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Full Length Research Paper

Islamic Banking development and evolution: current issues and future prospects

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Abstract

A number of economic concepts and techniques were applied in early Islamic banking including Mufawada, Mudarabah and Al-mal as existed in the medieval Islamic world. Interest free banking attracts more attention because of the political interest. The most controversial issues about interest free banking are the profit and loss sharing formulae (Concept of Mudarabah). Disenchantment with the value neutral capitalist and socialist financial systems prompted not only Muslims but also others to look for ethical values in their financial dealings, and in the west some financial organisations have opted for ethical operations. It is in the course of brain storming for proffering solution to unpalatable state of our economy's financial system that the prescribe for Islamic banking (Non-interest banking) in Nigeria is being agitated for. The focus of this paper is to assess and predict the degree of acceptability of Islamic banking and finance in Nigeria. The research work carries out with the methodology of questionnaire-the primary data.

Keywords: Islamic banking, profit sharing, conventional bank and joint venture.

INTRODUCTION

Islamic finance is an integrated, compound and composite field of knowledge that welds together several compartmentalized branches which include Islamic banking, Islamic insurance, and Equity funds, Islamic investment, Islamic venture(capital leasing) under the Islamic system among others Ahmed I. (1999). The fact that Islam is unique way of life distinct from all other ideologies, naturally extend to the economic life of the members of the muslim ummah. Mordern banking based on interest is rejected as un-Islamic because the unequivocal prohibition of riba by the Quran, which is consensus of jurists had interpreted as covering alls kinds of interest, usurious or otherwise, irrespective of the nature and function of the loan.

Islam makes a clear distinction between what is halal (lawful) and what is haram (unlawful) in pursuit of economic activities. The objective of welfare Islamic goals in its dealing with persons or institutions is considered them as partners and thus were profit is made it is shared equitably between them and were losses are incurred it is shared together. Unlike conventional banks, basic principle of operation is to maximise profit and thus, it does not seek to be welfare oriented and it consider those who borrow from them not as partners but creditors. Any loss incurred is at the expense of these who received the advances from them.

The banking activities carrying out in Nigeria as in any other secular economy is interest based. As interest is evil it lacks full supports from the Nigerian Muslims to resort to them in obtaining loans so as to build and develop the economy. Therefore, this research wishes to address these problems by proposing the introduction of Islamic banking system as an alternative to the conventional banking system since it is based on profits and losses sharing. It is an alternative which holds ultimate solution to secular banking, thus everybody with a viable project would have an access for finance on non interest basis and see how Islamic bank can turn around the economy of Nigerians in order to bring accelerated development to its citizens.

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Review of literature

Historical Development and Evolution of Islamic Banking

The literature of the Islamic banking period begins with evaluation and ends with attempt at finding ways and means of correcting and overcoming the problems encountered by the existing banks. The history of interest- free banking focus on two major points; the “idea and reality”. It means that when interest free bank was still remained an idea (plan and suggestion) and secondly when it becomes a reality (true situation) by private initiative in some countries and by law in others. Therefore, the origin of the modern Islamic bank can be traced back to the very birth of Islam when the prophet himself acted as an agent for his wife’s trading operations.

The following Islamic scholars Anwar Qureshi(1946), Naiem Siddiqi (1994) and Mahmud Ahmad(2001) Mawdudi in (1994) and Muhammad Hamidullah (2007) recognized the need to establish Islamic banking and pointed out evil of interest in conventional commercial banks, and proposed a banking system based on the concept of Mudarabha-profit and loss sharing basis. Emphasis was made that to accept interest charged by the commercial banks was “Riba” and to develop an alternative system in banking. All the effort to make the shariah courts effectively discharge these duties was abolished or ineffective by the colonial powers. Muslims had no alternative but to work with the colonial institutions, including commercial banking.

Conference of the Finance Ministers of the Islamic countries held in Karachi in 1970, the Egyptian study in 1972, first international conference on Islamic Economics in Mecca in 1976, International Economic conference in London 1977 metarphorsed to Islamic banking system; which gave birth to the Islamic Development Bank in 1975 as a result of involvement of institutions and governments and referred to as inter-governmental bank was formed by 42 Muslim countries under the umbrella of the Organization of Islamic Conference (O.I.C). The various experiments of these banks led to the establishment of the Nasser Social Welfare than commercial and the bank is still alive.

