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Islamic Banking: Its Nature and Role in Economic Development

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The wide impact of religion on human life has long been recognized. Islam is a religion that has increased in influence and has strong implication from day-to-day life of consumers. A particular aspect of Islamic law that has had unique impact is Islamic banking. It is our purpose to provide an outline of the nature and scope of Islamic banking and to develop a preliminary conceptual model of its likely effects.

Introduction

According to surveys, most of the people in the world say that religion is very important in their lives. Many would say that without it, their lives would be meaningless. It's tempting just to take them at their word, to declare that nothing more is to be said — and to tiptoe away. Who would want to interfere with whatever it is that gives their lives meaning? But if we do that, we willfully ignore some serious questions. Can just any religion give lives meaning, in a way that we should honor and respect? What about people who fall into the clutches of cult leaders, or who are duped into giving their life savings to religious con artists? Do their lives still have meaning, even though their particular "religion" is a fraud?

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> Churches make a great show about the creed, but they don't really care. A lot of the evangelicals don't really care what you believe as long as you say the right thing and do the right thing and put a lot of money in the collection box.
>
> Churches have given us great treasures. Whether that pays for the harm they have done is another matter.
>
> *Daniel C. Dennett*

Religion and/or spirituality in its various forms has had a major influence on humanity since prehistoric times and recently it has been suggested that it is evolutionary (Chisholm, 1999; Dennett, 2003). At its broadest it is a macromarketing variable that has the potential to affect all aspects of marketing. (Mittelstaedt, 2002, p. 6) in his seminal work, in macromarketing, on the topic has stated, "scholars need to understand the effects of religion on the kind of issues they face in business and, more important, how these issues are defined, informed, and regulated by religion." In the more general context his statement has most recently been echoed by Dennett (2006) who presents a cogent argument for the application of modern scientific methods to the exploration and evaluation of modern theories of religion and their social implications. This argument must be tempered by the historical ever-present hostilities and prohibition against the discussion of religion lest one be accused of blasphemy or heresy, and the possibility of the related dire consequences (The Economist, a,b,c,e). Nonetheless, the ubiquitous presence, power and authority of religious teachings and their effects are too important to continue to be avoided by marketing scholars.

Perhaps the most interesting starting point for any research agenda is the existence of hostility between the various forms of religious social groupings, despite the often cited similarity in the major forms of their divinely inspired dogma (e.g. Campbell, 1949; Dennett, 2006). The antagonism both externally (between different religions) and internally (between different sects of the same religion) is surprising given the common emphasis on compassion and peace of most religions. Indeed, some of the most cogent questioning of religious precepts have emanated from deeply religious philosophers (e.g. Dostoevsky, 1912; Wasserman, 1970) and is sympathetically handled in many religious tracts (Jones, 1966). For example,

> [24] Thomas, called the Twin, who was one of the Twelve, was not with them when Jesus came. [25] So the other disciples said to him, 'We have seen the Lord,' but he answered, 'Unless I can see the holes that the nails made in his hands and can put my finger into the holes they made, and unless I can put my hand into his side, I refuse to believe.' [26] Eight days later the disciples were in the house again and Thomas was with them. The doors were closed, but Jesus came in and stood among them. 'Peace be with you,' he said. [27] Then he spoke to Thomas, 'Put your finger here; look, here are my hands. Give me your hand; put it into my side. Do not be unbelieving any more but believe.' [28] Thomas replied, 'My Lord and my God!' [29] Jesus said to him: You believe because you can see me. Blessed are those who have not seen and yet believe. Jones (1966)

In part, The Economist (f, p. 78) in a review of Dennett (2006) captures the essence of the present situation as follows:

> Had he been writing today, in a month when Muslims and Christians are engulfed in passionate conflict over the ridiculing of the Prophet Muhammad in a European cartoon, Mr. Dennett, a philosophy professor at Tufts University, might have used a different metaphor or parable to convey the difficulties of discussing religion across high cultural barriers. Just as a set of rules and rituals can seem self-evidently horrific to some people and perfectly natural to others, the symbols of religion — holy persons, holy artefacts or holy buildings — can evince reactions ranging from awe to repulsion to indifference among people who in other contexts would find little to disagree over.

This relativist argument illustrates some of the difficulties associated with the translation and interpretation of abstract metaphysical texts into the applied context of day-to-day living where power considerations, uncertainty and conflict are ever present. Further, the complexity of the divine message leads the ordinary citizen to rely and have faith in particular human interpretations and their manifestations in rituals and normative rules (Dostoevsky, 1912; Wasserman, 1970). It is these interpretations, the derived normative rules or religious law and the strength of faith in them that determines much of social debate and action. In the marketing context there is perhaps no greater impact than that of the interpretation that has led to the development of the unique characteristic of "Islamic Banking." It is our purpose to focus on this one aspect of one particular religion and attempt to postulate some preliminary conceptual relationships for future macromarketing evaluation.

