justification of this research was to explore the potential of Islamic Banking to maximize the social market ethics and develop good relationship with the customers and enhance their satisfaction in positive tone.

Key words: Bankers, Perception, Performance, Marketing, Islamic Banking Industry

INTRODUCTION

The purpose of study is to explore the speedy change in sales and marketing atmosphere which has been demanded by bank employees to focus on customer effectively. Islamic banks perceived the customers’ need and demanded more focus on this aspect exclusively. The consumer banking has had exceptional progress in Pakistan over the five year period. There has been a phenomenal progress from State Bank of Pakistan to reschedule the banking sector as per market need and consumer demand. Banks have understood the significance of customer relationships which has

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long-lasting benefits. In Pakistan Customer Relationship Management practices are to be implemented which are not observed in the real sense in Banking sector.

The market strategy is competitively beneficial for customers. Islamic banking and its marketing ethics are based in the principles of integrity and justice in the society. Islamic banks provide the best possible services and enhance the customer satisfaction efficiently and effectively. Islamic banks cannot merely accommodate their business but also regulate the business strategies which focus on believers trust and piety. It emphasizes on equality, justice and welfare of society.

The Islamic Banking Industry in Pakistan consists of five full-fledged Islamic Banks. viz: Meezan Bank Limited, Al Baraka Islamic Bank (Pakistan) Limited, Dubai Islamic Bank Pakistan Limited, Dawood Islamic Bank Limited and BankIslami Pakistan Limited with 751 Islamic Branches of Conventional Banks and Sub Branches of full-fledged Islamic Banks. Their cumulative deposit portfolio was Rs.390 billion. (SBP, Islamic Banking Bulletin, Dec, 2010) [1]. Customer relationship is a core issue in Islamic Banking Industry in Pakistan with its Islamic essence and belief.

In presence of extensive and stable conventional banking market, expectations of customers are too high to be fulfilled especially due to the unavailability of enough products catering Shariah compliant financial services. The key dilemma in Pakistan is that there is not sufficient scope and facility to polish the Customer Relationship Officers to treat their customers as enjoined in Islam as they come from conventional banks and act as they did there.

To understand and promote the level of Islamic banking in macro level among the customers, whether Islamic or not is the core function of the Islamic banks Sales and Marketing staff should be groomed as per Islamic culture and norms. Due to low interest of frontline marketing staff in acquiring knowledge of Islamic banking products, procedural constraints of various financing products to ensure Shariah compliance during a financing facility, customers get disturbed when someone asks them to provide a number of documents for every transaction when they obtain financing facility from Islamic banks. It is therefore generally observed that the services provided by the Islamic banks are not at par with the conventional banks.

An observation of the working of Islamic banks reveals that the matter of bankers perception and performance in Islamic ethical sale behaviors in the Islamic banking industry of Pakistan needs to be explored. With rapid expansion of Islamic banking industry in Pakistan the researcher has taken the initiative to select this topic of immense importance and to analyze this issue.

Review of the Related Literature

Zainol and Shaari (2008) [2] also state that employees from Islamic banking apparently have a positive perception about the establishment of Islamic banks in

1 State Bank of Pakistan, (Dec, 2010), “Islamic Banking Bulletin”, Vol. 5 No.4
Pakistan. It is because of the simple fact that they strongly believe in the cause that is the exemption of *Riba* from the system, they consider it extremely important for them to promote Islamic law being citizens of a Muslim state. Along with that they also have a strong perception regarding the Islamic concept because they believe it to be good for them as well. Islam encourages brotherly relations among all the members of an organization which means that everyone is treated equally regardless of his/her position or status in the organization. Moreover, it also asks the employers to deal with their employees in calm and polite manner instead of flaunting authoritarian powers while it is also obligatory on the part of the employees to discharge their duties conscientiously because a true Muslim would always work for its organization with full passion and concentration as Islam gives the lesson of hard work and dedication towards the work. Moreover, it has also put great emphasis on the fact that nobody is greater than or superior to another, therefore one should develop a peaceful and healthy working environment.

However according to Alam, (2010) there are some practices of conventional banking system that Islamic banking employees would like to be introduced in their bank as well. Performance appraisal is one of such demand, as employees believe that this would prove to be an effective motivational support mechanism for them on the basis of which future bonuses, awards and perks are awarded to the employees rewarding them for the effort and hard work they have put in for the organization. As far as the development and progress of Islamic banks and banker’s perception are concerned, they have a strong belief in it as Islamic finance has shown a remarkable progress from the day of its establishment till the present time.

Bank policies and guidelines support the bank officers to handle the customers as well as operational activities. Training department also plays an effective role in achievement of good results as it not only helps employees become familiar with the general banking principles but also teaches them the complex requirements for Islamic products and services. Through these training programs, employees will receive the necessary knowledge and tools to benefit the customer's banking relationships.

Through traditional and Islamic banks policies and procedures on staff training, the bank will increase the confidence of employees who receive appropriate training and learn Islamic banking principles. They will be more concerned about the knowledge of Islamic products and services and will be better prepared for service to their clients. The training of staff will help financial institutions reduce the risk to their bank. Trained on the principles of Islamic banking the bank employees will be more ready to provide excellent customer service to banking customers with the latest and most advanced products and services. Islamic banks today, have a real and effective financial regulatory standard, and in their actual transactions and other interactions with customers, depositors and shareholders, as well as innovative and effective teaching and supervision of the implementation of collective religious rulings they fully abide by Islamic Shariah.

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The marketing job responsibilities include: management and implementation of the organization’s different activities, and the customers should be made aware of the market policy. Customer Relationship Management plays a significant role to persuade the customer by mechanizing the business stratagem. No matter whether the CRM are senior or junior, they deal not only with the new customers but also keep the old ones.

Main responsibilities will be supervision of banking operations and transactions and assisting financial engineering and investment sector appointments. The banks can provide a better service, in addition to providing their customers with a pleasant banking environment in all client segments. It has been analyzed that the performance of Islamic banks demonstrates good liaison and productivity (Bashir, 1999) [4].

When the words “marketing ethics” appear in the general media or business press, the reports typically describe a marketing stratagem, approach, or guidelines that some constituencies consider “unjust” or “exploitative” or “deceptive.” Often, the subsequent discussion turns to how marketing practices might become more consumer-friendly, socially compatible, or put in philosophical terms, how marketing might be normatively improved (Ahmad, 1987) [5].

Islam gives a lesson to those who involve in wealth possession / acquirement. In Holy Quran Allah S.W.T. addresses as follows:

O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent. And do not kill yourselves (nor kill one another). Surely, Allah is Most Merciful to you (Al-Quran 4:29) [6].

From the above verse, one could find a strong message concerning trading. Islam guides its followers to engage in commercial activities and to refrain from the practice of charging interest/usury. Therefore, commerce is something viewed as essential in Islam, for as long as the process is parallel with Islamic teaching on doing business. It should be noted that Islam views commerce as one crucial factor in human life, so crucial that Allah S.W.T. destined Prophet Muhammad S.A.W. to be a successful businessman before his prophetic life (Antonio, 2007; Arasly et al., 2005) [7][8]. Since Islam is a way of life, one could advance a logic that Islam must have written the code of conduct for doing business, among other things.

Islam is a comprehensive way of life which covers all aspects of human endeavor including commercial activities. Through Al-Quran and Hadith, the two

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6 Qur’an by Saheeh Intl (Arabic-English Medium PB), Publisher: Almunatada Alislami
main references for Islamic law, Islam exhorts its followers to avoid taking usury and instead maintain the quality of their wealth through just trading.

Narated Abu Hurairah RA: The Prophet SAW said, “Allah did not send any Prophet but he shepherded sheep.” His Companions asked him. “Did you do the same?” The Prophet SAW replied, “Yes, I used to shepherd the sheep of the people of Makkah for some Qirat” (Khan, 1997) [9].

The highest and most important concept in Islam is the Tawhid or oneness (Alhabshi, 1987; Haneef, 1997) [10][11]. This is the most important concept that Muslims must know in order to live and survive in this world and hereafter. Rice, (2001) [12], stated that the concept of Tawhid is the most crucial ingredient in commerce.

It could be argued that the objectives of Islamic marketing cannot be separated from the objectives of the Shariah. From the above presentation on the philosophy of Islamic marketing, it is clear that human beings are Allah's envoys in this world. Therefore, the trust that Allah gives must be utilised in all aspects of life, including marketing. Although in reality, different ways might be taken to utilise that trust as long as they meet certain principles. Those principles, according to Ahmad (1989) [13], are as follows:

- Agree with the principles of Islamic law or Shariah.
- Achieve the economic and social goal of Islamic civilization.

Islamic Banking And Pakistan

At the end of 70 Pakistan originated their banking system into Islamic paradigm, and by end by July 1985 all commercial banks were transferred into Islamic banking regime. (Tahir and Umar, 2008) [14]. The rapid switch over posed hurdles in execution however, from 2001 structure had developed for flourish of Islamic bank and then the first license of Islamic bank was issued in 2002 to Meezan Bank who had the honour of pioneering Islamic Banking in Pakistan. The transforming of economic and financial system on Islamic path is being pursued for the last 22 years but complete success is still eluding the grasp. However Islamic banking movement was revitalized in 2002, and presently there are five full-fledged Islamic Banks, viz: Meezan Bank Limited, BankIslami Pakistan Limited, Dubai Islamic Bank Pakistan Limited, Burj Bank (Formerly Dawood Islamic Bank Limited) and Al Baraka Islamic Bank (Pakistan) Limited with 751 Islamic Branches of

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14 Tahir, M., Umar, M., (2008), Marketing Strategy for Islamic Banking Sector in Pakistan
Conventional Banks and Sub Branches of full-fledged Islamic Banks (SBP, Islamic Banking Bulletin, Dec. 2010) [15] Islamic banking network is lock spread over in more than seven main cities of Pakistan, 79% of Islamic Banking network existst in Sindh and Punjab region.

Marketing Strategy Of Islamic Banking In Pakistan

The Islamic marketing system is a principle of justice and value maximization for society. The system raises the living standard of the common people through commerce. The Islamic moral guiding principles assure respect for individual freedom as well as of both bankers and consumers. (Khan, 1987) [16].

Islamic marketing is based on its ethical laws where no exploitation is suffered by its customers in any manner such as deceit, deception or fraudulence. Any immoral act does an injustice that wipes out the concepts of equality and fairness with human beings which is the essence of Islamic idea (Saeed, Ahmad and Mukhtar, 2001) [17]. Thus, adopting the Islamic marketing ethics ensures that the seeds of harmony are planted and a proper order in society is provided, thereby enhancing the dignity of, and upholding the rights of human beings.

Islamic banks face the marketing challenge by coming up with a full array of genuinely distinctive, innovative and competitive products. In Pakistan, Islamic banks have adopted a different strategy to influence their customers; they have offered innovative products and efficient services to their customers according to their requirements. The prices of products are compatible with those of conventional banks which influence the customers to patronize the Islamic Banks. The marketing strategy of Islamic Banks is purely Halal being “Riba free” which also is the promotional slogan of Islamic banks. They facilitate their customers by placing the Islamic products meet their requirements. They promote their product in such a way that the cost of promotion returns to bank through the customers (http://www.EzineArticles.com/?expert=Ahsan_Ayub) [18]. Like the products of “Labbaik Hajj and Umrah” and “Laptop Ease” are successful consumer financing products by Meezan Bank Limited of Pakistan. (www.meezanbank.com) [19]. Islamic banks have an active focal point on emerging their customer friendly relationship. they provide Islamic preferences to conventional banking products, aligned with their mission to offer a one stop shop for inventive products and services to their customers under the boundary of Shariah.

This study is designed to fill in the gap and its main objective is to identify the salient features of Islamic marketing and to evaluate the possible role of bankers as may be perceived by the customers of Islamic Banking in Pakistan.

15 State Bank of Pakistan, (Dec, 2010), “Islamic Banking Bulletin”, Vol. 5 No.4
19 (www.meezanbank.com)
Methodology

The methodology implemented for this paper is briefly given below:

Statement Of Problem

Evaluate the Bankers Perception and Performance in the frame of Marketing in the Islamic Banking Industry of Pakistan.

Strategy

The overall strategy of research was survey. Survey research is the most extensively used type in research. It involves the collection of data at one point in time from a random sample representing the population at that time. This study investigated the perception and performance of Bankers in Islamic banks in Pakistan. Study population was selected from the Islamic bank employees. The researchers explained the questionnaire and objectives of the investigation, defined the purpose and significance of the project and what is expected from the respondents.

There is a total number of 751 Islamic Branches of Conventional Banks and Sub-Branches of full-fledged Islamic Banks. Their cumulative deposit portfolio was Rs.390 billion. (SBP, Islamic Banking Bulletin, Dec, 2010)[20].

It was not feasible to carry out a census. Consequently stratified random sampling design was adopted. In the final stage of sampling cluster sampling design was used. In this design, the unit of sampling is not an individual banker but all the customers of the Islamic Banks present on the day of the survey. The total sample size was 180 bank employees from the Islamic banks of Pakistan. The break down of the sample is mentioned below:

<table>
<thead>
<tr>
<th>B A N K  B Y  G E N D E R</th>
<th>SOUTH</th>
<th>CENTRAL</th>
<th>NORTH</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISLAMIC BANKS MALE</td>
<td>125</td>
<td>17</td>
<td>14</td>
<td>156</td>
</tr>
<tr>
<td>ISLAMIC BANKS FEMALE</td>
<td>18</td>
<td>3</td>
<td>3</td>
<td>24</td>
</tr>
<tr>
<td>TOTAL</td>
<td>143</td>
<td>20</td>
<td>17</td>
<td>180</td>
</tr>
</tbody>
</table>

Research Instruments

Tailor-made questionnaires were developed for bank employees (See Appendix No. I). The questionnaire for bank employees comprised of 59 items. The items of the questionnaire were drawn from the content field in consultation with the experts,

review of the literature and the judgment of the researcher. The procedure ensured the content validity of the questionnaires.

**Data Analysis**

Two types of analytical techniques were used. First, qualitative analysis of the questionnaire was made and the results were described in the narrative form.

The second type of technique used was quantitative. Table with frequencies and percentages were used for description of data. For statistical inference, t test of significance was used. In testing the hypotheses involving two groups, the t test was used. In the light of the findings, several concrete recommendations were made for the betterment of Islamic banking system.

**Composition Of The Sample**

Table and Pie Chart shows the distribution of Bank Officers & Managers by Post Level.

**Table 1**

Distribution of Bank Officers & Managers by Post Level.