Dubai Islamic Bank was set-up in 1975 by a group of Muslim businessmen from several countries. It was the first private non interest or interest free bank that was established. Later two more private Islamic banks were established in 1977 called Faisal Islamic Bank in Egypt and that of Sudan. Nevertheless, Malaysia and Pakistan both in the mid-forties and late-fifties have tried Islamic banking system but they all failed or not survived. Mit-Ghamr (savings bank) established in 1963 in Egypt was a very popular islamic bank it was later closed down for some reasons. This era was referred to as interest-free banking as an idea.

The establishment of interest-free banking had been by private partnership initiative and were confined to that bank in many countries but reverse is the case in Iran and Pakistan it was by government initiative and covered all banks in the country. Ten years after the establishment of the first private interest-free commercial bank in Dubai, more than 50 interest-free banks came into existence. Today more than 250 Islamic financial institutions are operating in over 50 countries worldwide. The countries where Islamic financial institutions are functioning include: Albania, Algeria, Australia Bahamas, Canada, Iran, Iraq, Italy, Ivory cost, Jordan, Kuwait, Morocco, Netherland, Niger, Palestine, Qatar, Russia, Saudi Arabia, Senegal, South Africa, Switzerland, Tunisia, Turkey, Dubai, United Kingdom, United States of America to mention few.

Meaning of Islamic banking and basic fundamental principles

Islamic banking (participant banking) refers to a system of banking or banking activity that is consistent with the principles of the shariah (Islamic law) tailored and protected by Islamic economics. The principle deals with universal appeal and lay emphasis on moral and ethical values in all dealings of human transactions. In particular, Islamic ruling (shariah) prohibits the collection and payment of interest charge called Riba. Islamic jurisdiction prohibits investing in businesses that are considered unlawful or known as haraam and are contrary to Islamic values. More also, contracts where ownership of a good depends on the occurrence of a predetermined, uncertain or put in the future (chance) and speculative transactions are transaction that are prohibited by Islamic law because all involve excessive risk and are supposed to foster uncertainty and fraudulent behaviour.

RIba (USURY)

Riba (Usury) in Islam was well established during the life time of the Prophet Muhammed (SAW) and several verses in the Quran Lay emphasis on usury (Riba) as an unlawful act and totally prohibited. Riba, literally means ‘excess or addition. Islam categorically and unequivocally prohibits the practice of charging and receiving interest in all forms not only on loans but on other transactions. Several verses of the Holy Quran pointed out the prohibition of usury such as in (2:275-280, 3: 130-132, 4: 161-etc) and Hadith (saying and deeds or tradition) of the Holy Muhammad (SAW) against any transaction involving interest.

Musharakah (JOINT VENTURE)

Musharakah is an agreement between two or more partners, whereby each partner contributes or provides money/capital to be used in the business with an aim of making appropriate profit. These involve combination of resources by two or more people or persons (Partnership) and divide the net profit and loss according to the capital contributed by each (pro-rata). Meaning that, profits made are shared between the partners according to the invested capital, while losses are equally shared in the same ratio. This is also applicable if the bank provides the capital. According to shariah, each partner may or may not participate in carrying out the business; meaning that partner may be active or no active (sleeping). An active (working partner) gets more of a greater profit share compared to a sleeping (non-working) partner.

Hibah (GIFT)

This refers to voluntary token given by a creditor to a debtor in return for a loan given to him. It arises where and when Islamic banks voluntary give their customers a gift on savings account balances, representing a portion of profits made by using those savings account balances in other activities. Other interest, principle include QARDUL HASSAN (good loan), TAKAFUL (Islamic insurance), SAKUK (Islamic Bonds), WADIAH (safe keeping), IJARAH THUMMA AL BAI (hire purchase) and IJARAH (leasing) are fundamental issues in Islamic banking system.

Risk and uncertainty (GHARAR)

Are those businesses whose nature and consequences are hidden. Gharar means a situation where the buyer does not know what he bought, or the seller does not know what he sold. Reflecting that the parties do not have a sufficient knowledge of its outcome. “Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling”,(Prof. Mustafa Al-Zarqa). Therefore, Dr. Sami al-Suwailemn has used Game theory to try and reach a more measured definition of Gharar by defining it as “a Zero-Sum game with unequal pay offs”.Such activities or transactions include (sale of unborn-she-camel or sheep, conditional sale, sale with loan, selling of agricultural produce before mature, selling the fish in the water etc.) are not permissible/permissive.

Profit and loss sharing (PLS)

A profit and loss sharing arrangement simply demand agreement by all parties in an enterprise on how to share risk and reward in an enterprise. Since no business transaction is free of risk, the determination of outcome (result) before hand how the result will be shared has under scored the concept of equality of factors of production. Under Islamic finance, risk or loss is to be borne in proportion to capital contribution (on pro-rata basis).

