THE INFLUENCE OF QURAN AND ISLAMIC FINANCIAL TRANSACTIONS AND BANKING

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Abstract

The Quran is the holy book of the followers of Islam, where simple solutions to the day-to-day problems of life are discussed in detail. Whatever the nationality of a Muslim, the Quran and Islamic prayers remain in a single universal language called “Arabic”. Thus, uniformity has been maintained throughout the world from the days of the Prophet Mohammed, in the seventh century to the twenty-first century. Financial transactions and banking based upon Shariah are growing rapidly today. Islamic banking has been widely accepted in many countries such as Pakistan, Malaysia, Brunei, and Saudi Arabia, and are an increasing presence in Canada and Australia. Islamic banking and financial transactions are different from conventional banks, and this has led to some criticisms. After tracing the history of Islamic Banking some of these criticisms are discussed. While Islamic Banking does face some challenges, it continues to grow, and this growth reflects the desire for social, political and economic systems based on Islamic principles.

1. Introduction

Over twenty percent of the world’s population follows the Islamic religion. The followers of Islam are known as Muslims. Islamic law or Shariah is based on the holy Quran and the teachings of the Prophet Mohammed.

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The Quran deals with every transaction that is applicable to its followers in their day-to-day life. The Quran insists on the sharing of wealth and property amongst fellow beings. Islam is said to be God’s command, and business is not different from religion.

It has been stated in Al-Tirmidihi, buyu, 72 that, 37. “The Apostle of God passed by a pile of grain. He put his hand into the midst of it, and his fingers encountered moisture. He explained, ‘O merchant, what is this?’ The owner of the grain said, ‘It has been damaged by the rain, O Apostle of God.’ Then he replied, ‘if that is the case, why not put the damaged grain on top of the pile so that people can see it?’ Then he concluded ‘whoever practices fraud is not one of us’” [Cragg & Speight 1980 p. 89]. In this scenario, The Prophet conveyed a clear message that any business transaction has to be open and transparent and shall not disadvantage the consumer. All transactions under Islamic law are based on these principles, and morality and equity play a key role in financial transactions.

The principles of Shariah law are applicable to accounting, commerce, and finance, which in turn influence the Islamic banking system. Islamic finance and banking practices differ from the western conventional practices because of Shariah law.

This paper highlights some financial, commercial, and banking transactions under Islam and the Shariah, and the financial practices in some countries adopting Islamic banking and lending. The Islamic financial system has grown all over the world, and has encountered some inconsistencies, yet these can be overcome.

2. Influence of Religion

The Quran has been concerned about the economic inequilibrium and social inequalities that existed in the commercial society of Mecca, and has discouraged uncharitable behaviour. Fazlur [1994, p.38] wrote that “competition in accumulating wealth keeps you preoccupied until you visit your graves. Nay you shall find out soon; nay, nay, you shall find out soon [107:1-6]. Woe betides every fault finder, back slider, who collects wealth and counts it. He thinks his wealth will bestow eternal life upon him! Nay he shall certainly be thrown in hutama and do you know what hutama is? It is God’s fire that he lights and that descends upon the hearts [of callous miserly people]” [102:1-4]. According to the Quran,
God has created seven hells, and the worst hell of all is the seventh, known as ‘hutama’—the place for persons who accumulate wealth with no concern for others.

The Quran is not against the earning of wealth. It sets a high value for wealth as a bounty of God; however, it discourages abuse of wealth and lack of concern for the poor and the needy. The Quran encourages investment in trade and business, which is the principle of Islamic banking. Investment in trade and business is noted historically, as Abdullah, the father of Muhammad, was a trader employed in Mecca’s thriving caravan trade. Also, The Prophet was appointed as a business manager in his youth because of his honesty and virtues in applying Islamic principles [Esposito, 1991].

3. Interest—A Key Difference in Islam

Interest plays an important role in business, and this makes trade and commerce under Islam different from any other law. Usury, or the collection of interest on a debt, is forbidden by the Quran [Surah 2: 275, 276; 4: 161; 30:39, in Cragg & Speight, 1980]. Mayer [1981-82] further stated that any sinful activity is prohibited by Islam, and it is against morals to collect interest. Money should not be used to produce money. This is the concept of Islamic trading, where money cannot be viewed as a commodity.