The Nature of Islamic Banking and Its Sources

Islam is the fastest growing religion in the world and has over 1.5 billion followers by conservative estimates (Central Intelligence Agency 2005). This growth, coupled with the inordinate amount of media attention that Islamic fundamentalism has received in recent years, has raised awareness of the Islamic philosophy and precepts on several aspects of life such as economics and politics. The rhetoric of Muslim clergy and scholars have either proposed an alternative to secularism and economic liberalism, at best; or at worst, instigated a shift towards fundamentalism to regain the glorious days of the Islamic empire. This fundamentalism emanated in the modern time from the work of the Egyptian scholar Qutb who saw major contradictions between the evolving Western culture and the religion of Islam, and who initiated an attempt to revive its relevance (Sharma, 2005).

Although it is important to note that Islam is a varied religion, Muslim scholars in general agree that Islam is more than just a religion; it is a comprehensive way of life, prescribed through norms and practices outlined in the Holy Book, known as the Quran. Notwithstanding the broad and equivocal interpretations of Islamic scripture, there is little disagreement on the principles and laws of Islam, known as

Shariah. These *Shariah* principles are not new and pervade all aspects of a Muslim's life, including financial affairs (Taylor, 2003). The bases of the Islamic law governing economic transactions has it sources in the *Quran* where it is emphasized that all natural means of production, and resources have been created by God and it is, therefore, God who determines what is lawful (*halal*) and unlawful (*haram*) (Index to the Qur'an; Sharma, 2005). At its most general level this ancient law has many striking parallels with Christian religions and prohibits liquor, pork, gambling, pornography, usury and anything else, which is morally or socially injurious. An individual has the right to property ownership and to seek economic well-being, however this must be realized according to Islamic law and wealth must be used judiciously and not hoarded or wasted. While surplus wealth may be retained a portion must be allocated for the well-being of the community as a whole, so ensuring social justice without inhibiting individual enterprise.

From this general, basis *Shariah* is applied to financial matters because Muslims believe that it is God (*Allah*) who determines the fate of one's financial wealth and endeavors. As a consequence, financial exchanges or transactions should be conducted in accordance to *Shariah* if one wishes the outcome to emerge as duly fated by *Allah*. A product of one such philosophy is the concept of Islamic banking. In Islamic banking, financial transactions adhere to the rules and injunctions imposed by *Shariah* with the intended outcome of improved equality, as well as, financial and spiritual welfare. Therefore, in principle, Islamic banking is characterized by compassion for the poor, the sharing of risk, abolition of greed and the exploitation of one class by another (Zangeneh, 1989). Advocates of Islamic banking argue that departure from conventional banking practices and the adherence to *Shariah* hold the solutions to economic problems (Bjorvatn, 1998).

Since the modern incarnation of the Islamic banking movement began less than sixty years ago as an effort to defend Islamic civilization against foreign cultural influences (Kuran, 1995b), Islamic banks around the world today are managing about USD$200 billion in funds. To date, there are over 250 Islamic financial institutions operating in 48 countries, many of which are non-Muslim countries (The Institute of Islamic Banking and Insurance, 2006). Economist (The Economist, d) has recently reflected on Islamic Banking as follows:

> These are profitable days for banks in the Persian Gulf. And no wonder, you might say, with the price of oil topping $50 a barrel this week. The Gulf is awash in money, and banks, the conduits and depositories of it all, are doing nicely. In Saudi Arabia, by far the biggest of the six countries in the Gulf Co-operation Council (GCC), banks' profits in the first half of this year were 30% higher than in the same period of 2003. Last year wasn't bad, either: according to the Middle East Economic Survey, a weekly newsletter, full-year profits at GCC banks rose by almost one-fifth from 2002's level, to $7.1 billion. Only one of the 67 banks surveyed reported a loss.

At the outset, this provides credence for Islamic banking, not only as a legitimate and viable alternative to conventional banking, but perhaps, also as solution to economic problems. These particular issues should be of great interest to macromarketers — the legitimacy of Islamic banking as an alternative form of banking, its viability, and contribution to societal welfare — issues that are still relatively unexplored or unaddressed.

Principles of Islamic Banking

Operationalizing the *Shariah* in the banking context leads to a very interesting comparison between conventional and Islamic banking, and the application of financial principles. A distinguishing characteristic of Islamic banking is the prohibition of interest. The injunctions against the collection and payment of interest or usury (*riba*) are stated clearly in the Quran (These injunctions are contained in several verses in the Quran such as Sura II.). The bases for this injunction is the belief that income should not be generated without labor on the part of the lender and that exchanges based on interest are considered to benefit the rich at the expense of the poor (Noorzoy, 1982). The condemnation of usury is not unique to Islam; it is also frowned upon in Christian and Jewish teaching as well as by philosophers such as Aristotle (Hardie and Rabooy, 1991; Jones, 1966). Nonetheless, the sentiment against usury among Islamic scholars and religious leaders is well captured in the following quote by Taleqani (1983, p. 103):

> The greedy people with the poison of money through usury, extracted the economic blood from the body of the producing classes, which are the active and progressive organs of society, and injected into their fat bodies, which are the parasite of society... usury (is) the foundation and root of all or most social and economic problems.