<table>
<thead>
<tr>
<th>POST LEVEL</th>
<th>FREQUENCY</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>JUNIOR OFFICERS</td>
<td>42</td>
<td>23</td>
</tr>
<tr>
<td>SENIOR OFFICERS</td>
<td>138</td>
<td>77</td>
</tr>
<tr>
<td>TOTAL</td>
<td>180</td>
<td>100</td>
</tr>
</tbody>
</table>

It is evident that 77% of the Bank Management consists of Senior Officers and 23% Junior Officers.
TESTING OF MAJOR HYPOTHESES

NULL HYPOTHESIS

There will be no significant difference in the perception and performance of junior bank officers and senior bank officers in the frame of marketing in the Islamic Banking Industry of Pakistan.

**Analysis of the Problem**

1. \( H_0 : \mu_1 = \mu_2 \)
2. \( H_1 : \mu_1 \neq \mu_2 \)
3. \( \alpha : 0.05 \)
4. **Test Statistics**: \( t\)-test
   \[
   t = \frac{\bar{X}_1 - \bar{X}_2}{SE_{\bar{X}_1-\bar{X}_2}}
   \]
5. **Decision Rule**: Reject \( H_0 \) if computed \( t \geq 1.96 \)

Referring to Table 1, we find that the tabulated value of \( t = 1.96 \), with \( df = 178 \) at \( \alpha = 0.05 \) is greater than the computed value of \( t = 1.27 \). Therefore the null hypothesis is upheld and it is concluded that there is no significant difference in the perception and performance of junior bank officers and senior bank officers in the Islamic Banking Industry of Pakistan.

From the examination of the table, it is clear that the views of junior bank officers and senior bank officers regarding marketing about the Islamic banking are same.

Table 4.1. shows the application of \( t\)-test for testing the null hypothesis (See Appendix No. II)

**Conclusion**

The basic purpose of the study was to analyse the degree of the bankers perception and performance in the frame of marketing in the Islamic Banking Industry of Pakistan and make recommendations for increasing satisfaction among the bank employees so as to improve the effectiveness of marketing services of the Islamic banking system.

The cumulative rating of the bank by the respondents was Agree or Moderately Agree. Out of 180 respondents, 43% Moderately Agreed, 45% were Agreed, 10% were Strongly Agreed, 1% were Disagree and 1% Strongly Disagree.

Hypotheses was developed. The results are presented below:

**Hypothesis 1**: There will be no significant difference in the perception and performance of junior bank officers and senior bank officers in the frame of marketing in the Islamic Banking Industry of Pakistan.
The views of the junior and senior officers of the banks were satisfactory regarding the perception and performance in the frame of marketing under the Islamic banking of Pakistan because they have been professionally trained from the same banking institution. They performed their job as per their cadre, capability and proficiency. Hence both used their prudent potential to provide quality service to maximize the satisfaction level of their customers under the Islamic banking system.

**Recommendations**

The subsequent recommendations are furnished:

1) **Awareness Its Real Essence**

   It is recommended that the true essence of Islamic Banking and its components feature should be promoted among the consumers. Islamic marketing leads to satisfy the customers impressively with their core services.

2) **Promote The Islamic Marketing Tactics In Pakistan**

   In Pakistan the implementation of Customer Relationship Management practices are to be focused. Customer Relationship Management is a desk where they deal with the task of consumer outlet by adding related data about their customers with providing efficient services. It is recommended that standardized excellent service of Islamic bank be provided to magnetize the great number of customers.

3) **Promote Micro Financing**

   It is recommended to flourish the consumer banking and it is necessary to promote micro financing in every dimension of Islamic banking of Pakistan.

4) **Expansion In Product And Services**

   The quality of product is as per the standard of promotion. The customer should be adequately satisfied with the features of products and services as well as defined benefits. It is recommended that expansion in product and services should facilitate the customer demand and expectation.

5) **Profit At Par With Conventional Banks**

   It is recommended that the profit ratio should be high for the leading Islamic Banks which are growing well.

6) **Betterment Of Society**

   The concept of Islamic Banking system is a part of whole Islamic economic system with motive to promote a society based on equity and justice. Islam prohibits *Riba* or interest which leads to unjust and exploitative practices. Paying and changing interest is unjustified under the Islamic religious framework. The harmful consequences of *Riba* or interest which widens gap between the rich and poor ultimately lead to instability and social inclination in the economic.
References

Ahmad, A 1987, Development and Problems of Islamic Banks, Islamic Development Bank (IDB), Islamic Research and Training Institute (IRTI), Jeddah.


Qur'an by Saheeh Intl (Arabic-English Medium PB), Publisher: Almunatada Alislami


State Bank of Pakistan, (Dec, 2010), “Islamic Banking Bulletin”, Vol. 5 No.4

Tahir, M., Umar, M., (2008), Marketing Strategy for Islamic Banking Sector in Pakistan


Journal of Islamic Banking and Finance April – June 2012 45
### SECTION 1: Particulars about the Respondents.

**DIRECTIONS:** Please place a check mark (✓) in the appropriate space against each item.

<p>| | | | | |</p>
<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>1</td>
<td>GENDER</td>
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<tr>
<td>2</td>
<td>AGE</td>
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<tr>
<td>3</td>
<td>MARITAL STATUS</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>YEARS OF EXPERIENCE</td>
<td></td>
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<tr>
<td>5</td>
<td>QUALIFICATIONS</td>
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<tr>
<td>6</td>
<td>PROFESSION</td>
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<td>7</td>
<td>NATURE OF JOB</td>
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<td>8</td>
<td>INCOME GROUP</td>
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<td>9</td>
<td>U.C / TOWN</td>
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</tbody>
</table>

**1. GENDER**
- [ ] male
- [✓] female

**2. AGE**
- [ ] below 30 years
- [ ] 30-39 years
- [ ] 40-49 years
- [ ] 50 years and above

**3. MARITAL STATUS**
- [ ] married
- [✓] unmarried

**4. YEARS OF EXPERIENCE**
- [ ] less than 3 years
- [ ] 3-9 years
- [ ] 10-19 years
- [ ] 20 years and above

**5. QUALIFICATIONS**
- [ ] B.Com./BBA/B.A.
- [✓] MBA/M.Com./M.A./M.Phil./Ph.D.
- [ ] any other (specify)

**6. PROFESSION**

**7. NATURE OF JOB**

**8. INCOME GROUP**
- 10,000 - 20,000 Thousand
- 21,000 - 30,000 Thousand
- 31,000 - 40,000 Thousand
- 41,000 - 50,000 Thousand
- 51,000 - 60,000 Thousand
- 61,000 - 70,000 Thousand
- Above 70 Thousand

**9. U.C / TOWN**

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*Journal of Islamic Banking and Finance April – June 2012*
SECTION II:
Bankers Perception and Performance in the frame of 

Marketing in the Islamic banking industry

DIRECTIONS:
Below are listed several statements, each statement is a five-point scale: Strongly Agree (SA), Agree (A), Moderately Agree (MA), Disagree (D), Strongly Disagree (SD). Please place a check mark (✓) on the point in each statement which represents your position.

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Particular</th>
<th>SA</th>
<th>A</th>
<th>MA</th>
<th>D</th>
<th>SD</th>
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<tbody>
<tr>
<td>1</td>
<td>The social objectives cannot be separated from commercial objectives in Islamic finance.</td>
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<td>2</td>
<td>Marketing strategy for Islamic banking is based on equity and justice.</td>
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<td>3</td>
<td>The concept of Islamic marketing based on the effective customer relationship management.</td>
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<td>4</td>
<td>Do you feel competent enough to effectively solve customer's problems?</td>
<td></td>
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<td>5</td>
<td>The Islamic banks facilitate their customers by placing the Islamic Products as per demand.</td>
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<td>6</td>
<td>Do you agree that Islamic banking has emerged as a strong alternative in financial system.</td>
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<td>7</td>
<td>Islamic banking is inherently more stable than conventional banking.</td>
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<td>8</td>
<td>The mode of financing adopted by Islamic banking influences the mode of financing by conventional banking.</td>
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<td>9</td>
<td>The competency role of Islamic banking capture consumer banking sector.</td>
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<td>10</td>
<td>Islamic banks provide more alternative choices of similar products than Conventional Banks.</td>
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<td>11</td>
<td>The marketing strategy of Islamic bank have potential to produce profits higher than the conventional banking.</td>
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<td>12</td>
<td>Do you think that products &amp; services in Islamic banks are more costly than conventional banks?</td>
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<td>13</td>
<td>The Islamic banks charges compatible prices as compare to conventional banks.</td>
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<td>14</td>
<td>Do you have extensive work experience in the area of Islamic banking operations?</td>
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<td>15</td>
<td>I have clear &amp; efficient training related to products &amp; services.</td>
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<td>16</td>
<td>State Bank of Pakistan showing commitment in further developing Islamic banking system.</td>
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<tr>
<td>17</td>
<td>The marketing ethics of Islamic banking system promotes the customer satisfaction.</td>
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<td>18</td>
<td>Do you satisfied with competency role of Islamic banking?</td>
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<td>19</td>
<td>The Islamic Marketing ethics satisfy customer.</td>
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<td>20</td>
<td>The product of Islamic banking raise the customer standard of living.</td>
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<tr>
<td>21</td>
<td>The complete customer satisfaction is belief of management.</td>
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<td>22</td>
<td>Do you satisfy with the discipline of Islamic banks.</td>
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<td>23</td>
<td>Do you satisfy with standard of services provided by Islamic banks.</td>
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<td>24</td>
<td>Are you satisfied with the packaging formation (Promotional activities, quality of services etc.) of Islamic bank which portray a brand identity?</td>
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<td>25</td>
<td>Customers feel comfortable with Islamic marketing concept as compare to marketing concept of conventional banking.</td>
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<td>Is it true the performance of Islamic banks in Pakistan is better than conventional banks?</td>
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<td>Are you satisfied with the attitude of staff in Islamic banks is better than Conventional Banks.</td>
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<td>28</td>
<td>The Islamic banking maximize customer satisfaction through the quality of product and services.</td>
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<td>The quality of product is more impressive in the Islamic banking system.</td>
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<td>Do you think that quality of the products in Islamic banking is better than conventional banking products.</td>
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<td>The procedure of marketing and its service quality are attractive as compare to conventional banking.</td>
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<td>32</td>
<td>Islamic banking marketing strategy promotes prosperity in the society.</td>
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<td>The method of promotion used by Islamic banks are clear.</td>
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<td>34</td>
<td>Islamic marketing focus on Islamic ethical essence in Advertising.</td>
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<td>35</td>
<td>Do you agree organization climate of the Islamic banking promotes its business.</td>
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<td>36</td>
<td>I understand the objective of Islamic banking.</td>
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<td>37</td>
<td>Do you agree with the concept of Islamic marketing ethics.</td>
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<td>38</td>
<td>The Islamic marketing procedures are drawn from principles of <em>Shariah</em>.</td>
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<td>Customers choose Islamic banking for religious satisfaction.</td>
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<td>40</td>
<td>Do you agree Islamic bank facilitate their depositor through Profit and loss sharing base account (<em>Ribā</em>/interest free).</td>
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<td>41</td>
<td>Islamic banks perform as a progressive organisation.</td>
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<td>The marketing strategy for Islamic bank forbids investment in unethical and socially harmful activities.</td>
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<td>Islamic practices are transparent.</td>
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<td>Do you understand the key concepts of Islamic banking?</td>
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<td>45</td>
<td>Do you feel more comfortable using a <em>Shariah</em> based Financial Institution?</td>
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<td>46</td>
<td>Islamic banking system is introduced because <em>Ribā</em> is prohibited in Islam?</td>
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<td>47</td>
<td>Do you think that non-muslim customers are also interested in utilizing the Islamic products &amp; services at Islamic banks?</td>
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<td>48</td>
<td>Are you agreed Interest based government saving schemes are major barrier in promoting Islamic banking within the country?</td>
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<td>Do you think that customers choose Islamic banking products &amp; services because they are more interested in the Islamic concepts of financing.</td>
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<td>50</td>
<td>The marketers of Islamic banking are promoting only <em>Halāl</em> Product in the market.</td>
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<td>51</td>
<td>The implications of Islamic principles on the marketing aspect of business are same for both products and services.</td>
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<td>The objective of Islamic banks are professionally manageable.</td>
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<td>The Islamic marketing practices meet professional standards.</td>
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<td>The marketing strategy of Islamic banking is value-oriented.</td>
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<td>The marketing strategy of Islamic banking is non-exploitative.</td>
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<td>The marketing strategy for Islamic bank is fully viable in modern economics.</td>
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<td>Do you agree with the terms and condition which shall govern customer services?</td>
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<td>58</td>
<td>Do you think Islamic banks offering innovative products and services to compete the market.</td>
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<td>59</td>
<td>Are you agreed Islamic marketing is based on “pursuit of excellence” principle?</td>
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Appendix No. II

TABLE 4.2
Application for t Test for Testing the Null Hypothesis
(As viewed by Bankers)

Step 1: Tabulation of data

<table>
<thead>
<tr>
<th>S.NO.</th>
<th>JUNIOR OFFICER</th>
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<th>SENIOR OFFICER</th>
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\[
\sum X_1 = 8985 \quad \sum X_2 = 29631 \\
N_1 = 42 \quad N_2 = 138 \\
\sum X_1^2 = 1922713 \quad \sum X_2^2 = 6363327 \\
X_1 = \frac{\sum X_1}{N_1} = \frac{8985}{42} = 213.93 \\
X_2 = \frac{\sum X_2}{N_2} = \frac{29631}{138} = 214.72 \\
S_1 = \sqrt{\frac{\sum X_1^2 - (\sum X_1)^2}{N_1 - 1}} = \sqrt{\frac{1922713 - (8985)^2}{42 - 1}} = 3.71 \\
S_2 = \sqrt{\frac{\sum X_2^2 - (\sum X_2)^2}{N_2 - 1}} = \sqrt{\frac{6363327 - (29631)^2}{138 - 1}} = 2.75
\]
Step 3: Find the standard errors of the two means

\[ SE_{X_{1}} = \frac{S_{1}}{\sqrt{N_{1}}} = \frac{3.71}{\sqrt{42}} = 0.5727 \]

\[ SE_{X_{2}} = \frac{S_{2}}{\sqrt{N_{2}}} = \frac{2.75}{\sqrt{138}} = 0.2341 \]

Step 4: Find the standard errors of the difference between the two means

\[ SE_{X_{1} - X_{2}} = \sqrt{(SE_{X_{1}})^2 + (SE_{X_{2}})^2} = \sqrt{(0.5727)^2 + (0.2341)^2} = 0.62 \]

Step 5: Find the degree of freedom

\[ df = (N_{1} - 1) + (N_{2} - 1) = (42 - 1) + (138 - 1) = 178 \]

Step 6: Find t

\[ t = \frac{X_{1} - X_{2}}{SE_{X_{1} - X_{2}}} = \frac{213.93 - 214.72}{0.62} = 1.27 \]

Step 7:

Referring to Table t, we find that the tabulated value of \( t = 1.96 \), with \( df = 178 \) at \( \alpha = 0.05 \) is greater than the computed value of \( t = 1.27 \). Therefore the null hypothesis is upheld and it is concluded that there is no significant difference between the Junior Officer and Senior Officer about the level of satisfaction among customers about the Islamic marketing ethics of Islamic Banking Industry of Pakistan.