Ibn Masud said, 38. “The Apostle of God cursed the one who collected usury, the one who paid it, the two witnesses to the transaction and the one who recorded it”—Al-Tirmidhi, buyu, 2 [Cragg & Speight, 1980, p. 89]. Further, it is stated in the Quran [Nisa 4:161]… And this taking of usury when they were forbidden it, and of their devouring people’s wealth by false pretences. We have prepared for those of them who disbelieve a painful doom [Pickthall, p. 93].

Though Islam prohibits the payment and receipt of interest on deposits and loans, it encourages profit sharing in banks [Karim & Ali 1989]. Islamic banks neither pay nor collect interest from their customers, but do share in the risks. Loans are advanced where the lender and the borrower share the profit and loss together. A unique feature of Islamic Banks is that a tax (Zakat) is imposed on the funds accumulated, and is set aside for the poor or charity [Davids, 1983]. Every Muslim is expected to identify Zakat based on the assets and wealth in their possession.
This traditional approach to banking, which began in seventh-century Islam, is the core of all Islamic banks in the technological era of the twenty-first century. This banking system is growing in traditional Muslim and non-Islamic countries.

4. Islamic Financial Instruments and their Application

Islamic banks have devised many products based on risk and profit-sharing beliefs. These products satisfy the Islamic doctrine, and provide acceptable returns for investors. They are the means to an end in Islam. Today the most common forms are:

(a) Murabaha, where the Islamic bank purchases goods, takes title, and then re-sells these to a member at an agreed mark-up, or on deferred payment.
(b) Mudaraba, a business finance arrangement where the Islamic bank provides capital for a business venture, and receives a percentage of the businesses profits.
(c) Musharaka, a project where the bank enters into a partnership with a client where both share the equity capital and management. Profit or loss sharing is on the basis of equity shareholding.
(d) Ijara, (leasing) where assets are purchased by the bank, and leased, and an arrangement of deferred payment is made by the member.
(e) Takaful, (insurance) which is a policy of mutual co-operation, solidarity, and brotherhood against unpredicted risk or catastrophes. Parties contribute genuinely, and to pool their resources, in order to donate compensation to the aggrieved party when the insured event occurs. Funds are invested in projects acceptable under the Shariah.
(f) Muqarada, where a banks floats Islamic bonds to finance a project, and members take a share of the profits (or losses) of the project, and
(g) Salem, where a buyer pays, in advance, a specified quantity of a commodity at an agreed price.

Presently, many conventional banks (including Citibank, ANZ, Dresdner, Deutsche Morgan Grenfell, and ABN Amro) have started handling funds according to the Shariah by setting up offices dealing with Islamic banking facilities, and designing products that meet the needs of Islamic investors [Timewell 1998].
5. *Islamic Banking*

Though Islamic banking became popular in the 1970s with the oil boom, the first Islamic bank was incorporated in Egypt in the mid 1960s [Khalili, 1997]. Orthodox Muslims, who were not in favour of accepting and paying interest, and oil-rich Arab States which followed Islam, did not like to invest their wealth in conventional banks. Thus, Islamic banks were created, wherein members could share in profits and losses, and refrain from interest. Long-term investments were crucial for the survival of these banks. Project financing was found to be within the religious philosophy, where the success of the loan was linked to the success of the project.

Today, Islamic banking has been adopted in more than 50 countries [Khalili, 1997]. Timewell [1998] noted that according to the International Association of Islamic Banks, at the end of 1996 the number of Islamic banks and financial institutions totalled 166 world-wide. These institutions had a total of US$137 billion in assets, and produced profits of $1,683 million. This compares to 1994, where the list of Islamic institutions was 133, and assets were US$101 billion. Iqbal [1997] noted that today the market is estimated to be growing at an average rate of 15%

Under Islamic law, financial accounting and reporting in the banking system is regulated with the assistance of religious advisers. Almost every Islamic bank has a committee of religious advisers whose opinion is sought on the acceptability of new instruments, and who provide a religious audit of the bank’s end-of-year accounts.

Islamic banking in all countries is shaped according to Shariah, and it is followed in Islamic and non-Islamic countries. The countries highlighted have unique features.

