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### **Islamic Banks and Wealth Creation**

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#### **Abstract**

One of the primary objectives of the shariah concerning the community's wealth is to ensure its preservation and growth. At the same time, the maqasid al shari'ah is also aimed to make the distribution of economic resources, wealth and income fair and equitable. Thus it is the utmost important that the Islamic banking system could bridge the gap between the rich and the poor by modifying the distribution of wealth and economic resources. Theoretically, the money invested by customer (depositors), or money invested by banks or money (as capital) utilized by customers (or economic agents like individual, firm and government) can generate profit and then can be distributed to Islamic banks and depositors and hence it could be used to preserve the wealth (mal) of economic agents. Does it true

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## 1. Introduction

One of the primary objectives of the shariah (or famously known as maqasid al-shariah) concerning the community's wealth is to ensure its preservation and growth.<sup>2</sup> Since that wealth consists of an aggregate, it is protected by establishing appropriate rules for its management both at public (such as regulatory and supervisory agencies) and private levels (such as Islamic financial institutions). The protection of the community's wealth as an aggregate depends on the protection of its particular individuals, property and wealth. In other words, the wealth owned by the individuals benefits both its respective owners and the whole community for its utility is not restricted to the immediate beneficiaries handling them.

The maqasid shari'ah is also aimed to make the distribution of economic resources, wealth and income fair and equitable. Islam discourages concentration of wealth in few hands and ensures its circulation among all the sections of society. It means that the wealth should not be allowed to concentrate in few rich hands; rather it should freely circulate among all the people thus enabling the poor and destitute among the nation to also take benefit from it.<sup>3</sup> Thus it is the utmost important that the Islamic banking system could bridge the gap between the rich and the poor by modifying the distribution of wealth and economic resources in favor of the less-fortunate.

The study on the above issues is important due to three reasons. First, it will address the wealth creation in Islamic banking system. Second, Islamic economic system ensures fair and equitable distribution of wealth through positive as well as negative measures.<sup>4</sup> Third, by abolishing interest rate, does it mean that Islamic banks are able to distribute the income more equitable.

Both issues will be addressed in this paper. Therefore, the aim of this paper is to examine the wealth created by among Islamic banks. How the money invested by customer (depositors), or money invested by banks or money (as capital) utilized by customers (or economic agents like individual, firm and government) can generate profit and then can be distributed to Islamic banks and depositors and hence would be able to preserve the wealth (mal) of economic agents.

How it contribute to the well-being of by focusing on return to depositors and return to shareholders. The remaining discussion of this paper is organized into five sections as follows: section 2 discusses the prior studies. Section 3 describes the measuring inequality. Section 4 will produce findings and section 5 concludes the discussion.

## 2. How Could Wealth be Created in Islamic Banks?

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<sup>2</sup> Views from fuqaha such as al-Shatibi (no. date), Ibn Aahur (1966) and al-Ghazali (see, Ismail (2010)), are much related in this case.

<sup>3</sup> Refer to surah Al-Hashr 59:7, Allah says: "That which Allah give that as spoil unto His messenger from the people of the townships, it is for Allah and His messenger and for the near of kin and the orphans and the needy and the way farer, that it become not a commodity between the rich among you."

<sup>4</sup> Both measures are introduced via the preservation of mal such Zakat and Sadaqat, laws of inheritance and will; and the identification of things that threaten mal such as payment of interest, prohibition of earning of wealth by Haram (unlawful) means, and prohibition of hoarding

A significant development and rapid expanding trend of Islamic banking in the present century can be witnessed in the Muslim countries as well as major western countries such as United Kingdom, Australia, and Hong Kong. At the outset, the crux of Islamic banking departure from conventional banking systems is the prohibition of *Riba*, in which the orthodoxy equates with interest in general term while promoting profit-loss sharing (PLS) as a viable alternative for Islamic bank to operate as intermediary. Leaving itself from interest as its central allocation tool, Islamic bank has developed an impressive range of modes of transactions which primarily based on PLS that could appeal to different types of customers. These include two major modes of financing, namely *mudharabah* and *musharakah* that is desirable in an Islamic context due to the characteristics on fair sharing of profit/loss and risk between contracting parties. By offering these modes of financings, as highlighted by Nik Hassan et.al. (2004), Islamic banking system should seek for social economic justice in order to create an environment that promotes cooperation among society. The adoption of PLS modes of financing by Islamic bank as intermediary would leads to the fairness in serving the interest of community as a whole and is expected to promote value creation to the depositors, share holders and eventually to the economy.