From the analysis of the table, it is clear that the junior and senior bankers views regarding level of satisfaction among customers about the Islamic marketing ethics are same.
Factors That Affect The Profitability Of The Conventional Bank And Shariah Bank In Indonesia

By Muhamad Nadratuzzaman Hosen*

ABSTRACT
The research aims to investigate factors of profitability that affected the performance of conventional bank and Islamic bank in Indonesia from period 2002 to 2010. With use regressions models, where ROA and ROE are as dependent variables presenting profitability of banker, whereas internal and external factors as independent variables include: GDP per capita, size, financial development indicator (FIR), liquidity, concentration, cost, numbers of branches, operational cost operational income (BOPO), NPL’s ratio, and inflation. The results identify that in conventional bank in Model I, number of branches is the most significant determinant of conventional banks performance and in Model II numbers of branches, GDP per capita, FIR, and liquidity are the most significant determinant of conventional banks performance, whereas in Islamic bank in Model I, NPL’s ratio, numbers of branches, and inflation are the most significant determinant of Islamic bank, and in Model II there are no significant determinants of Islamic bank performance.

KEYWORDS: Profitability factors, Conventional bank, Islamic bank.

Introduction
The Indonesian banking industry has been growing fast as it is demonstrated by the growth of its assets year after year. When the number of banks is increasing the products and pricing will become widely spread out. Bankers should be more rational and creative in raising and mobilizing deposits. When the bank could manage its operation in effective and efficient manner, most likely it would lead its competitors.

The source of funds of a bank is by raising the funds from community, which is then managed by the bank to earn more revenue for the bank. In order to increase the source of funds, the bank performance must be increased by achieving high profitability and sharing the highest profit with its stakeholders. When the

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profitability increases, the level of trust of the society will also increase, whereas the collection of funds for bank deposits will get a boost as well, and the assets of bank will be grow fast.

As one of the important institutions in our economic stratum, there is a need for banking performance supervision by the banking regulator. One of the indicators to evaluate the financial performance of the bank is by looking at its profitability. It is highly relevant as to how far the bank manages its business in a efficient manner. Efficiency is measured by comparing the profit earned with asset or capital that is used to produce such profit. The higher the profitability of a bank, the financial performance is at its best (Stiawan, 2009).

The indicators of measuring the level of profitability are by looking at the return on equity (ROE) and the return on asset (ROA). ROE demonstrated the ability of the management in managing the capital to generate the net income, the more the return the higher the dividend to be distributed to the shareholders. In the meantime, ROA demonstrated the ability of the bank in using the assets to generate income from its assets management (Yuliani, 2007).

Indonesia has a very large potential for financial institutions market share, such as banking industry, especially, the Islamic banking system. The majority of Moslem population in Indonesia and the fatwa from its council of Indonesian Ulama (MUI) in regard to the prohibition (haram) of interest, has triggered the growth of our Islamic banking system. There is increasing demand of community which will invest their funds in Islamic banking system. With the rapid growth of Islamic banking system in Indonesia, it is expected to be in line with our economic growth. The Islamic banks performance should be maintained/improved and it need to be supervised for an optimal performance.

The importance of measuring banks performance from its profitability, has become an important factor for the bank to keep increasing its profitability. There are many factors that will affect the bank profitability, the internal factor (micro) or the external factor (macro). This paper will analyze which factors affect the level of profitability of banking system in Indonesia, whether it is Islamic bank or conventional bank. The identification of factors that affect the bank’s profitability is expected to ease the evaluation process to achieve the optimum of bank’s profitability. This paper is a comparison between the profitability of Islamic bank and that of conventional bank in Indonesia. This comparison is to be done in order to have both Islamic and conventional Bank’s to increase their performance which in turn the will increase the growth of our economic system as well.

Theoretical analysis
Profitability of banking system

As opined by Stiawan (2010: 14) that one indicator to evaluate financial performance of a bank is by looking at its profitability. This is relevant as to how far the bank manages its business efficiently. The measurement of efficiency is by comparing the profit acquired with the assets or the capital used for income generation. The higher the profitability of a bank, the performance of the bank is considered to be better.
Sastradipoera (2001) stated that profitability is the extra amount of regular and irregular expense variable minus the income over the expenditure of a bank. Hadaddkk (2003: 1) defined the profitability as the basis of correlation between the operational efficiency and service quality produced by the bank.

Gozali (2010: 23) said that the profitability ratio is a measure for management effectiveness based on the return acquired from lending and investment. The common indicator is to measure the performance of a bank from its profitability on ROE (Return on Equity), which is the ratio that illustrates the higher return over the capital to generate income, ROA (Return on Asset) is the ratio which illustrates the ability from the total assets to be used for the purpose of income generation.

\[
\text{ROE} = \frac{\text{Net Income}}{\text{Capital}} \times 100\%
\]

\[
\text{ROA} = \frac{\text{Net Income}}{\text{Total Assets}} \times 100\%
\]

**Previous research papers**

Sriwijanaaand Siswanto (2007) analyzed the effect of the level of inflation, interest rate and the value of foreign exchange against the profitability of Islamic bank in Malang region for the period of 2004 to 2006. It is known the three variables simultaneously did not significantly affect the profitability of Islamic Banks in Malang region. The inflation level and the value of our IDR currency has also not significantly affected the profitability of Islamic banks in Malang region.

Stiawan (2009) has analyzed the affect of macroeconomic factor which measure by the growth of inflation and GDP, the market share measurement and the bank character based on CAR, FDR, NPF, Efficiency, and its SIZE against the profitability for Islamic bank which is measured by ROA. As a result, it is known that the growth of inflation and GDP is not significant against ROA, while FDR, market share and CAR are positively significant against ROA. In the meantime, NPF, Efficiency and size significantly negative against ROA.

Al-Tamimi (2010) made a comparison of the factors that have an affect on profitability between the Islamic bank and conventional bank for the period of 1996 to 2008. The regression model using ROA and ROE as its independent variables, determined internal and external factors which are GDP, bank size financial development indicator (FIR), liquidity, asset concentration, cost of funds and number of branches. The result has identified that the liquidity and asset concentration is the most significant factor for the conventional bank, while the most significant factor for the Islamic bank is the cost of funds and number of branches which will affect the financial performance of Islamic bank.

Ali, Akhtar, and Sadaqat (2011) have identified the factors of profitability of Islamic banks in Pakistan. The data for the period of 2006-2009 was analyzed by using the return on asset (ROA) and the return on equity (ROE) as independent variables which illustrate the level of profitability. It is known that the ratio of lending over capital (gearing ratio) and the capital adequacy ratio (CAR) has a
positive affect and statistically significant. The asset management is significant in model I and it is not significant in model II which affect positively both models. The size of bank has negative influence and non-significant in both models. Whilst the NPL ratio has a negative affect for both models, which significantly affected in model 1 and not significantly affected in model II.

Since there are not so many researches as of Islamic bank’s financial performance in Indonesia, therefore this paper will analyze which factors affected the profitability of Islamic banks and conventional banks and furthermore, will make a comparison of both banking systems.

Research Methodology

Description of Data

The object of this research paper is the financial reports of Indonesia’s commercial banks, both Islamic banks and conventional for the period of year 2002 to year 2010. This data is a secondary data acquired from Bank Indonesia publication reports from year 2002 to year 2010.

Analysis Method

This paper conducted the analysis using the quantitative method. The quantitative analysis is in the form of numbers and statistic calculation method, therefore the data must be classified into specific category using specific table in order to simplify the research using the SPSS programs. The analysis tools are multiple regressions with previous classical examination assumption. Furthermore there is a hypothesis examination, partially or simultaneously. The partial exam using the T exam while the simultan exam using the F exam.

As according to the banking financial reports, profitability is measured by the ratio of ROA and ROE, therefore it has two equations modeling of regression:

Model (I) : Return on Asset (ROA)

\[
\text{ROA} = \alpha + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + \ldots + e
\]

Model (II) : Return on Equity (ROE)

\[
\text{ROE} = \alpha + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + \ldots + e
\]

Research Variable Table is as follow:

<table>
<thead>
<tr>
<th>Variable Type</th>
<th>Indicator</th>
<th>Definition</th>
<th>Scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent</td>
<td>ROA</td>
<td>Return on Asset</td>
<td>Ratio</td>
</tr>
<tr>
<td></td>
<td>ROE</td>
<td>Return on Equity</td>
<td>Ratio</td>
</tr>
<tr>
<td>I</td>
<td>ECON</td>
<td>Economic Condition (GDP)</td>
<td>Ratio</td>
</tr>
<tr>
<td></td>
<td>SIZE</td>
<td>Bank Size in term of Total Asset</td>
<td>Ratio</td>
</tr>
</tbody>
</table>
Hypothesis analysis

Based on the above assumption the writer has produced the formula, as follows:

\( H_0 = \) There is no influence between the internal and external factors for the profitability of conventional banks and shariah banks.

\( H_a = \) There is an influence between internal factor and external factors for the profitability of conventional bank and shariah bank.

In order to have the significant result (close to the reality), this paper is using 90 degree of statistic confidentiality 90 % (\( \alpha = 10 \% \)).

The finding of the research and the arguments

Profitability of Conventional Bank

a. Model (I): Return on Asset (ROA)

 Previously, we have done a multicollinearity test to detect whether or not there is a sign of multicollinearity between independent variable and equation modeling. The result of a multicollinearity test is on Table. 2. Pearson Correlation Coefficient.

Table 2: Pearson Correlation Coefficient

<table>
<thead>
<tr>
<th>Independent</th>
<th>Financial Development (Total Asset/GDP)</th>
<th>Liquidities Bank (Debt over Deposits)</th>
<th>Asset Concentration of a Bank (total asset bank overall banks total assets in Indonesia)</th>
<th>Total Cost of Funds</th>
<th>Operational Cost/Operational Income</th>
<th>Non Performance Financing</th>
<th>No. of Branches</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>FIR</td>
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<tr>
<td>COST</td>
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</tr>
<tr>
<td>BOPO</td>
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<tr>
<td>NPL</td>
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<tr>
<td>BRAN</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>INF</td>
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</tr>
</tbody>
</table>

Previously, we have done a multicollinearity test to detect whether or not there is a sign of multicollinearity between independent variable and equation modeling. The result of a multicollinearity test is on Table. 2. Pearson Correlation Coefficient.
The conclusion of this test is that in the equation modeling, there is no sign of multicollinearity and the regression result on Model I, is as follows:

Table 3: Statistic Regression Model I

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-0.188573</td>
<td>0.868968</td>
<td>-0.217008</td>
<td>0.8316</td>
</tr>
<tr>
<td>ECON</td>
<td>-5.30E-08</td>
<td>4.36E-08</td>
<td>-1.214497</td>
<td>0.2469</td>
</tr>
<tr>
<td>SIZE</td>
<td>4.25E-09</td>
<td>2.64E-08</td>
<td>0.161043</td>
<td>0.8745</td>
</tr>
<tr>
<td>FIR</td>
<td>-0.034425</td>
<td>0.037267</td>
<td>-0.923735</td>
<td>0.3725</td>
</tr>
<tr>
<td>LIQ</td>
<td>-0.045942</td>
<td>0.041667</td>
<td>-1.012611</td>
<td>0.2902</td>
</tr>
<tr>
<td>CONT</td>
<td>0.205895</td>
<td>0.847035</td>
<td>0.243077</td>
<td>0.8117</td>
</tr>
<tr>
<td>COST</td>
<td>-0.008345</td>
<td>0.020950</td>
<td>-0.398313</td>
<td>0.6969</td>
</tr>
<tr>
<td>BOPO</td>
<td>-0.013529</td>
<td>0.020476</td>
<td>-0.660751</td>
<td>0.5203</td>
</tr>
<tr>
<td>NPL</td>
<td>-0.117065</td>
<td>0.090024</td>
<td>-1.303800</td>
<td>0.2161</td>
</tr>
<tr>
<td>BRAN*</td>
<td>6.45E-05</td>
<td>2.39E-05</td>
<td>2.691290</td>
<td>0.0185</td>
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<td>INF</td>
<td>0.001534</td>
<td>0.033168</td>
<td>0.046242</td>
<td>0.9638</td>
</tr>
</tbody>
</table>

Dependent Variable: ROA
Method: Least Squares
Date: 07/27/11 Time: 09:52
Sample: 2005Q1 2010Q4
Included observations: 24
It is known that the R-square is 0.682965. Thus the variable independent simultaneously influences the dependent variable against (ROA) which is 0.682965 or 68.29%. In partial, only the BRAN variable has a positive influence against ROA at Conventional bank. It is indicated that the more branches that the conventional bank has, the more assets it will acquire and that will be followed by the increment of its profitability level.

In the meantime, the external factor such as economic condition (ECON) and inflation (Sriwiyana & Siswanto, 2007) in particular do not affect significantly the bank’s profitability. The reason for that is stable economic condition and inflation level, during the finding of the research which do not have any affect on the bank profitability, although there is a stiff competition among banking systems nowadays.

b. Model (II): Return on Equity (ROE)

Previously, we have done a multicollinearity test to detect whether or not there is a sign of multicollinearity between independent variable and equation modeling. The result of a multicollinearity test is on Table 4. Pearson Correlation Coefficient.

