

Islamic Banking: Is It Ameans For Poverty Alleviation In Nigeria?

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Abstract

The principle goals and functions of the Islamic banking system include economic well-being with full employment and maximum rate of economic growth, equal distributions of income and wealth and as a result socio-economic justice, and the generation of sufficient savings and their productive mobilization and stability in the value of money. (Chapra, 2000). Moreover, poverty in the other hand refers to the lack of income and the necessary means of production to attain a "decent" standard of living. This study therefore was carried out to ascertain if Islamic banking can be another means for poverty alleviation in Nigeria. The study is exploratory in nature and study revealed that Islamic Banking will be an inevitable means of poverty alleviation. The study therefore concluded that that Islamic Banking is another means for poverty alleviation because the bank (Islamic banking) will not only provide the capital but will provide the financing by coming in as traders or partners proving the technical-no-how and all other techniques the borrower might lack thereby improving the investment. Based on this conclusion, the study now recommended that Islamic Banking should be highly encourage by the appropriate body(ies) in order to assist in the war against poverty in Nigeria
Keywords: Islamic Banking, Poverty, Conventional Banks, Interest, Loan

1. Introduction

Islamic banking has established itself as an emerging alternative to interest based banking and has grown rapidly over the last two decades both in Muslim and non-Muslim countries. Islamic banks have recorded high growth rates in both size and number and operate in over 60 countries worldwide and bankers predict that these banks could have control over 50% of savings in different countries within the next decade. (Ahmad, 2004)

The theory of Islamic Bank is based on the concept that interest is strictly forbidden and that religious teachings provide the required guidance on which to base the working of banks. The basic principle that has guided all theoretical work on Islamic bank is that although interest is forbidden, trade and profit is encouraged.

Conventional banking uses the interest rate mechanism to carry out its financial operations. Muslim scholars have developed a completely different model of banking that does not use interest but rather relies on profit-loss sharing for purposes of financial intermediation.

The basic principle in Islamic law is that exploitative contracts or unfair contracts that involve risk or speculation are impermissible. Under Islamic banking, all partners involved in financial transactions share the risk and profit or loss of a venture and no one gets a predetermined return. This direct correlation between investment and profit is the key difference between Islamic and

conventional banking which has its main objective in maximizing shareholders wealth. (Dar and Presley, 2000)

The practices and activities of Islamic banks reflect the environment in which they are based. There are strong retail operations in Iran and Saudi Arabia. In the secular societies of northern Africa, Islamic banks compete on the quality of products rather than on religious grounds. In Kuwait, financing has focused on the petroleum sector and real state investment and in the United Arab Emirates, the emphasis is on trade and finance. (Zaher and Hassan, 2001)

According to the American Economic Development Council (1984), "Economic development is the process of creating wealth through the mobilization of human, financial, capital, physical and natural resources to generate marketable goods and services". The large number of economic ills, including poverty, social and economic injustice, inequalities of income and wealth, economic instability and inflation of monetary assets are all in conflict with the value system of Islam.

It is the responsibility of the money and banking system to contribute to the achievement of socio-economic development and hence eliminate such economic ills. The principle goals and functions of the Islamic banking system include economic well-being with full employment and maximum rate of economic growth, equal distributions of income and wealth and as a result socio-economic justice, and

the generation of sufficient savings and their productive mobilization and stability in the value of money. (Chapra, 2000)

This practice has its origins in the fact that western banking institutions have profitability rather than social imperatives as their primary concern. The result of such practices is unequal income distribution, highly skewed towards the wealthier portion of society, and unjustly deprives non-property holders of gaining access to finance.

According to the World Bank Research Observer (1996), commercial banks prefer to lend to low-risk activities and are reluctant to finance high risk projects, even if such projects present better investment opportunities. They are also less willing to finance small firms that don't have adequate collateral.

In contrast, fostering serious economic development is a key objective of Islamic bank as they seek to maximize social benefit. Islamic banks therefore work hard to overcome shortages and difficulties to help the economy to progress to a higher stage of self-sustained development, resulting in a favorable effect on socio economic harmony due to equal income distribution.

It has been widely claimed by development economists that policy and resource allocation is strongly focused on large firms and that existing banking institutions prefer to grant credit facilities to clients who are able to offer sufficient collateral security.

According to Abdouli (1991), Kahf, Ahmad and Homud (1998), Siddiqi (2002), and Iqbal (1997), maximizing of profitability is not the only concern for faith-based banking institutes and the principles that Islamic banks are deeply integrated with ethical and moral values. They also state that Islamic banks do not depend on tangible collaterals and lead to a better distribution of income, allowing access to finance for those in poorer classes of society, and resulting in greater benefits for social justice and long term growth. In contrast with conventional methods, faith-based banking financing is not centered only around credit worthiness but rather on the worthiness and profitability of a project, and therefore recovering the principle becomes a result of profitability and worthiness of the actual project.