Unlike PLS, instruments that are interest-based are prone to favor the rich people and against the interests of the common people. For example, when entrepreneurs borrow huge amounts of money from the bank, they are utilizing depositors share into their profitable project. However, when they earn profit, they will pay nothing to the depositors. In the event of losses, it may lead to the bankruptcy of the bank itself and ultimately depositors will have to bear the whole loss. This is how interest-based systems create inequity and imbalance in the distribution of wealth to the economy. Generally, in PLS, both depositors and entrepreneur would be willing to share the results of the project in an equitable manner. In the case of profit, both will share in pre-agreed ratios and in the case of loss, all financial loss will be borne by the capital provider (Islamic bank) and labor losses is borne by the entrepreneur. This would build a link between both parties that have business skills but lack of capital and capital provider. The beauty of PLS attributes as modes of financing, could facilitate the role of Islamic banks in providing or channeling funds to the skilled entrepreneur in an effort to encourage economic growth.

According to Matthews, Tlemsani and Siddiqui (2004), the Islamic economic principles of risks and rewards sharing as well as joint involvement in the wealth creation activity through equity financing by investors and entrepreneurs has a potential to entice creativity and productivity in an economy. In addition, PLS contracts might drive fairness and subsequently create value for each contracting parties involved. However, experience (Abalkhail and Presley, 2000; Ahmed, 2002) show that there are some inherent problems (asymmetric information, moral hazard and adverse selection) that might hinders the application of PLS. Despite of that, Jarhi al- (1999) proposes that Islamic banking need to have an equilibrium combination between mark-up modes and profit-sharing modes of financing.

Based on the above studies, it is understood that the adoption of PLS contracts might lead to value creation to the Islamic banks, their share holders, customers and economy as a whole. Besides that, it drives the financial systems to the different platform that would create balance between the material and social objectives in an effort to provide fairness and justice. Therefore, the success of the application of profit-sharing

modes in financial systems will depend heavily on the resolution of the imperfections associated with their use.

### **3. Economic Contribution of Islamic Banks**

From the above discussion, Islamic bank can act as partner or *mudarib*. The actual facts show that Islamic banks also act as: to clear and settle payments; to aggregate (pool) and disaggregate wealth and to allow flow of funds so that both large-scale and small-scale projects can be financed; to transfer economic resources over time, location, and sectors; to accumulate, process and disseminate information for decision-making purposes; to provide ways for managing uncertainty and controlling risk; and to provide ways for dealing with risk and return issues that arise in financial contracting. These acts will be discussed in the following sub-title.

#### **(a) Law and Finance**

Law and finance are considered as set of contracts. These contracts are defined – and made more or less effective – by legal rights and enforcement mechanisms. From this perspective, a well-functioning legal system (and also its origin from Al-Quran and Al-Hadith) is expected to facilitate the smooth operation of Islamic banking system. The shari'ah law, as mentioned in Ismail and Tohirin (2009), allows the enforcement of contracts which is tended to produce a better-developed Islamic financial system. Therefore, the overall level and quality of financial services – as determined by the legal system- that could improve the efficient allocation of resources and economic growth. However, some countries might also prefer to choose among the following four legal families: French, English, German, and Scandinavian - descended from Roman law.

#### **(b) Pooling Savings**

In the economy, financial capital can be directly or indirectly invested. Financial capital (via savings) can flow to Islamic banks or when the owner himself establishes a *shirkah*. Savings can come from individuals, institutions and government. This section explains the relationship between savings and investments (via indirect channels), and the important difference between individual savings and aggregate savings.

*Individual savings* means spending less on consumption than available from one's disposable income. What an individual saves can be held in many ways. It can be deposited in a bank, put into a pension fund, used to buy a business, pay debts, or kept under the mattress, for example. The common element is the claim on assets that can be used to pay for future consumption. If there is a return on the saving in the form of profit, dividend, rent, or capital gain, there can be a net gain in individual savings, and thus in individual wealth.

Suppose an individual decides to increase savings by consuming less. His cutback in spending necessarily means a reduction in income to others. They in turn might cut their consumption to match the loss of income, but then others would lose income. Most people do not reduce consumption equal to the loss of income, so there will usually be a net reduction in savings. Thus the net saving may individually decrease more than the original increase, which would result in a decrease in aggregate savings.

*Aggregate savings* do not increase as a result of individuals acquiring pieces of paper like ringgit sukuk or stock. That merely swaps one type of financial asset for another without affecting the total. Aggregate savings occur when the nation acquires real domestic assets, such as new housing, new machinery, new factories and offices, additions to a firm's inventory of goods, or new claims on assets overseas. And that is precisely what is meant by investment.