<table>
<thead>
<tr>
<th>ROE</th>
<th>ROA</th>
<th>NRM</th>
<th>ECON</th>
<th>SIZE</th>
<th>FIRQ</th>
<th>LIQ</th>
<th>CONT</th>
<th>COST</th>
<th>DPO</th>
<th>NPL</th>
<th>BRAN</th>
<th>INF</th>
</tr>
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<tr>
<td>0.9230</td>
<td>0.3405</td>
<td>0.2072</td>
<td>-0.8729</td>
<td>-0.6160</td>
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<td>-0.8729</td>
<td>-0.6160</td>
<td>-0.8729</td>
</tr>
</tbody>
</table>
The conclusion of this test is that in the equation modeling, there is no sign of multicollinearity, and the regression result on Model II, as follows:

**Table 5: Statistic Regression Model II**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>-9.238154</td>
<td>6.445590</td>
<td>-1.433252</td>
<td>0.1754</td>
</tr>
<tr>
<td>ECON*</td>
<td>-5.82E-07</td>
<td>3.24E-07</td>
<td>-1.797497</td>
<td>0.0955</td>
</tr>
<tr>
<td>SIZE</td>
<td>1.88E-07</td>
<td>1.96E-07</td>
<td>0.958666</td>
<td>0.3552</td>
</tr>
<tr>
<td>FIR*</td>
<td>-0.500269</td>
<td>0.276430</td>
<td>-1.809751</td>
<td>0.0935</td>
</tr>
<tr>
<td>LIQ*</td>
<td>-0.601104</td>
<td>0.309066</td>
<td>-1.944907</td>
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</tr>
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<td>CONT</td>
<td>9.774549</td>
<td>6.282900</td>
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<tr>
<td>COST</td>
<td>-0.107533</td>
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</tr>
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</tr>
<tr>
<td>BRAN*</td>
<td>0.000601</td>
<td>0.000178</td>
<td>3.381221</td>
<td>0.0049</td>
</tr>
<tr>
<td>INF</td>
<td>0.055749</td>
<td>0.246022</td>
<td>0.226602</td>
<td>0.8243</td>
</tr>
</tbody>
</table>

|            | R-squared   | Mean dependent var | 0.233929 |
|            | Adjusted R-squared | S.D. dependent var | 0.026336 |
|            | S.E. of regression | Akaike info criterion | -5.081323 |
|            | Sum squared resid | Schwarz criterion | -4.541382 |
|            | Log likelihood | Hannan-Quinn criter. | -4.938076 |
|            | F-statistic | Durbin-Watson stat | 1.680769 |
|            | Prob(F-statistic) | 0.005898 |
It is known that R\-square is 0.781217. Thus the independent variable simultaneously affects the dependent variable (ROE) which is 0.781217 or 78.12%. In partial, the independent variable has a negative influence against the ROE at Conventional bank such as: ECON, FIR, and LIQ, while the (BRAN) has a positive influence on the profitability of a bank. This indicates that the economic condition (ECON), financial development (FIR), bank liquidity (LIQ), and the number of branches (BRAN) affect to the capital of a bank (tier one) which eventually will affect the profitability of a bank as well.

The profitability of shariah Bank

a. Model (I): Return on Asset (ROA)

Previously, we have done a multicollinearity test to detect whether or not there is a sign of multicollinearity between independent variable and equation modeling, the result of a multicollinearity test is on Table. 6. Pearson Correlation Coefficient.

<table>
<thead>
<tr>
<th>ECON</th>
<th>SIZE</th>
<th>FIR</th>
<th>LIQ</th>
<th>CONT</th>
<th>COST</th>
<th>BOPO</th>
<th>NPL</th>
<th>BRAN</th>
<th>INF</th>
</tr>
</thead>
<tbody>
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<td>0.90399</td>
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<td>FIR</td>
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<td>-0.60680</td>
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<td>-0.19011</td>
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<td>-0.44039</td>
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<td>0.162299</td>
<td>0.52998</td>
<td>-0.35659</td>
<td>0.994197</td>
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<tr>
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<td>0.216267</td>
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<td>-0.35659</td>
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</tr>
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<td>0.3585</td>
<td>0.3585</td>
<td>0.3585</td>
<td>0.3585</td>
<td>0.3585</td>
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</tr>
<tr>
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<td>-0.2587</td>
<td>-0.66742</td>
<td>0.50065</td>
<td>-0.69091</td>
</tr>
</tbody>
</table>

The conclusion of this test is that in the equation modeling, there is no sign of multicollinearity, the regression result on Model I, is as follows:

Table 7: Statistic Regression Model I

Dependent Variable: ROA
Method: Least Squares
Date: 07/27/11 Time: 11:47
Sample (adjusted): 2005Q4 2010Q4
Included observations: 12 after adjustments
It is known that $R^2$ is 0.999510. Thus the independent variable simultaneously affected the dependent variable (ROA) by 0.999510 or 99.95%. In partial, NPL has a positive influence against bank profitability (ROA). While the number of branches (BRAN) and inflation has a significant negative affect against the profitability of shariah bank (ROA).

There is a similarity between Islamic banking system in Pakistan and Indonesia, the profitability of a shariah bank in Pakistan is measured by ROA, and influenced by gearing ratio, NPLs ratio, CAR, and operating efficiency (Ali, Akhtar, and Sadaqat, 2011).

The finding of this result elaborates that shariah banks performance in Indonesia is encouraged to maintain a certain level of the Non Performing Financing (NPL) ratio. The NPL ratio has a positive influence, with the probability that the shariah bank has a low NPL ratio in which it will not reduce the profitability of shariah bank yet. The assets sold from collateral acquired by the bank as a result of the NPL will increase the bank asset; however the stability of NPL ratio must be continuously maintained.
The number of branches has a negative influence on the bank profitability. Thus, it is expected that the bank management must create innovative movement by expanding its business without opening up new branches. The shariah banks could open up office channeling at their parent company which is conventional bank and open up office channeling or shariah business unit at its previous parent company. In this way, shariah banks could manage to reduce their expenditure in order to increase their profitability.

In addition, inflation has the negative influence to the profitability of Islamic banks. As it is known that the increment of inflation, will increase the expenditure of people and their intention to invest their funds at a bank will decrease, as a result, the profitability of bank will decline as well. Considering that the inflation level in Indonesia is still in stable condition, it is expected that bank will keep on attracting its customers to deposit funds, and the bank will be managing the funds in a good manner in order to increase its profitability.

b. Model (II): Return on Equity (ROE)

Previously, we have done a multicollinearity test to detect whether or not there is a sign of multicollinearity between independent variable and equation modeling, the result of a multicollinearity test is on Table 8. Pearson Correlation Coefficient.

<table>
<thead>
<tr>
<th>ECON</th>
<th>SIZE</th>
<th>FIR</th>
<th>LIQ</th>
<th>CON</th>
<th>COST</th>
<th>BOPO</th>
<th>NPL</th>
<th>BRAN</th>
<th>INF</th>
</tr>
</thead>
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<td>-0.33414</td>
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</table>

The conclusion of this test is that in the equation modeling, there is no sign of multicollinearity, and the regression result on Model II, as follow:

<p>| Dependent Variable: ROE |
| Method: Least Squares |
| Date: 07/27/11 | Time: 11:43 |
| Sample (adjusted): 2005Q4 2010Q4 |
| Included observations: 12 after adjustments |</p>
<table>
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<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
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<td>2.461477</td>
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<tr>
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<td>1.01E-06</td>
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</tr>
<tr>
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<td>3.63E-05</td>
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<td>0.7669</td>
</tr>
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<tr>
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<td>0.5079</td>
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<td>INF</td>
<td>-2.719298</td>
<td>1.378605</td>
<td>-1.972500</td>
<td>0.2987</td>
</tr>
</tbody>
</table>

R-squared 0.993687  Mean dependent var 0.344567
Adjusted R-squared 0.930557  S.D. dependent var 0.137789
S.E. of regression 0.036310  Akaike info criterion -4.445008
Sum squared resid 0.001318  Schwarz criterion -4.000510
Log likelihood 37.67005  Hannan-Quinn criter. -4.609577
F-statistic 15.74030  Durbin-Watson stat 2.998357
Prob(F-statistic) 0.193896

It is known that the R-square is 0.993687. Thus, independent variable is simultaneously affected against the dependent variable (ROE) which is 0.993687 or equivalent to 99.37%. In partial, for the independent variable, there is no influence against the dependent variable in shariah bank.

It indicates that the capital of shariah bank is low, as a result, the factors/independent variables in this research have no significant affect to the profitability of a bank. As contrary to the research of shariah bank in UAE this has influence against the ROE such as: ECON, COST, and BRAN (Al-Tamimi, 2010).

Subsequently, in general, Indonesian conventional banks have been established and developed long before the shariah banks existed, and the conventional banks have large total assets and the market shares, therefore the profitability of
conventional banks is more sensitive to be affected by the independent variables. On the other hand, shariah bank which is an infant and has lower market share, the profitability is very crucial. Shariah banks in Indonesia are continuing improvement, regardless of the economic condition and inflation, and it will be advantageous for shariah banks.

The development of shariah banks must continuously be improved. There are many ways to increase the profitability of shariah banks, such as expenditure efficiency and effectively managing shariah banks activities. Shariah banks should increase their capital in order to increase their assets, followed by good performance and good management, in order to increase their profitability.

**Conclusion and Recommendation**

**Conclusion**

It is concluded that during the year 2002 - 2010, the profitability level of Indonesia banking system, both conventional and shariah was simultaneously affected by the internal and external factor such as economic condition, inflation, liquidity, number of branches and others.

However, this research finding showed that in partial, those factors have no influence against the profitability related to ROA or ROE. It has been demonstrated in the test result of conventional bank regression on model I in which partially only BRAN is affected, while in Model II only ECON, FIR, LIQ, and BRAN are affected.

The result for shariah bank, partially, Model I only the variable of NPL, BRAN, and INF is affected, while in Model II none of the independent variable is affected. The reason for this due to insufficient data gathered, since during the period of 2002 - 2010 the number of shariah bank and its development is out of number in comparison to its conventional counterpart.

**Recommendation**

Indonesia has a wide range of market share for the development of financial institutions, such as conventional bank and shariah bank. The maximum profitability will be continuously maintained. Hence, the increment of profitability and Indonesian banking performance will be better and the economic growth will improve as well.

Therefore, it is necessary to have some supports from other parties such as bankers, government and the community toward working together in order to improve Indonesian banking performance. Bankers should be rational and creative thinkers in mobilizing their source of funds in an effective and an efficient manner. The government role is to supervise and to control the development of our banking system for risk management purposes. The society must have an open mind that banks can be utilized to place their investment. As a way forward, it is expected that shariah banking development in Indonesia will continue to improve.
References:


www.bi.go.id
Financial Sector Liberalization, Foreign Banks Entry And Domestic Banks Performance: Malaysia’s Initial Post-Liberalization Experience

By

Fadzlan Sufian & Nor Halida Haziaton Mohd Noor*

Abstract

This paper seeks to examine the impact of foreign banks entry on the performance of the Malaysian banking sector. The empirical analysis is confined to the two full-fledged domestic Islamic banks, three full-fledged foreign Islamic banks, 11 domestic IBS banks, and 4 foreign IBS banks during the period of 2001-2007. The findings suggest that the incumbent banks are relatively more profitable compared to the De Novo Islamic banks. We find that the De Novo Islamic banks are relatively smaller, better capitalized, disbursed lower amount of loans, incur relatively higher operating costs, and have lower credit risk. We find that the Malaysian Islamic banks are better capitalized and larger, but recorded lower profitability during the post-entry period. The empirical findings seem to suggest that Malaysian Islamic banks incur higher operating costs during the post-entry period. The results also suggest that Malaysian Islamic banks have disbursed a lower amount of loans during the post-entry period, but the credit risks seem to have escalated.

Keywords: Islamic Banks; Performance; Malaysia

1.0 Introduction

In recent years, there is a worldwide phenomenon towards the internationalization of the banking sector. These developments arise from the

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unswerving pressures from the developed nations for the developing countries to open up their domestic banking sectors. Likewise, Malaysia is also obliged to open up its banking sector towards foreign participation under the multilateral framework of the General Agreement on Trade in Services (GATS) provided by the World Trade Organization (WTO).

As part of Malaysia’s WTO commitment to liberalize the banking sector and to give foreign banks wider access to the Malaysian markets, the Malaysian government announced in September 2003 the issuance of three new full-fledged Islamic banks licences under the Islamic Banking Act, 1983, to foreign Islamic financial institutions from the Middle East. Following this, the first full-fledged foreign Islamic bank, Kuwait Finance House, started operations in August 2005. The other two Islamic banks, namely Saudi Arabia-based Al-Rajhi Bank and a consortium led by Qatar Islamic Bank, started operations in 2006 and early 2007 respectively. Under the Islamic Banking Act, 1983, the new foreign Islamic banks are required to meet the minimum paid-up capital of RM10 million and will have to pay an annual licence fee of RM50,000, but are allowed to conduct a wide range of Islamic banking business in Malaysia.

In accordance with the objectives committed under the Financial Sector Master Plan (FSMP) issued in 2001, the central bank of Malaysia (Bank Negara Malaysia) further announced on April 9th 2009 that it will be issuing up to two new Islamic banking and five commercial banking licences to foreign players, while foreign equity limit in domestic Islamic and investment banks has been raised from 49 percent to 70 percent. The strategy is to create more competition, to tap new growth opportunities, and to raise the efficiency of the Malaysian Islamic banking industry as a whole.

The move to allow greater foreign participation in the domestic banking sector is applauded as the new foreign players may bring in greater product innovation and development. The entry of foreign banks into a country’s domestic banking sector may help improve the efficiency of the incumbent banks and increase the stability of the banking sector as a whole. However, in the case of developing countries where the financial markets are relatively under-developed, the competition from foreign banks could pose serious challenges and the impact on the incumbent domestic banks particularly the small players could be severe and far-reaching (Claessens et al. 2001; Claessens and Laeven, 2004; Lensink and Hermes, 2004).

It is therefore timely to provide empirical evidence on the impact of foreign banks entry on the performance of the Malaysian banking sector. However, due to data constraints, the present study will only examine the domestic Islamic Banking Scheme (hereafter referred to as domestic IBS) banks, the foreign Islamic Banking Scheme (hereafter referred to as foreign IBS) banks, the full-fledged domestic Islamic banks, and the full-fledged foreign Islamic banks. This study will explore whether the De Novo (new entry) foreign full-fledged Islamic banks are relatively more profitable than their domestic full-fledged Islamic bank, domestic IBS Islamic bank, and foreign IBS bank counterparts.

In undertaking the study, we have gathered various commonly used accounting based measures of financial institutions performance from the yearly financial
statements of the full-fledged (foreign and domestic) and IBS banks for the period 2001 to 2007. To assess the relative performance of the De Novo and incumbent Islamic banks, we employ a series of parametric and non-parametric univariate tests.

2.0 The Malaysian Islamic Banking Sector

In Malaysia, the first Islamic bank was established in 1983. Ten years passed before the government allowed other conventional banks to offer Islamic banking services under their existing infrastructure and branches. The move to create the Islamic banking window operations allowed the country to enjoy Islamic banking services at the lowest cost and within the shortest time frame. Today, Malaysia has succeeded in implementing a dual banking system and has emerged as among the first nations to have a full-fledged Islamic banking system operating side-by side with the conventional banking system1.

As presented in Table 1 below, as at end-2008 the Malaysian Islamic banking sector comprised of two full-fledged domestic Islamic banks, three full-fledged foreign Islamic banks, 11 domestic IBS banks, and 4 foreign IBS banks.