The natures of Islamic banks operations are directly affected by the success or failure of client enterprises as a result of the profit-loss-sharing process (Abdouli,1991). The relationship is based on a partnership, with cash being entrusted to bankers for investment, and returns shared between depositors and bankers. Losses are carried by fund owners. This sharing principle is very different to traditional banking practices. It introduces the concept of sharing to financing and creates a performance incentive within the mind of bankers that relates deposits to their performance in the use of funds. This increases the deposit market and gives it more stability (Kahf,2002).

Moreover, poverty in its broad definition refers to the lack of income and the necessary means of production to attain a "decent" standard of living. Researchers are concerned with the absolute poverty line concept, i.e. the bundle of basic consumer goods required, in addition to other expenditure on health, education, and housing etc.

However, Mahmood 2006 mentioned that the poor do not have any surplus production hence accumulation of capital is very difficult and sometimes impossible for them. On the contrary, owing to the absence of access to productive assets, lack of skills, low-level literacy, malnutrition and absence of an organization of their own, the rural poor fall into the poverty trap (Jaim, 1986). Besides, there are hardly any credits facilitating institutions that care about the ethical development of the rural poor to change their behaviour consistent with a disciplined approach to economic activity. Business behaviour and ethics are interrelated since the disciplined approach needed for good economic management is also seen as founded in ethically consistent behaviour.

2. Modes of financing Islamic Banks.

2.1. Investment financing

Investment financing in Islamic Banks can be done in three ways :

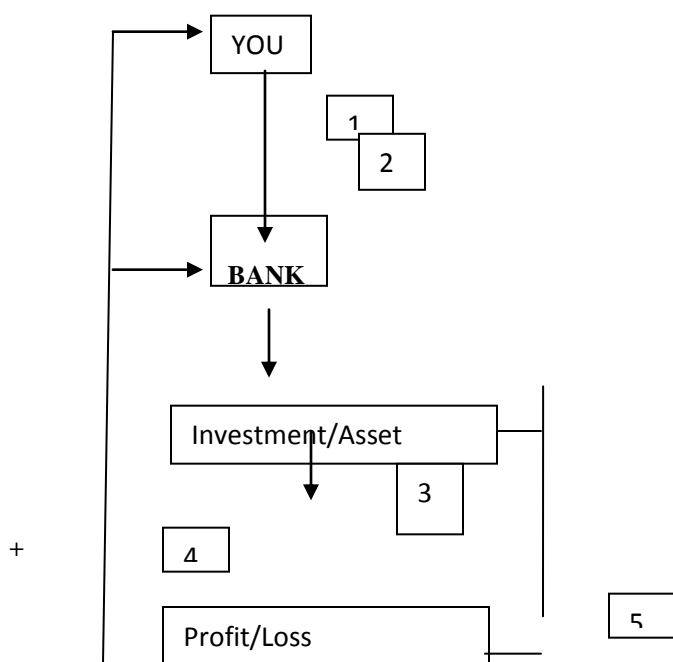
i) *Musharakah* where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent

legal entity and the bank may withdraw gradually after an initial period.

ii) - *Mudharabahis* a profit sharing arrangement between two parties, that is, an investor and the entrepreneur where the investor (bank) contributes the finance and the entrepreneur (client) provides the expertise, management and labour. Profits are shared by both the partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank. ()

iii) Financing on the basis of an *estimated rate of return*. Under this scheme, the bank estimates the

expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. (Perhaps this rate is negotiable.) If the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered the bank will take a share in it. (Gafoor, 1995)

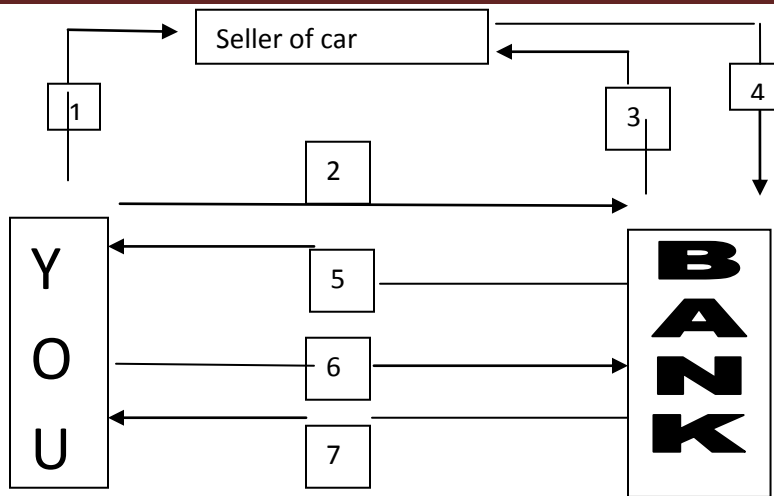


Source (www. BankingInfo.com.my, 2009)

