Time for Long-Term Islamic Financing

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THE ESTABLISHMENT OF Islamic banking and financial corporate entities is a new development in the contemporary corporate world. This is noticeable not only Muslim countries but also in non-Muslim countries. These institutions provide Islamic services on the basis of a unique and just profit- and-loss sharing principle. However such a novel working system should naturally be accompanied by a number of methodological and operational problems.

The proper diagnosis of these problems is the first step towards ensuring an adequate and efficient working of these institutions. Despite the problems faced by Islamic banks, including the competitive environment in which they exist, they have managed to make steady, and in certain cases even fast, progress. The total assets they manage the world over now exceed US$20 billion. This relatively fast development was not so much due to the religious commitment of their customers as to the nature and results of their financial activities.

In the last two decades, the practice of the majority of Islamic banks shows a widespread preference for murabaha (trade financing), and a lesser degree of murabah financing. And in contrast, musharakah (partnership) financing has generally been avoided on the mistaken presumption that it is an economically non-viable (high-risk) instrument. But the experience of the Sudanese Islamic Bank disproves this proposition. Rather, it testifies to the relevance of musharakah financing as a tool for rural development and development of the poorer sections of the population. In fact, musharakah financing can bring changes and commit the people to work hard (due to the incentive factor) for the betterment of their own lives.

This chapter focuses on a few fundamental issues: firstly, to present briefly the Islamic concept of development; secondly, to define what is an "Islamic bank"; thirdly, to state the main objectives of Islamic banks; and finally, to evaluate their efficiency vis-a-vis commercial, savings or investment banks.

The Islamic concept of development has a comprehensive character. It includes moral, spiritual and material aspects. Development becomes a goal-and a value-oriented activity, devoted to the optimization of human well-being in all dimensions-moral and the material, the economic and the social, the spiritual and the physical-which are in separable. The Islamic bank has a multi-dimensional approach based on Islamic principles for the benefit of mankind and gives serious consideration to the total development requirement of the community. Therefore, the Islamic bank should take this responsibility in the use of funds available. The investment strategy should directly relate to the development of mankind according to Islamic norms. This will require that investments should be to serve long-term development objectives rather than short-term ones. Islam came to show the right path for a good life. It must tackle the problem of developing man in his relationship with God, in his relationship with other human beings, not only in his personal life but in business as well.

An Islamic bank is not just a bank that does not operate under the interest mechanism, it is a bank based on certain economic and philosophical principles. It is an institution dedicated to serve the community and to foster economic welfare for the people and is given to development of human resources based on Islamic values. The main objectives of Islamic banks can be classified as follows:
A. **The Philosophical Principle.** The key belief of Islamic banking is that God of the Creator and Ultimate Owner of the Universe and man, on earth, is His vicegerent. Thus individual property is recognized but it is restrained by the teaching of God. Therefore, Islamic banks are not free to do as they please, but they have to integrate moral values with economic action. Money and property are social tools to achieve the social good. The objective of a bank should not be profit maximization irrespective of the means but maximization of social benefit.

B. **Profit-sharing Investment.** If conventional banks are established to lend money to those who need money with interest, an Islamic bank is established to supply funds on a profit-sharing principle. Without profit sharing an Islamic banking makes direct investment and equity financing a must. This will undoubtedly put great responsibility on Islamic banks since it would then be necessary to make sound feasibility studies for various projects. A partnership team work has to be created to identify bankable projects and make them ready for financing. The Islamic bank must achieve high returns to distribute to its shareholders and at the same time maximize social benefit.

C. **Positive Attitude.** The profit-sharing principle of Islamic banks makes it imperative to act in positive ways. An Islamic bank has to go out and search for new opportunities to invest funds available other than just lending the money for short-term gains. The lending practice of commercial banks, as can be easily seen, usually waits for their customers. Although the concept of marketing has been introduced in the field of banking the lending function is still an intermediate action between those who supply funds (depositors) and those who demand funds for investment (borrowers). Since the Islamic bank is an equity-based institution, it has to go out for joint venture or even for direct long-term investments. All these risk carrying ventures make sound feasibility studies necessary.

On the other hand, a depositor cannot have a fixed predetermined rate of return on his deposited money. The depositor himself cannot be passive. He has to be alert about the soundness and good management of the banks he chooses. Very often, big depositors once they are advised by an Islamic bank on an investment opportunity, prefer to go into business rather than just waiting for a return. Thus we should expect a positive attitude on the part of depositors and that Islamic banking managers should encourage a positive attitude among depositors and among the members of the society.

D. **Social Nature.** Islamic banks, by nature of their principles, must be social banks, not just banks performing some special social functions. No doubt the social nature of Islamic banking can be seen from the rate of return which must be higher than prevailing rate of interest. This will require more effort from the taskforce which will be assigned the responsibility of preparing sound feasibility studies for the Islamic bank to enable it to finance various viable projects.

From the above analysis one can question as to what extent the current Islamic banks have succeeded in achieving the social objectives according to Islamic norms. Undoubtedly the financial gap between short-term financing (through **murabaha** and **mudarabah**) and long-term financing (through **musharakah**) is widening and this has generated much apprehension among the members of the public.