**Table 1: Foreign and Domestic Islamic Banks**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Ownership</th>
<th>Paid Up Capital @ 31/12/08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affin Islamic Bank</td>
<td>100% Affin Holdings</td>
<td>RM160.0m</td>
</tr>
<tr>
<td>AmIslamic Bank</td>
<td>100% AMMB Holdings</td>
<td>RM435.8m</td>
</tr>
<tr>
<td><strong>Bank Islam Malaysia</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank Islam Malaysia</td>
<td>51% BIMB Holdings</td>
<td>RM1,725.5m</td>
</tr>
<tr>
<td></td>
<td>40% Dubai Investment Group</td>
<td></td>
</tr>
<tr>
<td></td>
<td>9% Lembaga Tabung Haji</td>
<td></td>
</tr>
<tr>
<td></td>
<td>70% DRB Hicom</td>
<td></td>
</tr>
<tr>
<td></td>
<td>30% Khazanah Nasional</td>
<td></td>
</tr>
<tr>
<td>Bank Muamalat Malaysia</td>
<td>100% Bumiputra Commerce Holdings</td>
<td>RM500.0m</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CIMB Islamic Bank</td>
<td>100% Bumiputra Commerce Holdings</td>
<td>RM550.0m</td>
</tr>
<tr>
<td>EONCAP Islamic Bank</td>
<td>100% EON Capital</td>
<td>RM389.0m</td>
</tr>
<tr>
<td>Hong Leong Islamic Bank</td>
<td>100% Hong Leong Bank</td>
<td>RM500.0m</td>
</tr>
<tr>
<td>Maybank Islamic Alliance Islamic Bank</td>
<td>100% Malayan Banking Group</td>
<td>RM184.7m</td>
</tr>
<tr>
<td></td>
<td>100% Alliance Financial Group</td>
<td>RM300.0m</td>
</tr>
<tr>
<td>Public Islamic Bank</td>
<td>100% Public Bank</td>
<td>RM159.2m</td>
</tr>
<tr>
<td>RHB Islamic Bank</td>
<td>100% RHB Capital</td>
<td>RM523.4m</td>
</tr>
<tr>
<td>Al-Rajhi Banking and Investment Corporation</td>
<td>100% Al-Rajhi Bank, Saudi Arabia</td>
<td>RM600.0m</td>
</tr>
<tr>
<td>Asian Finance Bank</td>
<td>70% Qatar Islamic Bank</td>
<td>RM355.0m</td>
</tr>
<tr>
<td></td>
<td>20% RUSD Investment Bank, Saudi Arabia</td>
<td></td>
</tr>
<tr>
<td></td>
<td>10% Financial Assets,</td>
<td></td>
</tr>
</tbody>
</table>

1 The first country which enjoyed a dual banking system was the United Arab Emirates (UAE) where Dubai Islamic Bank was established in 1973 with a paid capital of US$14 million (Metwally, 1997).
Throughout the years, the Malaysian Islamic banking sector has gained its significance and has been on a progressive upward trend. Since 2000, the Malaysian Islamic banking industry has been growing at an average rate of 18.9 per cent per annum in terms of assets. Figure 1 illustrates that the total assets of the Malaysian Islamic banking sector has increased from a mere RM1.2 billion in 1996 to RM157.1 billion in 2007, accounting for 12.8 per cent of the banking system’s total assets, while the market share of Islamic deposits and financing stood at 14 per cent of the total banking sector’s deposits and financing. With the growth in Islamic banking far surpassing the expansion in the banking system’s asset base, the Malaysian Islamic banking industry is expected to be able to achieve the government’s aspiration of the Islamic banking assets making up 20 per cent of the banking system’s total assets by year 2020.

Figure 1: Islamic Banking Assets as % of Malaysian Banking System Assets – 1996 - 2007

Source: Bank Negara Malaysia
3.0 Findings

In the preceding analysis, we will present and discuss the results derived from the parametric t-test and non-parametric Mann-Whitney [Wilcoxon] and Kolmogorov-Smirnov tests. We will first examine the performance of the new foreign banks (De Novo) compared to the incumbent banks, before proceeding to discuss the impact on the incumbent banks performance.

3.1 The Performance of the De Novo Banks Relative to the Incumbent Banks

To examine the difference in the relative performance between the De Novo and the incumbent banks, we perform a series of parametric (t-test) and non-parametric (Mann-Whitney [Wilcoxon] and Kolmogorov-Smirnov) tests. The results are presented in Table 2. The results from the parametric t-test suggest that the incumbent banks are relatively more profitable (0.64692 > -4.87202) and is statistically significant at the 1% level. We observe that the De Novo banks incur relatively higher operating costs, disburse lower amount of loans, and are better capitalized (statistically significant at the 5% level or better). The empirical findings also suggest that the De Novo banks are relatively smaller and have lower credit risk. The results from the parametric t-test are further confirmed by the non-parametric Mann-Whitney [Wilcoxon] and Kolmogorov-Smirnov tests.

Table 2: Summary of Parametric and Non-Parametric Tests

<table>
<thead>
<tr>
<th>TEST GROUPS</th>
<th>PARAMETRIC TEST</th>
<th>NON-PARAMETRIC TEST</th>
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<tr>
<td></td>
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<td>Mean Rank z (Prb &gt; z)</td>
</tr>
<tr>
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<td>NPL/TL</td>
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Note: Test methodology follows among others, Aly et al. (1990), Elyasiani and Mehdian (1992), and Isik and Hassan (2002). Parametric (t-test) and non-parametric (Mann-Whitney and Kolmogorov-Smirnov) tests test the null hypothesis of equal mean between the two models. ***,**, * indicates significant at the 1%, 5%, and 10% levels respectively.
3.2 Implications of Foreign Banks Entry on the Performance of the Incumbent Banks

In the preceding analysis, we will examine the difference in the performance of the Malaysian Islamic banking sector between the two periods i.e. before and after the foreign banks entry. As earlier, we perform a series of parametric (t-test) and non-parametric (Mann-Whitney [Wilcoxon] and Kolmogorov-Smirnov) tests. The results are presented in Table 3. The result from the parametric t-test suggests that the Malaysian Islamic banking sector has exhibited a lower mean ROA during the post-entry period (0.01012 < 0.1.27616) and is statistically significant at the 5% level (p-value = 0.022). The Malaysian Islamic banks are relatively larger (6.72363 > 6.30724) during the post-entry period. During the post-entry period, the Malaysian Islamic banking sector’s operating costs, level of capitalization, and credit risk are higher and are also found to be relatively higher although the difference is not statistically significant. On the other hand, the Malaysian Islamic banking sector disbursed a relatively lower amount of loans during the post-entry period, but again it is not statistically significant at any conventional levels.

### Table 3: Summary of Parametric and Non-Parametric Tests

<table>
<thead>
<tr>
<th>TEST GROUPS</th>
<th>PARAMETRIC TEST</th>
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Note: Test methodology follows among others, Aly et al. (1990), Elyasiani and Mehdian (1992), and Isik and Hassan (2002). Parametric (t-test) and non-parametric (Mann-Whitney and Kolmogorov-Smirnov) tests test the null hypothesis of equal mean between the two models. ***, **, * indicates significant at the 1%, 5%, and 10% levels respectively.
4.0 Discussions And Policy Implications

The move by the Central Bank of Malaysia to bring forward the liberalization of the Islamic banking sector, by announcing the issuance of new Islamic banking licences to foreign Islamic banking players, augurs well in terms of innovation and development for Islamic banking products and services. The new foreign full-fledged Islamic banks may have advantages, stemming from their wide international presence in mobilizing Islamic banking funds from the Middle East, as well as advantages resulting from their dynamism and innovativeness, in introducing and promoting new Islamic banking and finance products to cater to the domestic market’s needs. They may also possess inherent economies of scale, as a direct extension of their other international operations, and so are capable of competing with the incumbent banks.

From the policy-making perspective, the opening up of the Malaysian banking sector to the entry of foreign banks is important in the ongoing process of efficiency and productivity improvements, as well as innovation. However, as competition is expected to intensify, the smaller domestic as well as the foreign banks will have to work harder to increase their productivity and efficiency in order to remain competitive and profitable and, most importantly, to survive in a highly competitive environment.

The intensification of competition is therefore expected to induce the interest in cost cutting, productivity and efficiency in the Malaysian Islamic banking industry. Thus, the issue of increasing the efficiency and productivity of the Malaysian Islamic banking sector will become one of the main priorities of the regulators, as earlier studies have found that failing banks tend to have low cost efficiency prior to their failure and are likely to be located far from the best practice frontiers (Berger and Humphrey, 1992; Barr and Siems, 1994; Wheelock and Wilson, 1995). The continued success of Islamic banking in Malaysia will therefore depend on their efficiency, profitability and competitiveness, while having to give proper consideration to the need to minimize the risk to customers and to the legitimacy of its operations from the syariah point of view.

To prepare the IBS banks for stiffer competition from the foreign full-fledged Islamic banks, the Central Bank of Malaysia has encouraged the domestic banking groups to establish their wholly owned Islamic banking subsidiaries. Subsequently, all the local banking groups have now incorporated Islamic banking subsidiaries. To this end, the foreign IBS banks have also launched their own Islamic banking subsidiaries. This bodes well as the findings from the earlier studies (e.g. Sufian, 2007a; Sufian, 2007b) have found that the foreign IBS banks have been operating at economies of scale, implying that the foreign IBS banks may benefit from the increase in the scale of their operations.

In contrast to the ‘window’ structure, where Islamic banking operations reside within the conventional banking entity, the incorporation of the Islamic banking subsidiary also provides opportunities to potential institutional investors, both domestic and foreign alike, to participate in this activity through direct equity participation. The liberalized shareholding policy in the Islamic Banking Scheme, where foreign investors can now own up to 70 per cent equity from 49 per cent previously, will increase the potential to build strategic partnerships to acquire new
expertise, tap the best international talent and develop new value-added activities that would enhance competitiveness and stimulate greater innovation in the industry.

Going forward, there are many challenges awaiting the newly incorporated Islamic banking subsidiaries. Aside from higher overheads, the new subsidiary system will also result in a smaller marketing network, which could have adverse effects on the growth of Islamic deposits and financing. Despite that, the Malaysian Islamic banking subsidiaries may be able to reduce their overhead costs by outsourcing some of their operations such as computer solutions. Cross-selling is also an effective mechanism, but this must acquire syariah compliant status in so far as the sharing of premises and other logistics is concerned.

The establishment of Islamic banking subsidiaries may also prove to be fruitful to many concerned parties. As Islamic banking subsidiaries come under the governance of the Islamic Banking Act, 1983, instead of the Banking and Financial Institutions Act, 1989, it will remove most of the impediments that prevent Islamic banking windows from participating in non-traditional banking business such as wholesale and retail trading, purchases of assets and landed properties, and purchases of equities via joint venture and portfolio investments. The Malaysian Islamic banks can now underwrite Islamic bonds and stocks in addition to providing fee-based business such as brokerage and unit trusts.

By adopting the universal banking model, the Islamic banking subsidiary is set to offer non-traditional banking products such as Ijarah (leasing), Salam (pre-paid purchase and Istisna’ (sale by order), Mudharabah (partnership of skill and capital) and Musharakah (joint venture). These products will prove to be potent for entrepreneurial development, as the products are relatively collateral free. By carrying an equity flavour and risk-sharing values, Islamic banking subsidiaries can play significant roles in developing new entrepreneurial-friendly products not readily found in conventional banking. In the absence of a money-lending environment, entrepreneurs should stand a chance to flourish and perform even better under the new Islamic banking subsidiary system.

5.0 Concluding Remarks

This paper seeks to examine the impact of foreign banks entry on the performance of the Malaysian banking sector. Specifically working within the Malaysian Islamic banking sector, the empirical analysis is confined to the two full-fledged domestic Islamic banks, three full-fledged foreign Islamic banks, 11 domestic IBS banks, and 4 foreign IBS banks during the period of 2001-2007.

The findings suggest that the incumbent banks are relatively more profitable compared to the De Novo banks. On the other hand, the De Novo banks are relatively smaller, better capitalized, disbursed lower amount of loans, incur relatively higher operating costs, and have lower credit risk. We find that the Malaysian Islamic banks are better capitalized and larger, but recorded lower profitability during the post-entry period. The empirical findings seem to suggest that Malaysian Islamic banks incur higher operating costs during the post-entry period. The results also suggest that Malaysian Islamic banks have disbursed a lower amount of loans during the post-entry period, but the credit risks seem to have escalated.
References


Sukuk As An Alternative Avenue For Infrastructure Development And Job Creation

By

Oladokum Nafiu, Abdelghani Echchabi, Mohammad Fany Alfarisi

Abstract

This study aims at exploring the possible means through which sukuk can be used to raise funds for the development of infrastructure. The study will channel its argument towards potential benefits embedded in adopting sukuk model to build, upgrade and maintain infrastructure in majority of the Muslim countries where infrastructure decay is obvious and become a necessity in order to improve the living standard of the people. Apart from the benefits in term of infrastructure development, the study will also link the issuance of sukuk to poverty alleviation through job creation which thereby reduces unemployment in the society. The contribution of this study is mainly the enlightening of Muslims where majority of the population seemed oblivious of what Islamic economics entails with special emphasis on how funds raising through Sukuk can be a means of face-lifting the infrastructure in majority of Muslim countries. This conceptual paper will be based on literature survey and previous cases on sukuk issuance for infrastructural development. It is expected that this study will serve to allay the sceptic view of majority of Muslims regarding the core principle of Islamic Financial System (IFS) which is tailored towards a just society.

Keyword: Infrastructure, Micro-finance, Conceptual Paper, Alleviation, Liberalization

1. Introduction

Government participation and introduction of programs towards improving the role of microfinance related program in alleviating poverty and job creation have been traced to the 1960. The aim of such programs is to improve the participation of

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private sector and individual in business establishment. Through this, it is expected that unemployment would be reduced and economic condition of the populace would be improved.

Small business has got massive attention from the government in both developed and emerging country as part of its recognition as the back bone to the whole economic system (Ayanda and Laraba, 2011). Indeed the contribution of small business in employment generation, poverty alleviation, channel for rural and urban development, improving bilateral trade and increase productivity has been widely recognized and reflected by increasing funding and research in this area (McIntyre, 2001; Kwoka and White, 2000).

In recognition of the important and vast potential of the small business in unemployment and poverty ridden country like Nigeria, the federal government from time to time introduced programs aimed at improving this important sector of the economy. The eminent of such programs is the controversial Structural Adjustment Program (SAP) introduced and implemented by the former military ruler General Ibrahim Babangida in 1986. The main goal of SAP is the liberalization of the financial sector and less participation of the government in the business activities. The expectation was to increase the free flow of funds through financial liberalization policy. Following the removal of entry barrier and ease in getting licence, there was a surge in the number of banks from 40 banks in 1986 to 120 banks in 1992. Though, credit situation improved shortly after the program, the massive and systemic banking that followed the deregulation resulted to the shrinkages in the number of banks. This therefore forced the banks to tighten their credit requirement that made it difficult for the private sector and individuals to get access to finance. A host of other programs aimed at easing access to finance such as National Economic Empowerment and Development Strategy (NEEDS) have been introduced.