As strange as these concepts sound in conventional banking, let's take the example of a home mortgage. Here, a bank operating in conventional banking, loans the homebuyer money and charges interest on the principal. In Islamic banking however, the bank will buy the house from the seller and resell it to the homebuyer at a markup, which is equivalent to the time value of money and a premium that will be the bank's profits. The homebuyer pays the resale price to the bank in installments until it is fully paid up. Until then, the bank retains legal ownership of the house. These two separate transactions — the purchase of the house by the bank and the resale of the house to the homebuyer — circumvent the injunction on charging interest on the loan. This arrangement is known as *Murabaha*, which is analogous to 'rent-to-own' schemes in conventional finance.

A similar example in trade financing is *Bai' Bithaman Ajil*, where a business owner is looking to purchase equipment and inventory. In conventional banking, a business owner approaches the bank for a business loan, and upon approval which is subject to the feasibility of the business, the bank will provide that loan which is payable with interest. In Islamic banking, the bank purchases the equipment and inventory concerned and sells it to the business owner at a markup, which is equivalent to the time value of money and the bank's premium. The business owner is allowed to make deferred installment payments until the amount of the sale price is fully paid up. Until then, the bank retains legal title of the equipment and inventory. Again, the bank's resale of equipment and inventory with a markup equivalent to the cost of credit circumvents the prohibition of *riba*.

Consistent with this prohibition, banks are allowed to accept deposits from depositors but are prohibited from paying interest to attract or retain such deposits. Similarly, Muslim depositors are prohibited from expecting and collecting interest on their deposits. Yet Islam recognizes the need for a banking intermediary. In Islam, when a bank accepts a depositor's money, it becomes a trustee for his or her money. This deposit is available to the depositor at call and may be repayable with a 'gift' from the bank as a reward for using the funds. Often this 'gift' is equivalent to the time value of money but the bank does not officially guarantee its payment or a preset amount. This arrangement, known as *Wadiah*, is offered and promoted as an alternative to interest-bearing deposits.

The injunction against *riba* is supported by other Islamic principles advocating the sharing of risk, individuals' rights and duties to society, property rights and the sanctity of contracts (Zaher and Hassan, 2001). However, it is the Islamic principle that encourages fellow Muslims to share the risk and fate of financial exchange that is of particular interest. Between the bank and the business owner, this arrangement complements the injunction on usury because bank revenue conventionally received in the form of interest charges is now substituted with profit or dividends from its investment in its debtors' business ventures. Profit and loss sharing arrangements are also encouraged for its role in achieving and maintaining economic equality — one of the central tenets of Islam. Therefore, in principle, the sharing of profit and loss in commercial enterprise, known as *Mudharabah*, is another salient feature that distinguishes Islamic banking from conventional banking.

Let's take an example of a business loan in Islamic banking. In conventional banking, the bank loans the business owner money, which is repayable with interest that is equivalent to the prevailing market rate, irrespective of the eventual financial performance of the enterprise concerned. In Islamic banking however, the bank will lend the money to the business owner without charging any interest or fees. If the enterprise is profitable, the bank shall receive a portion of its profits, proportional to the capital loaned to it. If the enterprise makes a loss, the bank shall bear that loss. This *Mudharabah* arrangement will continue until the principal is fully paid up. Essentially, the bank's profit/loss is equivalent to the enterprise's profit/loss.

Another form of profit/loss financing encouraged in Islam is the *Musharaka* or the joint venture. In this arrangement, Islamic banks essentially perform the role of a venture capitalist by providing capital to entrepreneurs in exchange for a pre-agreed share of profits, if the venture is profitable. If the venture is not profitable, generally the banks will bear the losses. However, if it was found that the entrepreneur was negligent or deceitful in the management of the venture, the bank does not have to bear any losses.

In the same vein of profit and loss sharing, both the issuance and amount of 'gift' payments (*hibah*) in *Wadiah* arrangements in principle are tied to the profitability of the bank. Depositors, as providers of funds, are essentially shareholders of the bank, albeit silent partners. While there is little disagreement on this principle, its current implementation is highly debatable. Nonetheless, it is a profit-sharing alternative to receiving a predetermined interest rate, thus circumventing the injunction on riba. Ultimately, profit and loss sharing arrangements in Islamic banking are instrumental in reducing income inequality and class exploitation because it facilitates economic participation from lower socio-economic segments of the population who lack access to financing and capital.

To this end, the *Shariah* also discourages participation in risk-taking activities or activities where the outcome is unknown or hidden (*gharar*). Hence, it prohibits trading in financial risk and speculative investments as these behaviors are regarded as gambling, which is prohibited in Islam (*haram*). The application of these principles has significant implications on the treatment of financial risk (Hardie and Rabooy, 1991), imposing severe limitations on both Muslims and Islamic banks in the number of financial instruments available for sale, investment and trade (Noorzoy, 1982). Typically, Islamic banks do not offer its customers opportunities to trade or invest in derivative securities. It should be noted however that it is unclear whether Islamic banks themselves partake in the derivative securities markets, behaviors that would be prohibited in Islam for its characteristically high risk and volatility. It should also be noted that trading in derivative securities is permitted in many Muslim societies because the *Shariah* does not provide clear guidance on the acceptability of these instruments (Naughton and Naughton, 2000).