5.1 *Banking According To Shariah in Some Islamic Countries*

Banking according to Shariah has been adopted by Islamic countries like Pakistan, Malaysia, Brunei, and Saudi Arabia.

a) *Islamic Banking in Pakistan*

In 1979, government decrees in Pakistan set off a process of Islamisation of the entire banking system. The interest-bearing system was to be transformed into an interest-free system. Conventional banks would disappear after a period of transition. Today, the financial system in Pakistan not entirely devoid of western influence.
b) Islamic Banking in Malaysia

In July 1983, the Bank Islam Malaysia [BIM] was established as the first Islamic institution in South East Asia [Cumming—Bruce, 1983]. The BIM was largely supported by the deposits made by the federal government and state religious bodies. It also accepted current account deposits and savings accounts. The bank had business relations with corporate sector and non-Muslim investors. It also dealt with trade financing, currency, and commodity and financing fixed capital needs for medium- and long-term investment. By the end of 1993, BIM had 32 full branches and 10 mini-branches [Haron, 1995]. Longeran [1996] stated that Malaysia’s Islamic financial system is particularly successful because of the existence of a single Shariah council. The creation of a single Shariah council boosted Islamic banking. The Malaysian Central Bank, Bank Negara, was established as the final authority to apply Shariah law to Islamic banking, and this brought in uniformity.

c) Islamic Banking in Brunei

Islamic banking is encouraged in Brunei, and the first Islamic financial institution was established in 1991 by the finance ministry [Montagu-Pollock, 1997]. A range of services now exist in many Islamic bank branches, based on Islamic laws, including personal loan financing, insurance, motor car and house purchases.

d) Islamic Banking in Saudi Arabia

Although Saudi Arabia has adopted commercial regulations modelled after those of developed nations, the Saudi culture and legal system remain firmly rooted in the teachings of Islam. In Saudi Arabia, most banks operate according to the Quran. Joint ventures are also prominent. The Saudi American Bank, with a 40-60 Citibank/Saudi joint enterprise, adopted broader modern banking trends, to improve its services [Graham, 1987].

5.2 Banking According to Shariah in Some Non-Islamic Countries

Banking according to Shariah has been adopted, to some extent, even in countries which do not follow Islam, like Canada and Australia.
a) Islamic Banking in Canada

Approximately 500,000 Muslims live in Canada, who use regular banking systems, and hence, there is enormous scope for Islamic banking [Kutty, 1995]. The main hurdle, however, is the Bank Act, which requires a prescribed share of deposits to be kept as a reserve with the Bank of Canada, which would accrue interest. The Act also requires payment of interest on savings account. Thus, establishment of a Credit Union is seen as an alternative. Further, two mutual funds, and a number of housing co-operatives applying Shariah have been established. Investors are permitted to invest in profit-sharing ventures involving business risk, and lease deals. The Co-operative Housing Corporation uses a Shariah leasing system instead of mortgages.

b) Islamic Banking in Australia

Recent immigration from South East Asia and the Middle East has expanded the number of Muslims in Australia. In 1991 there were 147,500 Islamic followers, compared to 200,900 in 1996 [Australian Bureau of Statistics, 1998 Year Book].

The Muslim Community Co-operative (Australia) Ltd (MCCA) caters to the needs of Muslims looking for financial services based on religious principles. The MCCA was established in 1989, and its objective is “to provide a comprehensive Islamic alternative for all financing needs of the Muslim community in Australia. Membership is not restricted to Muslims alone, but also to those who are willing to transact in accordance with the Shariah” [MCCA Islamic Finance in Australia, Brochure]. MCCA has over 2,700 members, with a shared capital of over $12 million. The services offered in Australia are Halal investments, personal finance, business finance, Qard Hassan, and Zakat collections and distributions. Since 1997, the MCCA have been working on an application to become a Credit Union.

6. Criticisms of Islamic Banking

A number of criticisms have been made of the Islamic banking financial structures.

Ali [1998] noted that “the greatest challenge to the development of Islamic Banks comes from the inertia of a section of rich Muslims who could have played a more major role in promoting this concept” [p. 12].
Conventional banks grew powerful from the support of their people, yet the same could not be said of Islamic banks. Ali [1998] further noted that “Another reason why rich Muslims are not supporting Islamic banks may be that conventional banking, having been established for centuries, seems to them safer, and certainly guarantees a predetermined return with little or no risk” [p. 12]. On wealth, Clode [1998] also stated that the Islamic world has some of the widest disparities the world has ever seen, and more use could be made of Islamic banks.