It was expected to see improvement and growth in the small business operation in Nigeria and feel its impact in terms of poverty reduction and employment generation. The reverse is however the case. Majority of the studies rated the various government programs low and ineffective in reducing unemployment, (Sani, 2009; Christopher et al, 2010). Provision of conducive environment therefore remains imperative for poverty reduction and job creation for the millions of idle youth. Majority of the studies attributed lack of financial access and high operation cost as the bane of the problem that continues to serve as a threat to the sustainability of small business in Nigeria, (Sanni, 2009; Elumilade and Asaolu, 2006). Cost of renting stall constitutes a significant chunk of the total cost especially in the city where homeowners are notoriously known for demanding 2 years rent or more in advance before letting to those who need them. This thus calls for an alternative financial arrangement that will serve to support small business owner from avoidable failure. In view of this, the current study proposes a financial arrangement that will facilitate the raising of funds using sukuk otherwise called Islamic bond to finance the construction of stalls that will be let to small business at affordable rate. The main feature of this method is that, the contractual arrangement is based on partnership whereby, parties involved share the profit or loss resulting from the business rather than debt-based contractual arrangement. It is expected that,
this study will help in reducing the financial burden of small business owner and improve profitability. Achieving this will encourage other people with viable business idea who might have been obstructed from starting their own business to participate in small business.

2. Microfinance Issues In Nigeria

The increasing rate of poverty coupled with the escalating growth in unemployment rate in Nigeria and its consequences on socio-economic stability prompted high concern for the government to intensify programs that promote creation of small businesses in Nigeria. The Nigerian government has been playing active role in promoting private investment and small business since 1960’s. As part of the effort towards a conducive environment for the small business and private sector participation in the economy, the government of Nigeria introduced various programs. Among the numerous programs, introduced are, Structural Adjustment Program (SAP), Micro-Finance Policy (MFP), National Economic Empowerment and Development Strategy (NEEDS). Most of the programs are tailored towards the provision of private participation in the production activities through financial liberalization. The expectation was that, financial liberalization will facilitate the flow of funds for private and small business development. Factors such as political and economic instability and high cost of finance still remain the major impediments to the survival of small business in Nigeria, (Obamuyi, ND).

Scarcity of funds and high administrative cost has been identified as one of problems facing small business establishment and sustainability in Nigeria (Ekpenyong and Nyong, 1992; Dada, ND; Ayanda and Laraba, 2011). Due to the scarcity of funds and poor financial system, most micro-finance institutions charge exorbitant interest rate on their loans which make it hard for the borrowers to maintain and sustain the business. This accounts for the failure of the majority of the small business in Nigeria. Cost of doing business especially cost for renting stall in most of the cities in Nigeria discourage many people with business idea and innovation from starting their own business.

The important role of small business in the economy cannot be underestimated. Studies have shown and proved the resilience of this type of business during the period of economic recession, (Ayanda and Laraba, 2011).

3. Sukuk

Islamic finance business has grown rapidly in some Muslim majority countries. There are two factors that have contributed to the growth of the sharia-based business namely, the increasing trend of religiosity of Muslims and the failure of the current capitalist financial system to benefit the society at large. If we follow the journey of Islamic finance, it started by the idea of demolishing riba in economy. Islamic banking system, therefore, came into the picture with the distinctive features such as; profit-sharing based financing and deposits, supervision of sharia advisory board, and adoption of the universal banking model.

The Islamic banking model has been well accepted by many Muslim countries. Yet, some countries, such as: Malaysia, Saudi Arabia, and United Arab Emirates...
have taken the advantages of this newly banking model. Though, the Islamic banking system is deemed to be successful to fulfill the need of Muslim in financial sector; however, it is still not sufficient to be implemented in financing the large scale projects notably; infrastructure projects. With regard to financing the big infrastructure projects, Islamic banking system has at least two limitations namely; regulation in the banking industry and the scale of funds for financing the infrastructure projects. As a banking institution, Islamic banks are supervised by the Central bank. To some extent they have to abide by the rules and regulations similar to their conventional counterparts. Moreover, the scale of funds needed and the period of repayment in financing the infrastructure projects is one of the issues here.

With respect to limitations which have to be complied with by Islamic banking institutions, there is a need to have an Islamic investment scheme that can fulfill that gap. The tentative solution of this problem, so far, is by introducing Sukuk into the capital market. Sukuk as the investment avenue based on Islamic principles is currently growing in popularity in some Moslem countries. Based on the share of sukuk issuance worldwide, Malaysia is the leader in the sukuk issuance, followed by Qatar and Saudi Arabia in the second and the third positions. By definition, sukuk is a type of security which represents the claim of an asset or a bundle of assets (Adam & Thomas, 2005). Sometimes people perceive that sukuk is similar to bonds, however, there are some elements that differentiate them, such as: nature, claims, security, principal and return, purpose, trading of security and responsibility of holders (Adam & Thomas, 2005). The other distinctive feature of sukuk is the approval of shariah adviser to ensure that all aspects of sukuk issuance comply with shariah principles.

Similar to the other types of securities, sukuk also are having certain risks inside. Usually, the risk factors of sukuk issuance would be defined and explained in the sukuk prospectus. Credit risk, operational risk, sharia risk, and country risk, are just to name a few of risks that might influence the return and the repayment of principal to the sukuk holders. As a rule of thumb, before buying particular sukuk, the potential investors should read carefully the information given in the sukuk prospectus or they have to get professional advice from independent financial analyst, shariah advisor and lawyer on that matter.

Moreover, based on the contract used, sukuk can be classified into six models, namely: ijarah, musyarakah, murabahah, mudarabah, salam and ishtisna.

3.1 Sukuk al Ijarah

Ijarah is similar to leasing contract. This contract can be used in some activities, for instance: a landlord that allows his house to be rented by a tenant for certain periods or leasing company leases some airplanes to airline firms for certain periods. Both examples can be considered as ijarah contract. Additionally, there is an agreement made by both parties or sometimes only one party is involved in this arrangement.

\[^1\] ttp://www.mifc.com/index.php?ch=menu_know_stat_icm&pg=menu_know_stat_icm_outs
In the application of sukuk, ijarah can be used in a structure of sukuk whereby the underlying asset(s) is rented by the owner to the user (tenant). Moreover, the tenant gains usufruct for some periods mention in the contract. The rental payment will be paid periodically with the fixed amount. There are many sukuk using this contract, just to name a few: Nakheel Sukuk, Petronas Global Sukuk, Qatar Global Sukuk.

In the above structure, the Petronas Global Sukuk Ltd., is a SPV which issues the sukuk. The proceeds of the sukuk issuance will be used to buy the assets from sellers which are Petronas subsidiaries. Once the issuer got the beneficial ownership of the assets, then they would be leased by Petroliam National Bhd (lessee). The lessee would pay periodic rental payments to the issuer while it will use the income from rental as return to the certificate holders.

3.2 Sukuk Musyarakah

In musyarakah contract, two or more investors jointly start a business venture. Each investor would contribute certain amounts to the business venture. Moreover, profit and loss would be distributed based on pre-agreed ratio or capital contribution in the venture. The application of musyarakah in sukuk can be explained in the figure below:

Source: Petronas Global Sukuk Ltd. Offering Circular
Based on the above figure, the firm and SPV contribute to the Musyarakah agreement. The firm contributes the physical assets, while SPV supplies the funds from issuing sukuk certificates. The return of musyarakah would be shared between the firm and SPV based on pre-agreed ratio. The SPV, then would pay periodic profit to the investors. The other feature of this structure is, the firm, during the period of the contract, would buy the shares of SPV in business venture. Finally, at the maturity date, SPV would no longer hold any shares in musyarakah.

3.3 Sukuk Murabahah

Murabahah is a popular contract used in Islamic banking products. In some countries, the share of murabahah might go up to 70 percent of total financing given. The contract itself is a trading contract in which the seller sells goods with a price and profit stated clearly to the buyer. However, the implementation of murabahah by Islamic banks has been creating controversy, particularly by having bay al ‘inah and fixed return in the contract.

Since murabahah is a valid contract in Islamic law, therefore it might be used for other muamalat activities. The stakeholders of Islamic capital market use murabahah as one of mechanism that could be utilized in sukuk structure. The common figure of that structure can be seen in the figure below:
Based on the sukuk murabahah structure above, there are at least five parties involve in it. It is started by signing of master agreement between the SPV and the firm regarding the sale of commodities in which the price and profits clearly defined upfront. The SPV, then, issues sukuk and gets the sukuk proceeds from the investors. Moreover, the proceeds of sukuk issuance are to be used to purchase the commodities from the supplier on spot basis. Once the commodities are in the SPV possession, after that, it would be delivered to the firm. The firm, in this case, would be paying the commodities on installment basis to the SPV. The commodities then are sold to the buyer on spot basis. Finally, the SPV would pass the sale price and profits from selling the commodities on installment basis to the investors.

### 3.4 Sukuk Mudaraba

Mudharabah, originally, is a business contract between two parties, where one party acts as capital provider, while the other runs the business. Similar to musyarakah, the profit of the project would be shared based on pre-agreed ratio. However, when the business incurs loss, the capital provider would bear all the loss, while the manager would get nothing.
The above figure is a sukuk mudharabah structure. In the structure the step begin by agreement between SPV (mudharib) and project owner to undertake a project. To fund the project the SPV would issue sukuk. The investors or sukuk holders are the capital provider and they would share the profits with mudarib and bear any loss when the bad thing happened. The SPV would collect the periodic profits from the project and distribute them to the sukuk holders.

3.5 Sukuk Salam

Salam is a trading contract in which the suppliers of the goods promise to deliver them to the buyer on the future date. This contract is commonly used in agricultural activities. The price of the goods is paid in advance. Moreover, in the contract, the quantity and quality of the goods to be delivered should be clearly defined. The implementation of salam in sukuk would fit to the need of the firm that wants to buy certain commodities.

Based on the above figure, the sukuk salam is initiated by the agreement between the SPV and the obligator. Moreover, the obligator would buy the commodity and sell it on behalf of the owner. The SPV raises the funds to purchase the commodity by issuing sukuk salam. Once, the commodity has been bought from the seller, the sukuk holders are the owners of the commodity in the transaction and entitled any claim on it. Any proceeds of the selling of commodity by the obligator, would be passed to the SPV to be distributed to the sukuk holders.

3.6 Sukuk Istishna

Istishna is a contract that can be used for manufacturing goods that would be delivered on a future date. The buyer would specify the goods that he needs to the producer. Usually the buyer should pay the price that has been determined in advance. In the practice of sukuk, istishna can be used to facilitate the interested parties that intend to manufacture certain goods that would be delivered later.
The sukuk istishna is started by the issuance of sukuk by the SPV to fund the project. The proceeds of sukuk then are paid to contractor. Once the project is completed, the title of the assets is transferred to the SPV. Moreover, the SPV sells the assets to the end buyer with monthly payments. The proceeds from end buyer are channeled to the sukuk holders.

4. **Proposed model**
The proposed model shown in the above figure, and which is based on ijarah structure, works as follows:

1. The Special Purpose Vehicle (SPV) buys the asset directly from the seller according to the needs of the borrower. Particularly, the asset will be purchased from the government and will be developed in the form of a small supermarket with relatively small stalls destined to be rented to small businesses.

2. To pay for the acquisition, the SPV issues sukuk ijarah to sukuk holders.

3. a. Sukuk holders pay sukuk proceeds to the SPV.
   b. The SPV distributes the proceeds received from sukuk holders to the asset seller to pay for the asset acquisition.

4. The SPV leases the asset to the lessee. It is worth mentioning that in the case of Nigeria for instance, it is of extreme difficulty for small businessmen to rent a stall, as the owners require payments of at least one year rent in advance, which is not possible for most of those willing to rent.

5.a. As return on the lease transaction, the lessee pays regular lease payments to the SPV.
   b. The SPV distributes the lease payment to sukuk holders as the periodic distribution amount; this amount is equal to the lease payment received from the lessee.

6. At the maturity of the sukuk, the lessee repurchases the asset from the SPV at a nominal amount.

7. a. The lessee pays the repurchase price to the SPV.
   b. The SPV distributes the repurchase price received from the borrower to sukuk holders as a dissolution distribution amount.

The above model will give an opportunity to the small business in Nigeria and other similar countries to start their own business. This will be done not only through the stalls provided through this structure, but also by offering a reduced and relatively small rental payment and purchase price, since the asset itself is bought from the government.

5. Conclusion

This exploratory study examines the micro finance institution and its effect on the small business in Nigeria. It was revealed that, Government introduced many programmes and keeps coming up with new ones but to the disappointment of many observers, the effect of those programs is yet to be felt in terms of job creation, poverty reduction and economic growth. The current study therefore proposed and developed a model whereby funds would be raised through sukuk using the Islamic contract of Ijarah (Lease). The rent generated by the assets will represent the revenue for the investors. This proposed model has the potential to boost small business activities in Nigeria by easing the burden on the business owners who will be exonerated from the exploitation of the landlord.
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Petronas Global Ltd, Offering Circular Petronas Global Sukuk
Global Financial Crisis And Ethical Concerns In Financial System: Any Lessons From Islamic Finance Services Industry

By
Mobolaji Hakeem Ishola*

Abstract
The recent global financial crisis has once again lent credence to the financial instability hypothesis which argues that financial market in the world is inherently unstable. This instability is however worsened by heedless ethical standard in the industry. A salient feature of the financial sector is its contagious effect, thus a persistent crisis in the sector generates negative externalities within and across national boundaries.

The dimension, magnitude and impact of the crisis have left no economy immune from its shock. This paper analyses the role of ethics in financial industry. The paper argues that ethical and profitability concerns are not mutually exclusive business objectives, and that both should be pursued rigorously and simultaneously. To avert future crisis, the financial sector industry has to show greater concern for ethics and market discipline. It concludes that while the Islamic banks could learn more about product design and innovation from the conventional banks, the latter should learn more about ethical concerns from the Islamic Banks.

Keywords: Financial, crisis, credit crunch and banking
JEL Classifications: G00

Introduction
The financial crisis which broke out in August 2007 was considered as the worst crisis for the past 60 years, in its effects, scale, duration and international

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dimension (IMF, 2008, Mirakhor and Krichene 2009). No economy is insulated from
the crisis, due to the global connectivity among countries through the wave of
globalisation. However, countries only differ in their responses to these exogenous
shocks, while some respond so speedily and consider the shock as real and
permanent; others perceive the shock as transient or transitory and respond so
passively suggesting the economy could always restore itself back to equilibrium.
The crisis is made up of many interdependent and reinforcing forces.