Since risk-hedging investments are also prohibited in Islam, conventional insurance is naturally prohibited. As an alternative, Islamic banks offer *Takaful*. In conventional insurance, the insurance premium rate is a more-than-fair (for the insurance company) outcome of actuarial calculations on uncertain outcomes (*gharar*), which is prohibited in Islam. With *Takaful*, customers agree to contribute a predetermined amount (which may also involve actuarial calculations) into a pool of funds, which will be used to guarantee fellow contributors against loss or damage. Any surplus funds will be redistributed to contributing customers. Operating under the guise of a support network, *Takaful* also circumvents the prohibition of products based on *gharar*.

In Islam, the disdain for speculative profits also limits a bank's ability to engage in the equity markets. Vested financial interest on uncertain outcomes is regarded as gambling, which is prohibited in Islam (*haram*). Hence, speculative trading of equity instruments such as stocks and property by banks is generally prohibited. However, it should be noted that the *Shariah* permits the ownership of stock and that many Muslim societies have an active stock market, despite the presence of uncertainty and speculative opportunities in stock trading. These observations might suggest the interpretation of the *Shariah* is subjective and as a result, uncertainty persists with regards to which financial instruments and behaviors are *haram* and which are acceptable (Kuran, 1983).

There are other principles of Islamic economics that may not give rise to differences between conventional and Islamic banking that are as contrasting as those of preceding principles, but are still worthy of mention. One example is investment in activities labeled as *haram*. The *Shariah* prohibits investments in businesses that are involved in gambling, pornography, alcohol, and pork products. Islamic banks will then have to be more circumspect and transparent with their investments or confine their investments to instruments and companies that are approved by local governing *Shariah* councils. Another example is alms giving. The *Shariah* decrees that wealthier Muslims pay alms (*zakat*) to their poorer counterparts. In Islam, *zakat* is foreseen as a necessary arrangement to serve its goals in welfare distribution. While not directly related to Islamic banking, Islamic banks serve as collection agents for committees who determine its appropriation. Both these principles parallel efforts to shape banking and investment norms to conform to the Muslim way of life, but not without generating a debate about the legitimacy and viability of Islamic banking (Ali, 1964; Chapra, 1985, 2000; Sharfi, 2000).

The Benefits of Islamic Banking

The motivation for applying Islamic principles to banking is based on principles of equality and justice — values that are deemed to pervade all aspects of life including banking. The banking function plays a critical role in welfare distribution, the prohibition of *riba* and the sharing of profit and loss are intended to reduce inequality in income, wealth and welfare. Since interest is held to have adverse redistributive effects, the prohibition of *riba* seeks to eliminate the indebtedness of the poor to the rich (Wilson, 1982). The sharing of profit and loss then effectively eliminates the need for collateral, thereby providing the poor with better access to credit and financing. In turn, better access to credit and financing will increase the rate of economic participation and reduce income inequality. Along with the welfare transfer payments of *zakat*, this is a salient feature of Islamic banking given that most Muslim communities are characterized by sharp inequalities (Kuran, 1996).

Indeed, proponents of Islamic banking argue that it results in several positive benefits to the economy. Chiefly, Islamic banks play an important role in stimulating economic development in rural areas (Bjorvatn, 1998; Siwar and Karim, 1997) . Stiansen (1995) reported that through profit and loss sharing arrangements similar to Musharaka, small-scale farmers can offer a share of the harvest, in exchange for the required financial and physical capital that would not be obtainable otherwise through conventional banking. Caragata (2000) noted that the Indonesian government provides political support for Islamic banking as an alternative to conventional banking for rural entrepreneurs.

The elimination of interest can also have positive stabilizing effects on the economy. Darrat (1988) and Khan (1986) found empirical support to attest that, in underdeveloped countries, Islamic banking is superior to conventional banking because the prohibition of interest results in a more stable financial sector. In addition, Ghannadian and Goswami (2004) indicated that Islamic banking is the most appropriate choice during the transition of an economy. Consistent with the historical perspectives of many cultures that view money lending and usury as a parasitic activity, the elimination of interest would serve to minimize class exploitation and civil unrest.

Several authors attribute other economic benefits of Islamic banking to its unique profit and loss arrangements. Naser and Moutinho (1997) argue that profit and loss sharing arrangements forges closer ties between the banks and its customers. In these arrangements, both the borrower and lender have vested interest in the feasibility and productivity of the commercial enterprise. As a result, the sharing of information and risk between the two parties is increased, which in turn, reduces information asymmetry (Samad and Hassan, 1999) and inequitable returns (Zaher and Hassan, 2001). Zaher and Hassan (2001) purport that through profit and loss sharing arrangements, Islamic banking improves capital allocation efficiency because interest-based lending tend to reward capital to creditworthy borrowers rather than the most productive projects.