*Aggregate savings equals Investment.* Investment is what provides for growth in aggregate wealth. However we cannot increase investments without increasing aggregate savings. Measures taken to increase individual savings will not increase aggregate savings unless they increase investments. Instead they may bring down the income of others, and thereby reduce both aggregate savings and investments. For example if investment increases by RM10 billion, aggregate savings must have increased by RM10 billion. That means the aggregate income must have increased by RM10 billion more than the increase in aggregate consumption.

### (c) Channeling Funds

It is known that investment is the foundation of economic activity in any society. However, not every individual is capable of directly investing his own savings. Accordingly, Islamic banks play an important role by acting as a vehicle to attract the savings of individuals and investing those savings for the benefit of the individual and society.

Islam clearly encourages investment and spending. Indeed, when Islam imposed zakah, it required that wealth should be invested; otherwise it would be exhausted by zakah over a period of time.

However, in channeling funds, a new relationship between rabbul mal and mudharib might exist. The relationship might affect the screening and monitoring of potential entrepreneurs and the allocation of capital in the economy.

*Screening and monitoring potential entrepreneurs* - Islamic financing can be in the form of murabahah (mark-up based scheme) financing or mudarabah financing (Profit/loss sharing). The mark-up based scheme has a similar feature as debt contracts and involves similar screening and monitoring processes. Nevertheless, it has several differences that make it uniquely Islamic: (i) It is commodity based financing, (ii) No Penalty interest imposed for past-due payments, (iii) No compounding interest rate for the past due obligations, (iv) no floating interest rate during the whole period of the contract, (v) in case of bankruptcy, only the initial debt (including the mark-up) is recovered.<sup>5</sup> Thus this mark-up based scheme has similar features to 'standard debt contracts' in that it has the advantage of being an optimal contract.

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<sup>5</sup> Constraint (ii) and (iii) are applied in case of the customer is unable to pay.

In mudarabah financing, Islamic banks fund the project totally or in the form of a partnership with an entrepreneur on the Profit and Loss Sharing basis (PLS). Islamic banks may require the entrepreneur to maintain a minimum holding of certain assets relative to the business size, thus keeping its net worth high. When an entrepreneur has a higher stake of his net worth in holding, his tendency to be dishonest will be reduced because he has a lot to lose. Therefore, through screening and monitoring, an entrepreneur knows that he is being monitored and Islamic banks can predict what outcome could be expected from the entrepreneur. Thus, the entrepreneur will make management decisions that would bring monetary returns to both partners. As a result, this would enhance the level of investment.

*Allocation of capital* – Islamic banks can minimize the cost of acquiring and processing information about investments, which are costly for individual savers to attempt to obtain for themselves. The ability to acquire and process information leads to higher economic growth because Islamic banks are capable of allocating funds to the most promising firms. In addition, Islamic banks can stimulate the rate of technological innovation by providing funds to entrepreneurs with the best chances of successfully initiating new goods and production processes. Here, the specialty of the Islamic banks is to manage the deposit and at the same time allocate capital to entrepreneurs.

If the allocation of capital is based on the sharing of risks and profits, then, the actual performance of the project, enterprise or the economy as a whole determines the return on capital.<sup>6</sup> Therefore, in this profit sharing technique, capital and profit share will result according to productivity. Accordingly, the actually realized returns on profit is the price of capital, which will determine how it is allocated.

#### **(d) Custodian, Payment System Access and Accounting**

In Islamic banking operations, under the savings and current accounts, the Islamic bank has the authority to use our deposits and gives a guarantee to return it to us when we need it. We will periodically obtain a share of the profits earned by the bank when it utilizes our money to invest in business ventures. The portion of profit to be shared with us is at the absolute discretion of the bank. This arrangement is based on the Islamic principle of al-wadi'ah yad-dhamanah (guaranteed safe custody), in which Islamic banks as custodians, guarantee the safety of money.

At the retail level, most transactions use cash, in the form of notes and coins. However checks and plastic cards dominate in volume because they typically involve more expensive purchases. Islamic banks can provide access to payment systems such as cash payments, payments by check, Giro payments and plastic cards like charge cards, credit cards, and debit cards.

However, Islamic banks also transfer a large volume of funds electronically using various systems like EFPOST, CHIPS and the Automated Clearing House.