Types of accounts

All – non interest banks agree on the basic principles however, individual banks differ in their application as a result of the laws of the country, the objectives and the individual bank’s circumstances and experiences.
All Islamic banks have three kinds of deposit accounts and these types of accounts were accepted;

a. Current account
b. Savings account
c. Investment account

Other is Zakat Accounts.
Current or demand deposit accounts are actually the same with conventional banks where deposit is guaranteed. No interest was paid on savings accounts, but withdrawals could be made on demand. Small, short – term interest -free loans for productive purposes could be made. Funds in investment accounts were subject to restricted withdrawals and invested on the basis of profit sharing.

OBJECTIVES OF ISLAMIC BANKING SYSTEM

Islamic banks (non – interest bank) have to operate in accordance with the shanah (Islamic law)and they have different objectives to foster and improve the well being of an individual and the economy at large; Among these objectives are:

- To promote, foster and develop the application of Islamic principles, law and tradition to the transaction of financial and related business affairs.
- To promote investment campaigns, enterprise and concerns which are they engaged in lawful business activities.
- Investors getting their return from profit and business sharing (PLS) investment.

Theories of interest in secular economy

A quite number of economists (secular and Islamic) have examined and evaluated the theories of interest. They generally maintain that the Varian’s theories of interest have not adequately been answered and the question is that why should interest be paid. These theories rarely explain the origin or the justification on interest. Therefore, there is no agreement on the issues.

Most of the theories of interest do not integrate well with various explanations of value and capital; their theories did not adequately explain the reasons for charging interest.
The theories of interest to be examined are as follows:
- The classical theories of interest
- The Neo classical or marginality theories of interest
- The more recent theories of interest
- The current position on the secular theories of interest.

Classical theories of interest

Adam Smith believed that the main objective of business is to make profit. But profit is fluctuating and uncertain. Adam Smith equates- interest to be profit. It makes no clear distinction between interest and profit; to him interest or profit is just any yield on the capital of the investor without any consideration of risk bearing. Ricardo supports Smith's view but none of them made a functional distinction between interest and profit. Classical theories field provide comprehensive explanation of value and capital. They both attributed value to labour. The difficulty with classical theory of interest is that the classical economists believe that all value is the creation of labour and therefore, the cost of production is determined by the cost of labour, thus ruled out creation of value by any other factor such as capital.

Neo classical/ Marginalist theories of interest

The main contributions to the neo-classical school were made by economists such as William Stanley, J.B Clarks, and Alfred Marshall. The essential principles of this school lies in the belief that, value is the product of utility rather than of cost of production. Three different theories are identified within the framework of marginalism. They are:
- The waiting theories
- The time preference theory
- The scholastic substance concept of capital

The current position on secular theories of interest

Reading through the present day literatures on economics, one funds that the issue of the legitimacy of interest has not been resolved. Every author has his own conception of what interest is and why it should be paid. But a particular thing seems to common, Almost all of them have referred to one or two of the earlier theories of interest to explain why interest should be paid.

Yudistira D. (2003), Lipsey 1968, pp 422 and Fredman 1976 pp 285 regarded interest as a payment for the services rendered by the borrowed money. To them, money can be hired the way a car or a house is hired and since the owner of a car or a house is entitled to received rent the owner of money capital is in the same vein entitled to receive interest as a payment for the services rendered by his money to the borrower. They seem to forget that money is not a commodity like a house; it is just a means of exchange. Wannocott (2005 pp 785) still regards interest as a reward to savers for ' waiting' just as the wage rate is a reward to labour for its time and effect.

From this study, one may conclude that interest exist just because of existence of an institution, but there is no theory of interest that gives a convincing explanation of the existence of interest. All the studies have failed to give a satisfactory explanation as to interest should be paid. It is clear that there is no agreement on the issue. At this juncture, it is interesting to see whether to replace it with "profit and loss sharing scheme" in business finance proposed by Islamic economist.

RESEARCH METHODOLOGY

The primary sources of data through questionnaire method were used to carry out this research work. The use of simple judgment techniques of chi-square (X^2) statistical method were used for testing the hypothesis formulated.
The hypotheses are:
- Awareness of the modus operandi of Islamic financial services.
- Interest and profit are similar and the same.
- Non interest based financial system is not practicable in Nigeria.

Therefore, the null hypothesis is tested by using

$$X^2 = E \frac{(O_1 - E_1)^2}{E_1}$$

Where,

0_1 = Observed frequency
E_1 = Expected frequency

Decision rule

If calculated value is greater than critical value, reject null hypothesis but if otherwise accept null hypothesis is accepted at 5% level of significance.