An increasingly salient benefit of Islamic banking is its viability as an alternative form of banking. In Muslim countries, for example, Pakistan, Iran and Sudan where the entire banking system was reformed to conform to Islamic banking principles, observers noted that the financial system did not collapse as some skeptics had expected (Khan and Mirakhor, 1990; Pourian, 1995; Zangeneh, 1989). In fact, banking systems in Pakistan and Iran have since recorded significant growth in investment deposits (Khan and Mirakhor, 1990). Some researchers have found that the acceptance of Islamic banking among Muslim depositors is motivated by its ability to help them fulfill religious requirements (Kuran 1996; Metawa and Almossawi 1998,Metawa and Almossawi 1998, Shook and Hassan 1988, while others theorize that Islamic banking has attracted socially-conscious depositors (Gerrard and Cunningham, 1997; Taylor, 2003). Even though the natural target market for Islamic banks are Muslims, the banks have also been able to attract non-Muslims depositors (Caragata, 2000; Gerrard and Cunningham, 1997; Haron, Ahmad, and Planisek, 1994; Kuran, 1996). Religiosity aside, the growing participation of Muslims and non-Muslims in Islamic banking is also driven by the attractive returns received to depositors (Gerrard and Cunningham, 1997; Haron et al., 1994; Metawa and Almossawi, 1998; Naser, Jamal, and Al-Khatib, 1999).

Criticisms of Islamic Banking

The concept of Islamic banking is not without its critics, both due to its shortcomings as a theoretical concept and its implementation. Naturally, the biggest source of criticism is over the prohibition of usury and the ensuing impracticalities. In this section we will discuss three such areas of controversy, the first of which is related to the irreplaceable nature of interest in an economic system. The interest rate serves as a market-clearing mechanism for capital, assuming that people are rational and seek to maximize profits. As a consequence, interest, being the return on capital, is regarded as an effective allocative mechanism for financial resources. Eliminating the interest rate would disable market signals that help investors assess the relative risk of certain investments. Eliminating interest would then reduce the incentive to save, which would limit the funds available for investment and economic development (There is no empirical evidence that demonstrates the effect of Islamic banking on economic development.). Surprisingly, economic researchers have yet correct this research shortcoming, but the economic effects of an injunction on interest are easily conceivable and certainly worth exploring.

The second area of controversy is the interpretation of *riba* in the *Shariah*. In Islam, the receipt of earnings on the rental of physical capital is permissible. But the *Shariah* forbids profiteering from wealth *per se*, without any form of labor on the part of the lender. Critical questions arise as to the nature of the difference between these two revenue streams and which of the two is excessive and tantamount to usury. This ambiguity might also beg the question of whether interest is equivalent to usury or if zero interest means zero *nominal* interest or zero *real* interest. The most serious complicating factor emanates from the ambiguous interpretation of *riba* among scholars (Noorzoy, 1982). Muslim scholars and clergymen who interpret the spirit of the *riba* injunction argue that usury is excessive profits from increases in real interest rates, as opposed to those who interpret the injunction by the letter who argue that all forms of non-zero interest is equivalent to usury.

This duality gives rise to an array of economic and financial implications for the borrower and lender, as well as, the economy in general (e.g. Metawa and Almossawi, 1998; Metwally, 1992, 1997; Qureshi, 1974; Siddiqui, 1985; Zaher and Hassan, 2001). Noorzoy (1982) provides two basic implications that are of interest. If *riba* was deemed to be usury associated with excessive profits, then the author suggests that the only changes to the conventional economic model required are the elimination of monopolies and the continual intervention from the state to maintain workable market competition. If on the other hand *riba* was deemed to be zero interest, the entire economic system needs to shift towards stable prices, fixed returns and profit sharing.

The third area of controversy is whether existing Islamic banking offerings are truly interest-free. In the case of *Murabaha, Bai' Bithaman Ajil* and other similar leasing arrangements, the bank on-sells property or equipment to the borrower and charges a markup comprising the time value of money and the bank's profit. Critics assert that this markup is essentially disguised interest. Advocates of Islamic banking differentiate these arrangements from interest-charging loans because the bank retains legal ownership until the full sale price is paid and that the markup is fixed between both parties before entering into the arrangements. In the case of *Wadiah*, it is also reasonable to question the practice of rewarding depositors with payments disguised as 'gifts'. Even though these payments are not guaranteed, they are often promoted to depositors (Khan, 1986) and paid at the rate of the time value of money. Once again, the legitimacy of these markup arrangements is contingent upon the interpretation of the injunction on *riba*.

How Islamic is Islamic Banking?

The debate over the true economic contribution of Islamic banking remains unresolved. In this paper, we have thus far implicitly proposed two explanations for this. The first explanation is that the current interpretation and operationalisation of Syariah governing financial transactions and relationships among Muslims makes Islamic banking indistinguishable from conventional banking. The second explanation is that Islamic banking practices today do not conform to the values of Islam and its intended effects. With its asset portfolio predominantly in markup or leasing arrangements, both Islamic banks and Muslim investors have exhibited an aversion toward profit sharing arrangements Yet it is profit and loss sharing arrangements that have the greater potential to stimulate economic development, as well as being a better vehicle for the equitable financial outcomes that Islam advocates. Hence, we pose a critical question: Do Islamic banking practices today conform to the values of Islam and its intended effects? In the following section, we will discuss the state of Islamic banking today and whether Islamic banking practices contribute to greater equality and societal welfare. This discussion will assist in raising some issues regarding the longer-term viability of Islamic banking.