This shock has clearly shown that the present global financial system is
vulnerable and fragile, such that even advanced economies or financial systems are
not immune from this shock. Thus, to avert a huge systemic financial crisis in these
economies massive government bail out has to be resorted to. The frequency of
financial crisis in the world since the 18th, 19th and 20th centuries has clearly
demonstrated that the conventional financial system is inherently unstable. This has
once again reopened the quest for a stable financial system.

In the literature several factors have been identified as the causes of the crisis.
These causes range from lack of proper regulation, legislation and transparency
(Goodhart, 2008), others simply argue it is the confirmation of the financial
instability hypothesis (Minsky 1991). Loose monetary and macroeconomic policies
and incessant transformations in the financial system called Financial Engineering
have been adduced as the cause for the crisis by Truman (2009). Others observe that
financial expropriation (systematic extraction of financial profits) Lapavitsas (2009),
the abolition of the Glass-Steagall Act in 1999 (in force since 1933), this formally
enabled commercial banks to engage in riskier investment banking practices, created
opportunities for banks to trade on their own account. Chapra (2009) opine that the
inadequate market discipline, and too big to fail syndrome were some of reasons for
the crisis, yet Hassan (2009) proclaims the Moral and spiritual hypothesis to the

The broader lesson of this crisis is that globalization of trade (in both goods
and services, such as tourism), finance (in both the availability and cost of credit),
and labour (in terms of the direct and indirect demand for labour and the flow of
remittances) had tied countries together to a much greater extent than they had been
for about a century, since the early 1900s. This reality was underappreciated. The
consequence is that in today's world any crisis that affects a major country or group
of countries in the global economy or financial system will have some, largely
adverse, effects on all other countries. It follows that the citizens and authorities of
all countries, large and small, have a common interest in the quality of the economic
and financial policies in other countries, in particular in the systemically important
countries. Central to this crisis is the issue of ethical standard, substantial cause has
been linked to ethical abuse in the industry with its attendant effects. Hence, the
objective of this paper is to analyze the role of ethics in financial industry, and see
whether any lessons can be learnt from the Islamic banking system.

The paper is divided into six sections. Section two gives the literature review,
section three gives the policy responses and post crisis analysis, section four
presents the role of ethics in financial industry, section five has lessons from IBF,
section six gives the policy recommendations and section seven concludes the
paper.
2.0 Literature Review

Financial instability has been a recurrent event that plagued economies in the distant and recent pasts and no economy has been immune from its effect, suggesting that financial sector in the advanced countries are also vulnerable. The present crisis erupted due to the financial greed, speculation, interest-based system and other related interdependent factors (Chapra 2009).

Speculation is often fuelled by fictitious credit, swindle and fraud. Speculative burst has been a cause of many financial crisis in the world, this started in 1720 with the south sea company shares, great depression of 1929, Kuwait Crisis 1980, and now the housing crisis in US and Europe in 2007. The burst in the housing bubble, coupled with the collapse of credit derivatives and securitization (fictitious credit) and meltdown of sub-prime market loans, worsened the crisis such that several governments had to resort to massive bailout of financial institutions, to redeem the financial system from imminent total collapse especially in US and Europe.

2.1 Financial Instability Hypothesis

Irving Fisher (1933) reviewed many possible causes that may lead to financial instability. He argued that two dominant factors were responsible for each boom and depression: over-indebtedness in relation to equity, gold, or income which starts a boom, and deflation consisting of a fall in asset prices or a fall in the price level which starts a depression. The depression was triggered by debt liquidation. The contraction of deposits caused a fall in the level of prices. These are followed by a greater fall in the net worth of businesses, precipitating bankruptcies, a fall in profits leading to a reduction in output, trade, and employment, which in turn led to hoarding and slowing down of the velocity of circulation.

Minsky (1991) considered financial instability to be endogenous to conventional financial system. This is premised on the fact that the market is characterised by asymmetry information. His core model is known as financial instability hypothesis (FIH), which simply declares that stability in the system is inherently unsustainable. Minsky classified borrowers, according to their balance sheet and ability to make interest and principal payments, in three distinct categories, which are labelled as hedge, speculative, and Ponzi finance. Hedge financing units are those units that can fulfil all of their contractual payment obligations by their cash flows. According to Minsky’s definition, the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit. Speculative finance units are units that can meet their commitments on interest payment, even as they cannot repay the principal out of income cash flows. Such units need to roll over liabilities and issue new debt to meet commitments on maturing debt.

For Ponzi units, the cash flows from operations are not sufficient to fill either the repayment of principal or the interest on outstanding debts. Such units can sell assets or borrow. Borrowing or selling assets to pay interest (and even dividends) on common stocks lowers the equity of a unit. The key feature of a Ponzi scheme is its need to attract ever greater sums of money. To survive, Ponzi units must refinance, either by selling assets or by raising more debt. For this to happen, asset prices must
continue to rise. Ponzi finance typically emerges during a speculative bubble, when the margin of safety has been undermined.

The first theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system. Inspired by Schumpeter’s notion of “creative destruction”, Minsky described the proliferation of financial innovations as means to attract more borrowers and to bypass existing regulations. The level of product innovation has run far in advance of the capacity to utilize these products and the ability to understand the characteristics of risks and long-term consequences.

Minsky’s endogeneity hypothesis has yet to be supported empirically when confronted with actual role of central banks in major financial crisis.

2.2 Causes of the Present Global Financial Crisis

The housing crisis in USA would not have precipitated a global crisis had the commercial banks not adopted widespread securitization. Securitization is parcelling sub-prime mortgages into small amounts, packaging them with large composites of assets and selling them as new securities. Between 2004-2006, almost 80% of all sub-prime mortgages were securitised. Thus, sub-prime mortgage-backed securities ended up in the portfolios of major financial institutions throughout the world. Hence, when sub-prime mortgage holders began to default, this had immediate disastrous global impact, many financial institutions faced liquidity problem, since the mortgage backed securities were no longer saleable.

Banks transformed much of the high-risk mortgage debt (securitizations) into mortgage-backed securities (MBS) and collateralised debt obligations (CDO), and sold these assets on the stock markets to financial firms and insurance companies around the world, transferring to these investors the rights to the mortgage payments and the related credit risk (Pezzuto 2008) securitization was fashionable for two reasons, namely to generate more liquidity, remain solvent and make large profits while shifting credit risk off their balance sheet and minimising the amount of capital held to support their assets. Banks then became extremely conservative about further lending and the collapse of securitization led to credit crunch which impacted on aggregate demand leading to falling output, collapse of exports and rising unemployment. The financial crisis then led to global recession.

Another major reason was the interest element in all the conventional financial transactions, repayment of the interest and the principal worsen the illiquidity problem as there was high default risk. This illiquidity led to insolvency. The duo led to bankruptcy of many banks and high bank runs on their deposits. However, Mobolaji (2012) argues that institution of interest rate is a controversial concept in economics, the concept of interest rate has gone through four stages, starting with a stage of wide condemnation from early to 17th centuries, to a stage of restrictive permission in the late 18th century. Then later, it became a basis for financial
transactions in the 19th to 21st century, and in the late 21st century, there has been the resurgence of the call to zero interest rate (see Schumpeter 1934)\(^1\). This concept remains inconclusive in the literature. Persky (2007) concludes that the controversial concept is a modest dispute between a failing master (Smith who died in 1790) and an over-eager disciple (Jeremy Bentham). The classical economists contend that interest rate enhances savings but discourages investment, but both savings and investment are needed for economic growth.

Furthermore, others adduce moral and spiritual hypothesis. Hassan (2009) opines that the global financial crisis in reality is a crisis of failed morality, manifested in forms of greed, exploitation and corruption. Failure in the relationship between investment originators and investors and failure to communicate potential risks involved in these transactions with the investors (borrowers) (See also Siddiqi 2009)

\[\text{“Evil has appeared in land and Sea because of what the hands of men have earned, that He may make them taste a part of that which they have done, in order that they may return” Q30:41.}\]

### 3.0 Effects Of The Crisis And Policy Responses

Economic and social consequences of financial instability are often disastrous, from history we recalled in USA the great depression of early 1940s. The present financial crisis has had an inflationary spiral on many economies, reduced real incomes. It has also further eroded real savings and sometimes could also undermine long-term economic growth. Some of the visible Post crisis effects include the Euro crisis of 2011 in general and the Greek Debt crisis in particular with its effect on national economies within the European Union (EU), and survival of the EU. The impact could equally be felt in America, and the social uproars that trailed the austerity measures of the country, the Anti-wall protest in 2011 etc.

Forced taxation through inflation and rapid declines in real incomes which could cause deep social disenchantment, worsens unemployment and poverty as well as increasing political apathy among people. This may also aggravate crime rates in the society. It has also increased the social security bills in many countries in Europe and America.

#### 3.1 Policy Response

The conventional response has been a massive bail-out or socialization of losses. This imposes moral hazard and accentuates reckless behaviour, as against the theory of averting systemic crisis. Massive bail-outs socialize losses, while they protect private gains from speculation; they impose huge cost on present and future generation of taxpayers to protect the wealth of bankers and high salaries of banks and hedge funds managers. They amount to adverse wealth redistribution with negative impact on social justice. It further worsens moral hazard, as reckless behaviour is bound to continue.

\(^{1}\) For a detailed analysis on the metamorphosis of interest rates, (see Persky, 2007).
Thus, new terms emerged in the industry which includes responsible lending and a clarion call for an alternative framework came through different conferences and for a among which are; World Economic Forum (WEF) in Davos, Switzerland with the theme “Shaping the Post-Crisis World” Jan 26-30th, 2009, and simultaneously another one World Social Forum (WSF) in Benlem, Brasil “Another World is Possible” and several others, end up with the search for a credible alternative, and Islamic finance is one veritable alternative to stem the occurrence of future crisis.

4.0 Role of Ethics in financial industry

One of the potential benefits of ethics in Finance is that ethics reduces transaction costs and enforcement costs, as ethics entrenched in the system establishes public confidence and hence social capital, and attendant possibility of reduction in incidence of bank-run.

Ethical concern becomes imperative given the fact that the system is fast spreading across the globe. Thus, in order to ensure uniformity for the good health of the industry, this kind of evaluation and reflection is necessary. This will ensure, that in the frantic efforts to provide Islamic panacea to the global economic meltdown we do not grope in darkness. For even some of the western economists and financial experts are now willing to allow the Islamic financial and banking system to play a more active role as one of the possible ways of alleviating the current ailments as a result of the highly speculative and exploitative free-market forces which created ‘a crisis of deviant economics’ (Robert Skidelsky, 2008) and enthroned the ‘Religion’ of ‘market idolatry’ (William Raspberry, 1998) which plunged the world into ‘The Age of Turbulence’ (Alan Greenspan, 2008).

The concept of ethics in finance is a contentious issue among scholars. Some perceive ethics as antithesis to efficiency, and that business concerns must be ethically neutral such that the self interest motive dominates business environment. Others argue that ethics ensures uniformity in business practices and must be upheld. There are yet others who simply believe ethics is by merely observing business rules. Schwartz and Carroll (2003) identify the responsibilities of a firm as economic, legal, ethical and philanthropic/discretionary. The economic responsibility is provision of goods and services to earn profit. Firms have to comply with all the laws and regulations of a country in the pursuit of profit. A firm must also observe some ethical values in its operations. It is also expected that a firm becomes socially responsible through its philanthropic gestures.

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3 William, Rapsbery (1998), Religion of Market Idolatry,
4 Alan Greenspan (2008), The Age of Turbulence-Adventure in a New World London: Penguin
Velasquez (2006) defines ethics as principles of conduct governing an individual or a group. It is the study of morality. Business ethics relates to the moral standards applicable to business policies, institution and behavior. The issues treated in business ethics include systemic (economic, political, legal and other social systems within which businesses operate), corporate and individual.

Norms in any society can be distinguished as morals, ethics and laws. Hazard (1994) defines morals as ‘notions of right and wrong that guide each of us individually and subjectively in our daily existence’. Erhard et al (2009) views morality as a societal issue and defines it as ‘the generally accepted standards of what is desirable and undesirable; of right and wrong conduct, and what is considered by that society as good behavior and what is considered bad behavior of a person, group, or entity’. They place morality in the realm of ‘social virtue domain’. Morals are embedded in cultures and determined by a variety of factors such as upbringing, education, religion and environment. Morals tend to have emotional orientation whereby their validity is taken as given (Ray 1996).

“The word ethics comes from the Greek word ethos, meaning character or custom,” Etymologically, the above definition of ethics suggests its basic concerns: (1) individual character, including what it means to be ‘a good person’, and (2) the social rules that govern and limit our conducts, especially the ultimate rules concerning right and wrong, which we call morality. However, some philosophers try to draw a line of demarcation between ethics and morality such that ‘morality’ according to them refers to human conduct and values and ‘ethics’ they opined refers to the study of those areas. This work is not concerned with such controversies since they are outside its scope.

Business ethics on the other hand, can be defined as the study of what constitutes right and wrong, or good or bad, in human actions in a business context. Professional ethics are the rules that are supposed to govern the conduct of members of a given profession. Ordinarily, members of a profession are expected to abide by certain rules as a condition for practicing such profession. Failure to abide by such rules or codes usually results in disapproval of one’s professional colleagues, in some serious cases, withdrawal of one’s license banning one from practicing the profession. Suffice to say that Muslims are supposed to be ethical at all times and under all circumstances. Once the Prophet was answering a poser from Jibril (A.S.) about what is Al-Ihsan (righteousness) he (the Prophet) responded by saying: ‘It is to serve or worship Allah as if though one sees Him, for if one cannot see Him, He sees one’. This is needed in formulating or suggesting necessary code of ethics for IBF.

Hazard (1994-1995) defines ethics as ‘norms shared by a group on a basis of mutual and usually reciprocal recognition’. Erhard et.al (2009) define ethics as ‘the

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8 ibid
agreed on standards of what is desirable and undesirable; of right and wrong conduct; of what is considered by that group as good and bad behavior of a person, sub-group, or entity that is a member of the group, and may include defined bases for discipline, including exclusion’. They identify ethics to be in the realm of ‘group virtue domain’. One way in which ethics can be understood is to examine the ends or consequences of actions or activities. Thus, an act will be ethical ‘when it promotes good of society or more specifically, when the action is intended to produce the greatest net benefit or (lowest net cost) to society when compared to other alternatives’ (Schwartz and Carroll 2003).