Islamic banks also play a role in providing the maintenance services of the books and records of fund management companies so as to accurately record the assets,

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<sup>6</sup> Elsewhere it is mentioned as Profit Loss Sharing. Return based on real performance of the project, i.e. *ex-post facto* and not a pre-determined form for one party, an *ex-ante* assured return.

liabilities, income, and expenses of funds in accordance with International Accounting Standards (IAS) or US Generally Accepted Accounting Principles (GAAP), and the Securities Commission guidelines or any local accounting guidelines that may be issued from time to time by local regulatory bodies. The investment portfolio may contain a variety of instruments (both OTC and exchange traded). The result of corporate actions (e.g., dividends, stock splits, etc.) will be reflected in the books and records of the funds. Periodically (usually on the valuation date), the portfolio is marked-to-market and, if appropriate, adjusted for foreign exchange in order to provide the basis for issuing a number of accounting statements, the most important being the calculation of the Net Asset Value (NAV).

#### (e) **Information Disclosure**

Information disclosed through Islamic banks annual reports are a primary source of public information. Such disclosures help develop a trust in the ability of Islamic banks to realize their roles, and to highlight the unique relationship among the agents. In the absence of trust in the ability of Islamic banks to invest efficiently and in full compliance with shariah, many individuals may refrain from investing through Islamic banks. One of the pre-requisites for the development of such trust is the availability of information that assures the investing public of the ability of Islamic banks to achieve their objectives. Among the important sources of such information are the financial reports of Islamic banks which are prepared in accordance with the standards that are applicable to Islamic banks.

The financial reports need to be submitted on a periodical basis to regulators. It covers the Islamic bank's financial position, results of its operations, and cash flows, to assist users of such reports in making decision. The function is to provide important information which assists the Islamic bank's management in directing their available economic resources. Accordingly, it facilitates management efforts in planning, directing and supervising the Islamic banks' activities. It also facilitates the roles of regulators responsible for supervising the economy and the stability of the banking system, and for collecting tax and zakah based on the financial information which it produces.

*Agency relationships* - Agency problems as a result of separation of ownership and control is theoretically an established aspect in the agency theory. This theory examines the relationship among the contracting agents. Therefore, in this case, agent and principals are bonded through contracts. Agents are expected to fulfill their obligations to the best interest of the owner as principal. However, conflicts are likely as agents and individuals may have their own ideas of maximising funds which may not be what is required in the contracts. Therefore, Islamic banks need a proper monitoring mechanism due to such opportunistic behavior. Disclosures are an important mechanism to monitor and mitigate agency problems and enhance agency relationships in contracts.<sup>7</sup>

The contracting agents also create asymmetric information. Unequal access to information may occur among the agents. The application of contracts between shareholders-managers, sukukholders-shareholders, buyers-sellers and employer-

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<sup>7</sup> Other mechanisms such as governance and regulation can also be used to monitor the contracting parties.

employee could result in unequal access to information due to conflict of interests. This may impact management incentives in disclosure decisions.

Information advantageous to one party have negative consequences to other parties. For example:

*Ibn ‘Abbas (Allah be pleased with them) reported Allah’s Messenger (saw) as saying: “He, who buys food grain, should not sell it, until he has taken possession of it.” Ibn ‘Abbas said: “I think it applies to all other things as well.”*

The example hadith shows the imperfect market and creates a market for uncertainty when an Islamic bank, for example, sells a house without taking possession of it. This can put the buyer at a disadvantage since he cannot tell who owns the house.

#### **4. Wealth Creation**

Islamic banks play a valuable and integral part in the development of the national economy. By focusing on sustainable economic wealth, Islamic banks can economically empower employees, shareholders and business partners, and can also contribute to the sustainability of state treasuries and a diverse spectrum of important social development projects. In essence Islamic banks are able to generate employment and to increase the shareholder’s and entrepreneur’s wealth. The economic contribution of Islamic banks can be seen by looking at the following example.

As reported in 1, during our financial year to 31 December 2008, Islamic bank A created wealth of RM20.2 billion, an increase of 14% on the wealth created during the 2007 financial year. While much of wealth generation benefits the employees, shareholders, customers, suppliers and government treasuries, Islamic banks remain focused on contributing to the socioeconomic development of the communities.

Islamic bank A recognizes and accepts the responsibility to contribute (via zakah) to the broader socioeconomic goals of poverty relief, improved health, better education and general social development especially in poor communities. Such bank-led initiatives encourage economic development, strengthen civil society and promote the development and building of a democracy.

The benefits of Islamic bank A involvement include transferring technology, expanding financial services and providing capital in the countries in which Islamic bank A operate. These benefits support growth and development.

The primary challenge for Islamic bank A is to operate successfully in an increasingly globalised environment. At the same time, business is required to go beyond narrow financial considerations and to balance the social, environmental and economic demands of its stakeholders. Islamic bank A contribution to the economies in which it operates should be seen in this context.