Currently, the asset portfolio in Islamic banks is heavily weighted towards short-term financing with an overwhelming majority in markup or leasing arrangements. Profit and loss sharing arrangements and long-term financing continue to be a small share of the overall portfolio (Aggrawal and Yousef, 2000; Bjorvatn, 1998; Dixon, 1992; Khan and Mirakhor, 1990). Such a portfolio structure is disconcerting for at least three reasons. First, Islamic banks' aversion to long-term financing limits its ability to contribute to economic growth and development (Iqbal and Mirakhor, 1999). The high monitoring costs (The lack of industry expertise combined with profit underreporting and tax evasion by the entrepreneur makes it costly for the bank to monitor the progress of the project.) involved in profit and loss-sharing projects invariably skew the duration of these arrangements toward the shorter end. Second, the Islamic banks' aversion towards profit and loss-sharing arrangements is perplexing because these arrangements have significant potential to catalyze rural development and increase economic participation from the poor. *Mudharabah* is an ideal source of financing for the rural poor because it does not require collateral from the borrower and the bank shares the risk associated with the venture. Since the bank's return on capital is tied to the profitability of the venture, the borrower's position is less vulnerable to fluctuations in economic conditions. Economic participation among the poor should therefore increase as capital becomes more easily obtainable under these arrangements. The desired effect of course is a reduction in income inequality. Caragata (2000) reports a successful example of *Musharaka*, where Islamic banks act as venture capitalists to small-scale farmers who obtain seed capital for agricultural ventures. Finally, the difference between interest-charging loans and markup or leasing arrangements may be marginal, particularly to the poor and those who lack access to credit and capital. Indeed, Taylor and Evans (1987) warn that markup or leasing arrangements may open a 'backdoor to interest' and recommends that Islamic banks should shift their emphasis from markup and leasing arrangements towards profit and loss-sharing arrangements. In the former, the ability of the poor to own equity on assets still hinges on their ability to pay the markup and creditworthiness — both of which deteriorate in tougher economic conditions. Despite the consequences, the bank continues to expect markup payments while retaining equity on the asset. If this illustration draws parallels with an interest-charging loan, then the Islamic banks' reliance on markup and leasing arrangements would do little to reduce the gap between rich and poor.

The current customer base of Islamic banks also casts doubts about whether it has the capacity or willingness to reduce inequality. The typical Islamic banking customer is likely to be highly educated, have a high income, and lives in the city (Metawa and Almossawi, 1998; Naser et al., 1999; Ratnawati, 2001). Researchers propose that Islamic banking would have the most positive impact on reducing income inequality by providing financing to the poor in rural areas (Bjorvatn, 1998; Ratnawati, 2001).

Yet the coverage of Islamic banks continues to be concentrated in urban areas and is underrepresented in rural areas (Bjorvatn, 1998; Carpenter and Jensen, 2002; Sarker, 1999; Siwar and Karim, 1997). The concentration in urban areas may indeed be driven by market forces (the need to attract deposits). However, these decisions should not be solely driven by business rationality, particularly when most Islamic banks operate under the auspices of Islamic law.

Indeed, Muslim norms and religiosity are important concepts in Islamic banking. Since Islamic banking is promoted as banking that conforms to the Shariah, the natural target market consists of Muslims who want to fulfill their religious obligations. These norms are particularly salient for depositors who might have to forgo interest revenue on their deposits. With the growth in Islamic bank assets worldwide, it would be reasonable to infer that either religiosity and social consciousness among Muslims or the number of Muslims is also growing. But a closer examination suggests a different inference. The growth in Islamic banking is in part attributable to the growth in the number of non-Muslim customers who are seeking higher returns (Caragata, 2000; Gerrard and Cunningham, 1997; Naughton and Shanmugam, 1990). Moreover, Haron et al. (1994) indicated that Muslims patronize Islamic banks because of the returns they would receive from their investments. It is quite curious that returns have been consistently promised and paid at a competitive rate to depositors (Kuran, 1995b), when it can only be derived from profits from non-interest charging markups and leasing arrangements. Kuran (1995b) reported that employees of Islamic banks unofficially promise potential depositors rate of returns that are consistently close to the prevailing interest rates, and hence inferred that the returns on Islamic banking products are derived from interest-bearing investments (see also Metwally, 1997).