According to the Pope’s *Centesimus Annus*, what is lacking in our time is moral culture capable of transforming economic life so that it has a context in humane community (William, 1993). Individuals face ethical issues at work on a regular basis (Beekun, 1996), issues ranging from stealing, lying, fraud and deceit (Wall Street Journal, 1991) to those of drug and alcohol abuse, conflict of interest, quality control issues, discrimination in hiring and promotion, misuse of proprietary information, abuse of company expense accounts, plant closing and lay-offs, misuse of company assets and environmental pollution (Ethic Resource Center, 1990). Bauman (1987), reports how in a survey of 300 companies across the world, over 85% of senior executives indicated that issues bordering on top ethical matters were of great concern. Such issues include: employee conflict of interest, inappropriate gifts, sexual harassment and unauthorized payments.

Over the centuries, as state and church separated, particularly in the western societies, religion became a private matter as a result of which the so-called ‘value-free society’ developed such that economists focused exclusively on the mechanics of economics (Gillian, 1999) a situation that has led to cases of ethical problems. In the recent time, some journal articles have addressed ethical issues in business based on the relevance of religious ethical or moral principles. Such articles include Green, 1993; William, 1993; Rossauw, 1994; Gould, 1995. There is need for managers to be moral champions (Annie, 1996), much as they need to appreciate the ethical norms of different groups and cultures in order to gain confidence and understanding of the cultural environment in which they operate (Al-Khatib et al., 1995).

Islamic firms in general and Islamic banks in particular necessarily need to conform not only to the national laws and statutes, but also to the Islamic law of contracts at the transactions’ level and must be ethical as this is one of the unique features of the industry.

All Islamic banks will be expected to be ethical in ways similar to their conventional counterparts. As mentioned above, these ethics include among others conducting operations with integrity and with due skill, care and diligence, avoid conflict of interest, etc (Davies 2001).

Ethics in business sometimes is relegated to the background due to profit maximization concern of business entity. Hence, principal-agent relationship view of business sometimes impact on the efficacy of ethical standards. The bank managers are agents who must necessarily work for the interest of the owner (principal) as against social or ethical interest. If ethics is not entrenched on religious value, it is
the prisoner’s dilemma holds, where rational economic agent pursuing self-interest prefers to be unethical when there is a marginal gain from unethical behavior. Thus, it may not be optimally sustainable.

However, it is better to be ethical in business than to be unethical because business interactions are ongoing (Al-Jarhi, 2007) such that mutual trust, integrity, honesty and transparency are required. All these virtues are ethical issues that are sin qua non for sustainable business.

Bernhard and Andreas (2011) find that higher transparency always raises expected bank profits, but may lead to a higher or lower expected loan volume. Moreover, higher transparency may reduce economic welfare.

5.0 ISLAMIC FINANCE AND LESSONS FROM IT

5.1 Concept of Islamic Finance

Interest in the Islamic finance began in the 1970s, due to accumulated petrol-dollars in Arab Countries; the West had to respect the Islamic principles of finance to attract the wealthy Arab investors to their countries. Also, the Arab investors heavily shifted their investment to Asian countries in late 1990s and early 2000s (Asian-Tigers of 1990s), thus the global economic growth then shifted to Asia, this Asian development then resuscitated the need for the west to once again try to woo the Muslim investors. Furthermore, the re-awakening of Islamic consciousness among Muslim intellectuals and resettlement of many Muslims in the West which led to transfusion of cultures, the global perception of the evils of interest rate and lastly the collapse of the conventional financial system has furthered shifted attention to Islamic finance as a credible, efficient and sustainable alternative financial system.

The Islamic finance observes Iqbal (1997:4)\textsuperscript{10}, ‘broadly refers to financial activities that are guided by the teachings of Shari’ah (the Islamic Law), which strictly prohibits the payment and receipt of interest. However, describing Islamic Financial system simply as ‘interest free’ does not reflect a true [w]holistic picture of the System. Islam in general and Islamic finance in particular strives for [the] preservation of property rights, emphasizing ethical standards, sharing of risks, and promoting social justice. Moreover, not only must investment activities be in line with the ethical principles of the Shari’ah, they should also take into consideration public interest (Masalih)’. It is therefore, a banking and finance system which is essentially based upon the Islamic worldview with particular reference to equality of humanity, justice, equity, even/equitable distribution of wealth and al-falah, that is, the bliss here and in the hereafter.

In Islamic finance there is always a close link between financial flow and productivity. This intrinsic property of Islamic Finance (IF) contributes towards insulating it from the potential risks resulting from excess leverage and speculative financial activities. Another fundamental principle of Islamic Finance is the risk and profit-sharing feature of Islamic Finance transactions (such as Mudarabah or Musharakah contracts). It is this profit and risk-sharing feature of Islamic Finance

transactions that requires a high level of disclosure and transparency in the IF system. These disclosures allow the market to assign the appropriate risk premiums to companies, thereby enhancing the potential for market discipline to take effect. These features, which are required by Shariah (Islamic law) injunctions, provide built-in checks and balances which serve to ensure the financial stability of the Islamic Financial system.

5.1 Stability of the Islamic Financial System: Lesson for others

In Islam, Allah redeems economic systems by prohibiting Usury;

Those who eat Riba will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaytan leading him to insanity. That is because they say: "Trading is only like Riba," whereas Allah has permitted trading and forbidden Riba. So whosoever receives an admonition from his Lord and stops eating Riba, shall not be punished for the past; his case is for Allah (to judge); but whoever returns (to Riba), such are the dwellers of the Fire - they will Abide therein Q2:275

(O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (from; Q3:130, 30:39)

Two fundamental principles arise from these verses, firstly is that an Islamic financial system is driven by trade and production and secondly is that an Islamic system based on trade will be immune to instability. An Islamic financial system as one in which there are no risk free assets and where all financial agreements are based on risk and profit and loss sharing. Hence all financial assets are contingent claims and there are no debt instruments with free or floating interest rates (Mirakhor and Zaidi 1988), they further showed that the rate of return to financial assets is primarily determined by the return to real sector, and therefore in a growing economy, Islamic banks will always return net positive returns.

An Islamic bank is expected to match deposits maturities with investment maturities. Short-term deposits may finance short-term trade operation. For longer-term investment, long-term deposits are used. Though, an Islamic bank may engage in various short-term and long-term modes of financing. Typical operation includes Mudarabah, Musharaka, Murabaha, Istisnaa, and leasing and instalment sales operation. The major objective is that investment opportunities are identified and evaluated to minimize risk. In achieving this, sometimes the bank may participate directly in the management, monitoring and execution of trade and investment operations; and release funds for purchase of goods and services as required for the completion of these operations. Investments are often determined by real savings and savings to income ratio (Mirakhor and Zaidi 1988, Chapra 1986), and not by credit multiplier as in conventional banking. The growth of financing activity will therefore be stable and determined by real growth in the economy and not by unstable speculative finance or money creation by a financial institution. Accordingly, an Islamic system would not be expected to experience deep boom and burst cycles.

Islamic finance avoids excessive speculation and leverages, with an implicit position, that you can not sell what you do not own, hence selling debts to others, other forms of artificial transactions called securitization are forbidden.
The current crisis of the financial markets inspires the nascent Islamic financial industry to present an alternative paradigm and poses additional challenge of moving from mere Shariah-compliant to Shariah-based financial products and a more creative ways to manage assets and invest wealth.

Islamic finance is an ethical system based on religious values, with a fundamental requirement that financial transactions are linked to real economic activity or real sector development. This system has to be embraced in its entirety, and must be faithfully implemented, if it should contribute towards economic development and there must also be existence of a strong regulatory framework to check abuses and arbitrariness (See Sanusi 2010, Mobolaji 2012).

Islamic finance means shari’ah compliant and ethical investment. Both mandate ethics on the industry. Indeed, ethics is strongly linked to survival of the industry. Many financial contracts in Islamic finance require ethics in their implementation, thus, the system is susceptible to abuses and arbitrariness especially as financial markets are characterized by information asymmetry.

5.1 Lessons From Islamic Finance

The relative stability of Islamic finance institutions even during the current global economic recession has earned it prominence to such an extent that even the Vatican said banks should look at the rules of Islamic finance to restore confidence in their clients.

Chapra (2009) opines that the resilience of the Islamic finance against the global financial crisis was partly due to the level of market discipline, avoidance of excessive leverage and formidable regulatory framework, and strong ethical concern. These values are gradually being eroded for mere profit motives.

Walsh (2007) observes that in response to corporate governance failures such as Enron, the United States took the first stride towards adopting a similar, ethical business model, the Sarbanes-Oxleyed Act of 2002, which heightened disclosure requirements and raised the level of accountability. Sarbanes-Oxley introduces ethical principles to the United States corporate environment through the application of many rules. Currently, however, there is a backlash against Sarbanes-Oxley as it is perceived as being too costly, demonstrating the continued chasm between ethics and corporate law in America.

Perhaps, the cost of enforcement of divine rules is less compared to cost of enforcing man made law. When reforms are internally motivated as against externally imposed they are easily obeyed without qualms. Sarbanes-Oxley is an attempt to mandate ethical practices through enforcement of the law. Companies are forced to factor in the cost of compliance with Sarbanes-Oxley as a business expense without the offset of new gains. Hundreds of millions of dollars have to be spent in order to comply with Sarbanes-Oxley. In Islamic finance, those that enter the market and comply with the regulations at cost, do so with intentions that this cost will be offset by the gain from the new market.

Unlike the AAOIFI, which is premised on ethical principles, American corporate law is based on the enforcement of rules. He finally suggests to American
society, that the transformation from rules to principles would be a positive step. Ethical principles need to be inherent in business practices for the chasm between ethics and corporate law to be eliminated. Merely satisfying the requirements of legislation do not suffice because it encourages a corporate culture that backlashes against the rules.

Obaidullahi (1995) argues that there is no trade-off between Islamic values (ethics) and market efficiency in Islamic finance. He concludes that an attempt to ensure Islamic ethics would, in general, lead to enhancement of efficiency. The Islamic ethical norms of freedom from riba, gharar, ghubn, jahalah, najas, ihtikar etc. are all clearly identifiable with notions of efficiency.

There are certain regulatory measures, which enhance both ethics and efficiency. For instance, mandatory disclosure norms reduce asymmetry of information (improve informational efficiency) and at the same time, ensure greater ethics through provision of freedom from misrepresentation and right to equal information. However, more often, regulations are seen as an outcome of a continuous tug-of-war between concerns about efficiency and ethics.

Bernhard and Andreas (2011) find that higher transparency always raises expected bank profits, but may lead to a higher or lower expected loan volume. Moreover, higher transparency may reduce economic welfare Islam does not give room to the kind of exploitation advocated by Carr11 when he argues that:

‘Business, as practiced by individuals as well as by corporations, has the interpersonal character of a game—a game that demands both special strategy and an understanding of its special ethical standards. Business has its own norms and rules differing from those of the rest of society.’ Thus according to Carr, a number of things that we normally think of as wrong are really permissible in a business context. His examples include deliberate and conscious misstatement and concealment of pertinent facts in negotiation, lying about your age on a resume, deceptive packaging, automobile companies neglect of car safety, and utility companies’ manipulation of regulators and overcharging of electricity users.’

Consider what ‘Umar bin Khattab (R.A.)12 says:

‘No selling (for any one) in our market unless (for the one who) comprehends religion.’

The following among others are some of the ethics as against what Carr advocates in his well known and influential essay, ‘Is Business Bluffing Ethical?’:

(1) The profession is a kind of amana (trust) over which one is accountable before Allah. It therefore requires the consciousness of Allah all the time.

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Journal of Islamic Banking and Finance April – June 2012 101
(2) Truthfulness as well as honesty and trustworthiness should be the watchword.

(3) There is no sale of what is not available; hence fruit yet to be ripe, ewe or any other animal yet to be delivered by their mother are not to be sold.

6.0 Policy Recommendations

Based on the findings availed by this study, the following policy recommendations are made:

- That there is need for more ethical concerns in the financial industry
- Profitability and Ethical concerns should both be considered as feasible business objectives
- A continuous training programme for the practitioners in the field to uphold the ethical value as against the mere profit motive;
- That firms in the industry must ensure full disclosure of financial arrangements or transaction at the time of sealing an agreement and post contractual period;
- In the design of curriculum for finance experts there is a need to add modules on ethics in financing;
- There must be more articulate screening process at both product design and implementation stage;
- There is a need for greater interaction between the conventional banks and Islamic banks to share experience as well as best practices
- The regulation of the industry must embrace stakeholders’ interest which should not be left for the industry alone, since the industry is ever prone to crisis
- There is always the need for regulation of the industry, such that would promote healthy well being of the industry without strangulating innovations; this need is essential because of the contagious effect of the industry to other sectors

7.0 Conclusion

The global financial crisis in recent and distant past has again shown that conventional banking system is inherently unstable. Rapid expansion of credit which is not backed by real savings creates booms followed by crashes. Such instability has often led to prolonged economic decline that wiped out real income gains of the pre-crisis period. Central to this crisis is the ethical concern in the industry. The policy response of bail-outs has further increased moral hazard and reinforced financial instability as this validates uncontrolled money creation by banks and imposes a formidable tax on the economy.

To avert future systemic crisis in the industry, the issue of ethical concern must be taken very seriously. Though, it has been argued that both ethical and profitability concerns are feasible business objectives, complementary and not substitute, as there
are no clear empirical evidence for any trade-off between the two, however, in case they clash, then ethical concerns must take precedence over profitability concern if the survival of the industry is to be guaranteed.

Ethics has been observed as one of the major banes of the conventional system, there is need to guard against all sort of market indiscipline

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Note to contributors

Journal of Islamic Banking and Finance is an official publication of International Association of Islamic Banks Karachi, Pakistan. It is a refereed quarterly journal, as well as a pioneer in the field of Islamic banking and finance being published since 1984. It provides a forum for researchers, particularly in Islamic Banking and Finance, wishing to share their expertise with a vast intelligentsia in the form of articles, research and discussion papers and book reviews. Major areas of interest for the journal include: (i) Theoretical issues in banking and financial industry specially from Islamic perspective; (ii) Empirical studies about the Islamic banking and financial institutions; (iii) Survey studies on issues in Islamic banking and finance; (iv) Analytical studies of applied Islamic banking; (v) Comparative studies on Islamic and conventional banking systems; and (vi) Short communications and interviews investigating the perceptions of leading bankers and banking experts as well as policy makers.

Articles Submission:

The contributors are requested to observe the following rules.

- Articles should be typed in M.S. Word and restricted to 10 to 15 pages of A-4 size paper. We accept original contributions only and if the material is taken from some book or any other source, the source may be mentioned. The editorial team does not assume any liability for the views of the writers expressed in their articles nor may necessarily agree with their views.

- The articles should be submitted before start of the first month of each quarter, beginning from January, April, July & October enabling review and approval of the material by the editorial board for publication in the issue in hand.

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