ANALYSIS OF DATA

Three hypothese were tested in this study and the formula is represented by

$$X^2 = \sum \frac{(O-E)^2}{E}$$

Where O = Observed value
E = Expected value
$\sum$= Summation

Table 1. Awareness of Islamic financial services

Religions	Responses yes	No	Total	Table Value x^2_1	Computed X^2_c
Islam	30	0	30	5.99	9.27
Christianity	18	7	25		
Others	20	5	25		
	68	12	80		

N = 80 D.F = $2_a 0.05$
Source: - Researchers" computation.

Table 2. Interest and profit are similar

Religions	Responses yes	No	Total	Table Value x^2_t	Computed X^2_c
Islam	30	0	30	5.99	6.21
Christianity	20	5	25		
Others	22	5	25		
	72	8	80		

X^2 = Computation of the test statistic.
Hypothesis 1
H_1, Awareness of the modus operandi of Islamic financial service
H_0, Awareness of non modus operandi of Islamic financial service (Table 1)

Decision Rule

From the calculation above X^2_c is 9.27 while X^2_t is 5.99.The computed valued of X^2_c greater than the value X^2_t
Have the null hypothesis (H_o) is rejected. Therefore the alternative hypothesis (H_1) which says that the respondents are aware of the modus operand of the Islamic financial system – banking, housing mortgage etc is accepted.
Hypothesis 2
H_1 – Interest and profit are not similar and not the same
H_0 – Interest and profit are similar and the same (Table 2)

Decision Rule

From the above calculation X^2_c is 6.21 while X^2_t is 5.99. The computed value of X^2_c greater than the table value X^2_t. The null hypothesis (H_o) is rejected, while alternative hypothesis (H_1) is accepted.
Hypothesis 3
H_o – The non interest based financial system is not practicable in Nigeria.
H_1 – The non interest based financial system is practicable in Nigeria. (Table 3)

Decision Rule

Above table shows that X^2_c is 6.06 greater than X^2_t is 5.99. The computed valued X^2_t is 5.99. The Null hypothesis (H_o) is rejected, while the alternative hypothesis (H_1) is accepted. The non – interest based financial system is practicable in Nigeria.

FINDINGS

Based on the analysis of the data collected, respondents are aware of (1) the modus operandis of the Islamic financial system. (2) The interest and profit are not similar and not the same (3) the interest free/non interest financial system is practicable in Nigeria. (Table 4)

CONCLUSION

There are Islamic banks in many Muslim countries, and a few in non-Muslim countries as well. Despite the successful acceptance there are problems. These problems are mainly in the area of financing. Obviously, Islamic banks can get rid of all their cumbersome and doubtful forms of financing and provide a clean and efficient interest-free banking. There are quite a number of Nigeria Muslims and non Muslims obtain approval for

Table 3. Non interest banking are practiceable

Religions	Responses yes	No	Total	Table Value x^2_t	Computed X^2_c
Islam	24	6	30		
Christianity	20	5	25	5.99	6.06
Others	25	0	25		
	69	11	80		

Table 4. The calculation of the expected values and the computed value (X^2_c) are shown thus.

I

Cell	Observed O	Expected E	(O-E)	$O\text{-}5^2$	$O\text{-}E^2$ E
A	30	25.5	4.5	20.25	0.79
B	18	21.3	-3.3	10.89	0.79
C	20	21.3	-1.3	1.69	0.08
D	0	4.5	-4.5	20.25	4.5
E	7	3.7	3.3	10.89	2.94
F	5	3.7	1.3	1.69	0.45
					9.27

$X_c^2 = \sum (O\text{-}E)^2$

E = 9.27

II

Cell	Observed O	Expected E	(O-E)	$(O\text{-}E)^2$	$(O\text{-}E)^2$ E
A	30	27	3	9.0	0.33
B	20	22.5	-2.5	6.25	0.27
C	22	22.5	-0.5	0.25	0.01
D	0	3.0	-3	9.0	3.00
E	5	2.5	2.5	6.25	2.50
F	3	2.5	0.5	0.25	0.10
					6.21

$X_c^2 = \sum (O\text{-}E)^2$

E = 6.21

full pledged for non interest or interest free banking. There is a demand and a market for profit and loss financial product and there is great opportunity for Islamic financial system in Nigeria. It is quite evident that interest free bank or finance is of numerous advantages to start with, it results in efficient allocation of investible funds. Islamic banking system can offer alternatives at the micro finance level. The social benefits are obvious since the poor are often exploited by tender charging usurious rates. Therefore, this research study conclude that the classical economists has not answered the question why should interest be paid.

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