In light of this evidence, some researchers warn of serious defects in current Islamic banking practices and question whether interest-free banking is really interest-free at all (Hardie and Rabooy, 1991; Kuran, 1986). Errico and Farahbaksh (1998) provide several examples where actual Islamic banking practices diverge from the theoretical paradigm. Their investigation showed that all deposits in Islamic banks are always explicitly or implicitly guaranteed, as is the rate of return on investments in profit and loss-sharing arrangements. Advocates of Islamic banking concede that since many Islamic banks operate in conventional banking systems, they are compelled to adopt a 'hybrid' method in order to compete with conventional banks (Zaher and Hassan, 2001).

It should also be noted that the viability of Islamic banking cannot rely on the Muslim norms alone. Pro-Islamic banking rhetoric hinges on the assumptions of the solidarity and benevolence of the Muslim community. But economist Kuran (1983, 1986, 1995a, 1996) is critical of these assumptions and argues that Islamic economists tend overstate the role and enforceability of Islamic norms in today's social environment. He argues that evasion of Muslim obligations is harder to detect in a large and heterogeneous society, thus making altruism harder to achieve. He also argues that Islam economists, scholars and clergymen have not addressed the ambiguity in Islamic norms in the modern economic and financial context, which gives rise to a multiplicity of interpretations of these norms, even from the most pious of Muslims (Kuran, 1986).

Moreover, he criticizes Islamic economists for failing to address the problem of moral hazard among Muslims, many of whom have historically exhibited the rationality and opportunism that resides in other non-Muslim individuals. Indeed, the Islamic banks' aversion to profit and loss-sharing arrangements like Mudharabah and Musharaka are largely in part a result of moral hazard. Once the entrepreneur's risk is shared by the bank, he or she has an incentive to underreport the profits of the venture. Khan and Mirakhor (1990) and Sarker (1999) report that since tax evasion and underreporting is pervasive in profit and loss-sharing arrangements, the monitoring costs and associated risk of these arrangements become prohibitively high. Thus, it would be safe to conclude that the viability of the theoretical concept of Islamic banking cannot rely on Muslim norms alone. Its viability invariably requires the support of the government and central banks. If Islamic banks were to operate under the injunction on riba, its asset portfolio would be heavily weighted towards profit and loss-sharing arrangements. This position adds substantive volatility in the banks' profitability and return to its investors and depositors. The government will be required to stabilize fluctuations in deposits and liquidity by prescribing a range of return on investments. This range however could be construed as interest, which may then shift the portfolio back towards interest-like products. Since the 'dividends' of Islamic banks and the interest rates of conventional banks are controlled by central banks and monetary authorities, pro-Islamic governments are in a position to enhance the attractiveness of Islamic banks, which might explain its relative higher returns (Kuran, 1986). In short, government support has enabled Islamic banks to better compete with conventional banks, but has also inadvertently molded Islamic banks in the likeness of conventional banks.

Indeed, the growth in markup and leasing arrangements and continual aversion towards profit and loss sharing arrangements makes Islamic banking increasingly indistinguishable from conventional banking. More importantly however, this trend underscores the divergence between economic rationalization and religious norms in the marketplace. Mittelstaedt (2002) referred to the influence of religion and religious norms on the marketplace and called for macromarketing researchers to seek a better understanding of this relationship. In heeding this call, this paper presents a conceptual model postulating not only the welfare effects of Islamic banking, but also its socio-psychological determinants. A study of the effect of religious norms on economic decisions would be incomplete without studying psychological factors.

Towards a Research Agenda in Marketing

Islam is, similar to Judaism and Christianity, a monotheistic faith that emphasizes compassion and peace. At its best it is a tolerant religion whose emphasis is on practice of Islamic law and so to human welfare. As such it has clear prescriptions for day-to-day life and strong implications for marketing for those operating within its context. In particular, one area in which it has had unique application is Islamic banking. The scant marketing literature on Islamic banking has been confined to studies of customer satisfaction and service quality (Gerrard and Cunningham, 1997; Haron et al., 1994; Metawa and Almossawi, 1998; Naser et al., 1999). Given this, it is surprising that it has not been more extensively researched in marketing literature, nor has it been comprehensively discussed in the macromarketing forum (see Mittelstaedt 2002 for a notable exception). The question of whether Islamic banking is better for economic development and societal welfare provides a unique opportunity for macromarketing researchers to evaluate the effects of what may be described a natural experiment. It is our purpose in this concluding section to attempt to sketch out a conceptual basis for the evaluation of the effects of Islamic banking. This is being done as a preliminary step and basis for discussion rather any strong theoretical statement.

From the preceding discussion it is clear that religion plays an important part in the day-to-day lives of individual consumers. Islamic banking is a form of product or service deliberately developed from religious law. As such it not only has implications for divine retribution but much more directly for human welfare. However, in attempting to develop causal relationships between a religiously-based banking practice and human welfare, one is faced with complexities that are difficult to overcome, for religion may affect almost every aspect of human life. There are therefore complex interactions and other highly correlated cultural variables (The Economist, g; Gruber, 2005; Mittelstaedt, 2002). One aspect that must form a vital part of any model developed relates to the discrepancy between the normative questions of values and the descriptive issues associated with practice (Hunt, 1976a,b). The first variable in our Figure 48.1, has, therefore, been labeled "religiosity." This is a variable full of surplus meaning, however, we are using the term strictly as an indicant of values, i.e., in the normative sense. It is a measure of perceptions of strength of faith and should be clearly distinguished between actual measures of religious practice and other external indicators.