In terms of the services offered, Clode [1998] reported that the existing products presently offered “cover only a tiny percentage of the potential market and are clumsy, inflexible and expensive” [p. 2]. Islamic Finance must be able to offer instruments to match, or act as alternatives to, those offered by conventional banks. Clode [1998] noted that the provision of retail banking in large western Islamic communities remains largely untapped. Ali [1998] supports this view: “A major impediment to the growth of Islamic banking is the shortage of marketable financial instruments” [p. 12]. The financial market has reached a stage where the present set of instruments cannot attract investors, and services need to improve. Clode [1998] stated a central Shariah board, with autonomy to review new instruments, is required. Shariah advisors should be proactive in assisting in developing instruments.

Clode [1998] further reported that other major problems of Islamic finance are the lack of liquidity, and the difficulty of providing long-term finance. “The Islamic world has an enormous need for project finance for infrastructure and industry which . . . is simply not being met by Islamic finance” [p. 3]. A lack of co-ordination between different Islamic banks is hindering development, particularly as conventional banks can quite easily form syndicates and benefit from taking on long-term projects. Islamic banks need to use each other to a greater extent, or develop an Islamic money market.

A Research and development culture which matches that of the conventional banks is also important for the future survival and growth of Islamic banking. Ali [1998] noted that Islamic banking allocates negligible funds to the training of its staff. There exists a shortage of Shariah scholars who are well-versed in the field of banking and finance, and the lack of an institution to impart education is also hindering Islamic banking. Further, Islamic banks must make more use of the great potential which present-day technology offers [Ali, 1998].

Disagreement between Shariah councils, and variation in the interpretation by Shariah advisers, is typical of Islamic financial structures,
and will remain so in the absence of a set of international guidelines, or the creation of a single internationally-recognised authority [Longeran 1996]. Iqbal [1997] also noted that a uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed. Different bank boards may interpret transactions differently, and this may prevent meaningful comparisons of financial statements [Ainley 1997]. Finally, problems can exist between western regulators and Islamic banks, and Islamic financial institutions face difficulties operating in non-Islamic countries [Ainley 1997].

7. Conclusion/Future Direction

Many of the criticisms about Islamic banking can or will be overcome in the short term. Already, Islamic banks are working together more with conventional banks and each other. Khalili [1997], for example, noted that a $2 billion project in Kuwait was financed by a group of Islamic and conventional banks, after negotiations with Shariah scholars and western banks. The Institute of Islamic Banking and Insurance has established a Shariah advisory unit, an Islamic banking diploma course, and is providing training to staff in specific banking principles, and research and development. New Islamic products are being developed, and the newly-created Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has developed a uniform standard structure for financial statements.

Perhaps the area of main concern is the lack of uniformity in the interpretation of the Shariah in regards to banking. While calls for a Uniformity exist (i.e., a banking standard), this may be difficult because of the natural differences that exist between environments and countries. Indeed, can such a standard be created? While some world-governing banking standard (as opposed to accounting) may be introduced, this should be of a very general nature, conforming to the universal language of the Quran, and allow for specific differences in countries. Islamic banking is based on a simple philosophy, and the aims of these institutions should not differ greatly.

Can an integrated Islamic financial system be created? Of course, the answer is yes. Certainly, the Islamic banking and financial system could be more visible if a country, or state, could incorporate the financial, spiritual, and social aspects of Islam. While this could exist in Islamic countries, it has proven difficult. Perhaps an alternative may be to rely
on the Muslim community within countries. These communities have the ability to introduce a complete system, within that smaller population base, to show how the system can fulfil the five pillars of the Quran. The future of Islamic banks, and the growth thereof, rests with Muslims, and the desire for socio-political and economic systems based on Islamic principles. A totally-integrated financial system based on the Quran would be the best in the world, because such a system was given to us by the Creator.

The Quran and the Shariah hopefully can ensure that the criticisms of this young industry will not hinder its growth. The positive trends in Islamic banking are at this stage much stronger than the problems.

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