##### **(a) Benefiting Employees, Customers and Communities**

Islamic bank A, as shown in Table 1, paid the employees RM8.5 billion during 2008. The amount paid in 2007 was RM7.6 billion. A conservative economic estimate indicates that

more people directly depend on Islamic bank A for their livelihood. Customers received an amount of RM31.2 billion during 2008. It contributed a substantial amount to their wealth.

Furthermore, Islamic bank A contribute to the economy by providing affordable, effective banking and financial services to diverse individuals and organizations; contributing over RM2.9 billion to the government in the form of taxes in 2008; and promoting economic stability and convenience in local communities through extensive branch networks.

### (b) Islamic Banks -Value Added Wealth

Value-added wealth is the wealth created by Islamic banks through the provision of banking and other financial services. The Islamic banks' returns in fee-based income has been included in profit, commission and other revenues.

Islamic bank A once again met their primary financial objectives of strong value-added growth. This increased from RM17.6 billion in 2007 to RM20.2 billion in 2008. As a result, the distribution of wealth to employees, government and shareholders increased from RM7.6 billion, RM2.8 billion, and RM1.9 billion in 2007 to RM8.5 billion, RM2.9 billion and RM2.3 billion in 2008, respectively. At the same time, the retained earnings also increased from RM5.5 billion in 2007 to RM6.5 billion in 2008. The figures above show a significant contribution by Islamic bank A to the economy during the period of 2004-2008. On the average, as shown in Diagram 1, the employees, government, shareholders (all are economic agents) and **retentions** received about 44.2%, 15.2%, 10.2% and 30.4%, respectively of the total wealth.

**Table 1: Financial Summary of Islamic Banks**

	2008 RM	%	2007 RM	%
Value added				
Profit, commissions and other revenues	51 391		50 368	
Profit paid to depositors and cost of other services	31 191		32 704	
Wealth created	20 200		17 664	
Distribution of wealth				
Employees				
Salaries and other benefits	8 499	42	7 581	43
Governments	2 914	15	2 770	16
Shareholders	2 277	11	1 857	10

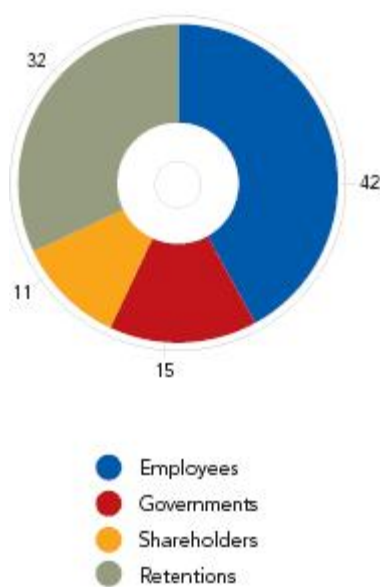
Dividends paid to shareholders	2 150		1 753	
Earnings attributable to outside and preference shareholders	127		104	
Retentions to support future business growth	6 510	32	5 456	31
Retained surplus	5 591		4 625	
Depreciation and amortization	919		831	
<b>Wealth distributed</b>	<b>20 200</b>	<b>100</b>	<b>17 664</b>	<b>100</b>

#### Wealth distribution over five years (%)

	2008	2007	2006	2005	2004
Employees	42	43	46	44	46
Government	15	16	16	15	14
Shareholders	11	10	10	10	10
Retentions	32	31	28	31	30

**Diagram 1: Distribution of Wealth to Economic Agents**

Distribution of wealth created by the group (%)



## 5. Conclusions

The role of Islamic banks includes: to clear and settle payments; to aggregate (pool) and disaggregate wealth and to allow flow of funds so that both large-scale and small-scale projects can be financed; to transfer economic resources over time, location, and sectors; to accumulate, process and disseminate information for decision-making purposes; to provide ways for managing uncertainty and controlling risk; and to provide ways for dealing with risks and return issues that arise in financial contracting. These roles can be performed by offering financial transactions, pooling savings and channeling funds. By performing these roles, Islamic banks play a valuable and integral part in the development of the national economy by creating wealth for individuals and the community. Therefore, there are a number of suggestion for future research: first, the adoption of PLS modes of financing by Islamic bank as intermediary would leads to the fairness in serving the interest of community as a whole and is expected to promote value creation to the depositors, share holders and eventually to the economy. Could a higher PLS create a better distribution? Second, regulation such regulation on non-performing financing and investment risk allowance might change the distribution of wealth. Third, financial reporting based on contract might produce a more transparent distribution of wealth.

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