Although Islamic banking is itself an indicator of religious practice, the next variable simply labeled "Islamic practice" is a more general formulation indicating general compliance to Islamic law without reference to banking practices. The next variable in the model "Islamic knowledge" is based on the work of Gerrard and Cunningham (1997) who surprisingly found that there was a general lack of awareness and familiarity of Islamic banking among Muslims. This suggests the existence of a problem area for Islamic banking whose promoters may have to implement stronger education and marketing practices. Based on the research by Gruber (2005) who found that a "major determinant of religious participation is religious market density, or the share of the population in an area which is of an individual's religion," a variable simply labeled "Islamic Density" is postulated. Another related notion is that a web of church-going relationships may foster trust. This "social capital" may facilitate business dealings, and provide support in difficult times. Each of these variables is postulated to be related to the likelihood of "Islamic banking participation" which in turn leads to increased "human welfare". Both of these variables are postulated to be influenced by "individual characteristics" such as education.

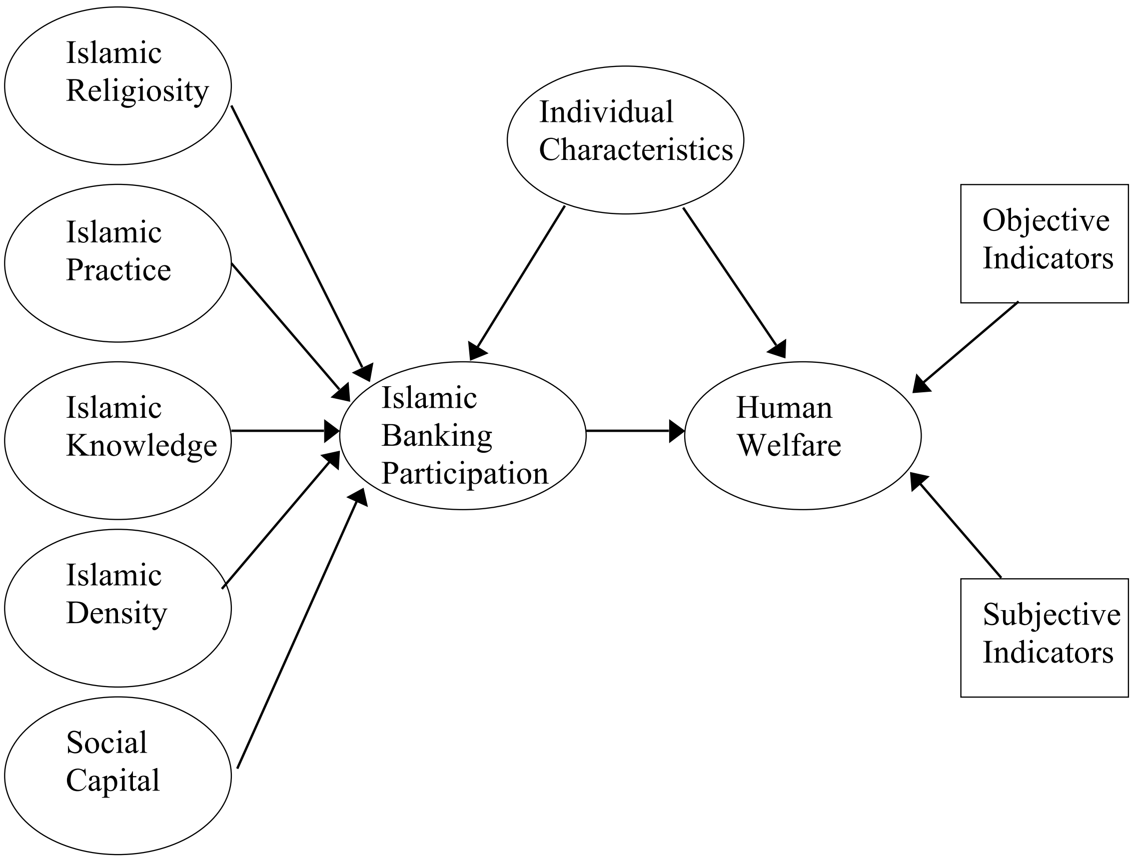

Figure 48.1: Islamic Banking and Human Welfare

Conclusion

Religion has long been recognized as a major factor in the formation of social structure and human action. It has been our purpose to follow in the footsteps of Mittelstaedt (2002) and introduce the dogma behind Islamic banking to macromarketing scholars. This is a unique characteristic of a major world religion whose effects need to be carefully examined. After a discussion we have attempted to develop a rudimentary conceptual model whose broad boundaries may be helpful in developing future research projects. It is important that this be done because Islamic law is not only reactive by prohibiting, for example, capital investment in companies involved in harmful activities, such as gambling and alcohol, but, proactive in developing Islamic banking practice designed to guarantee social justice in financial transactions and improving societal welfare (Taylor, 2003).

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