The challenges that face Islamic banks today require major changes in their perception and attitude. Islamic banks should play a major developmental role through their heavy involvement in partnership financing. They have a moral obligation, which makes their role unique and superior to traditional banks, to fulfill in order to alleviate some of the problems that face the Ummah today. This requires more hard work, dedication and investment in human development projects by training those who are the engines for change; Islamic banks can play an active role to promote such projects to develop financial independence and an active
entrepreneurship.

Malaysian leadership has made the economic, financial and political environment suitable to realize this objective. One cannot overlook the importance of Malaysian agricultural sector in the support of greater productivity throughout the economy. There are two ways of how the greater agricultural productivity and output contribute to the economic development. According to Meier these are firstly, by supplying foodstuffs and raw materials to other expanding sectors in the economy and secondly, by providing an "investible surplus" of savings and taxes to support investments in other expanding sectors. Thus the agricultural sector makes it feasible for other sectors to emerge and grow and for international flows for development, just as these other sectors and the international flows make it feasible for the agricultural sector to operate more efficiently as a producing unit and use its product more effectively as a consumer unit.

The Malaysian government has lately adopted a new strategy based on "balanced economic growth." This wise policy means that industrial development in the country should go hand in hand with growth in the agricultural sector. No doubt the policymakers have realized that if food supplies fail to expand in pace with the growth of demand the result is likely to be a substantial rise in food prices leading to discontent among the people and pressure on wage rates with consequent adverse effects on industrial profits, investment and economic growth.

Malaysia is a rich nation in terms of natural resources and the leadership succeeded during the last two decades in utilizing some of these resources for productive purposes, for the benefit of the society as a whole. Others have not yet been exploited due to various factors including the bankers' perception (as the main suppliers of credit) and the attitude of the people (as the users of funds). The government has been encouraging as it should be, although the government has provided all the necessary support through technical assistance programmes to help the entrepreneurs. Grants have also been extended for preparation of feasibility studies required by the entrepreneurs. The objectives are mainly to create confidence in the entrepreneurs and to support them to move gradually and successfully towards absorbing long-term financing.

The question is why have the bankers not responded to the challenges. Is it because of their perception (that long-term financing is risk oriented and should be avoided) or is it because of the lack of understanding of the project financing concept which is one of the most rapidly growing areas in the field of modern financial management?

This dilemma has to be resolved and this can only be done through the establishment of Islamic Investment Companies (IICs). The task is definitely not an easy one but the initiative must be taken before it is too late. The practical steps to setting up IICs are:

1. **Identification and Selection of the Project.** The project manager who is assigned the responsibility has to select his own staff. The criteria for selection are important to make the project successful. They should be partners, committed to the business, responsible and hard workers for the nation. The government through the Ministry of International Trade and Industry has made the task easier by selecting priority sectors or areas in the economy. For example, small-and medium-scale industries (SMIs) are considered the top priority sector of the economy. Very often we hear that there is a lack of project available for investment in developing countries. The truth is, there is usually no shortage of proposals for projects that have been identified, but there may be a shortage of projects prepared in sufficient detail to permit implementation.

The project manager and his active partner have to make their own selection based on economic and financial viability-usually done through a feasibility study. The feasibility study should clearly define the objectives of the project. It should explicitly address the question of whether alternative ways to achieve the same objectives may be preferable.
2. **Appraisal.** Usually, when a project is proposed, a critical review or an independent appraisal would be carried out. The active partner should go to the field to do this. This provides an opportunity to re-examine every aspect of the project plan to assess whether the proposal is appropriate and sound before a large sum of money is committed.

3. **Implementation.** The objective of any effort in project planning and analysis is clearly to have a project that can be implemented for the benefit of the society. Financial institutions both the Islamic and the secular-are very keen to provide credit to the client once they have been convinced that evaluation has been made by the project manager.

No doubt, a careful feasibility study conducted by an Islamic consultancy house (ICH) will have to be made available to the Islamic banks, which will not shy away from funding a project once the management of these bank are convinced that the project is economically viable and financially profitable. If more bankable projects are in the pipeline then the problem of surplus fund will be resolved and the funds will be channelled to productive use. If dividends accrue the managers can distribute the same among their shareholders and investors.

The current problem facing the financial community-for both Islamic and secular institutions-is the lack of viable projects, which has caused these institutions to accumulate huge surplus funds. If this problem cannot be resolved by Islamic financial institutions in Malaysia, through creating viable projects ready for financing, the Islamic banks (or Islamic counters which have recently been established in all commercial banks) are going to face the same problem (of surplus fund) as other Islamic banks in the Gulf countries during the oil boom, where huge asset accumulation occurred when no viable projects to channel those funds were available.

4. **Disbursement of Fund.** Since IICs have a special interest to execute as many projects as possible for the benefit of the society, disbursement should not be a problem. Once the investment bankers are convinced (based on quarterly reports received from the executing agencies) about the progress of the projects disbursements will be made.

5. **Follow Up and Monitoring.** The success or the failure of any project will depend entirely on continual monitoring and following up. In most developing countries, however, monitoring and following up do not take place once a project has taken off. If this practice persists, corruption will increase and the disbursement of funds will be delayed.

In the final analysis, the Malaysian economy is growing rapidly and it is the right time for policymakers to study the new proposal for establishing IICs to play an active role in channelling funds for productive activities. Long-term financing through partnership will surely help the nation progress further and curb capital flight from the country.

**References:**