- 1) You supply funds to the bank after agreeing on the terms of the *Mudharabah* arrangement.
- 2) Bank invests funds in assets or in projects.
- 3) Business may make profit or incur loss.
- 4) Profit is shared between you and your bank based on a pre-agreed ratio.
- 5) Any loss will be borne by you. This will reduce the value of the assets/ investments and hence, the amount of funds you have supplied to the bank

2.2 Trade financing

This is also done in several ways. The main ones are: a) *Mark-up* where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on. b) *Leasing* where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning and becomes the owner of the item. c) *Hire-purchase* where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item. d) *Sell-and-buy-back* where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price. e) *Letters of credit* where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis.. (Gafoor, 1995)

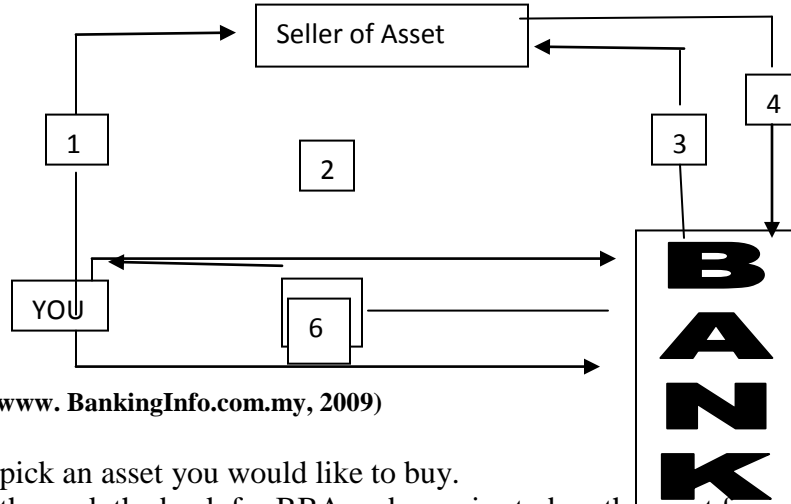


Source (www. BankingInfo.com.my, 2009)

- 1) You pick a car you would like to have.
- 2) You ask the bank for *Ijarah* of the car, pay the deposit for the car and promise to lease the car from the bank after the bank has bought the car.
- 3) Bank pays the seller for the car.
- 4) Seller passes ownership of the car to the bank.
- 5) Bank leases the car to you.
- 6) You pay *Ijarah* rentals over a period.
- 7) At end of the leasing period, the bank sells the car to you at the agreed sale price

2.3 Lending

Main forms of Lending are: a) *Loans with a service charge* where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities. b) *No-cost loans* where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers. c) *Overdrafts* also are to be provided, subject to a certain maximum, free of charge. .(Gafoor, 1995)



Source (www. BankingInfo.com.my, 2009)

- 1) You pick an asset you would like to buy.
- 2) You then ask the bank for BBA and promise to buy the asset from the bank through a resale at a mark-up price.
- 3) Bank buys the asset from the owner on cash basis.
- 4) Ownership of the goods passes to the bank.
- 5) Bank sells the goods, passes ownership to you at the mark-up price.
- 6) YOU pay the bank for the asset at the mark-up price.

6) You pay the bank the mark-up price in installments over a period of time.

3. Conventional Bank Vs Islamic Bank

The principle of Islamic banks is the principle of justice which is an essential requirement for all kinds of Islamic financing. In profit sharing of a financed project, the financier and the beneficiary share the actual or net profit/loss rather than throwing the risk burden only to the entrepreneur. The principle of fairness and justice requires that the actual output of such a project should be fairly distributed among the two parties. If a financier is expecting a claim on profits of a project, he should also carry a proportional share of the loss of that project (Ahamed, 2008). Other differences include:

Conventional Bank	Islamic Bank
The investor is assured of a predetermined rate of interest.	It promotes risk sharing between provider of capital (investor) and the user of funds (entrepreneur).
Lending money and getting it back with compounding interest is the fundamental function of the conventional banks.	Participation in partnership business is the fundamental function of the Islamic banks. So we have to understand our customer's business very well.
it can charge additional money (penalty and compounded interest) in case of defaulters.	The Islamic banks have no provision to charge any extra money from the defaulters. Only small amount of compensation and these proceeds is given to charity. Rebates are given for early settlement at the Bank's discretion.
Very often it results in the bank's own interest becoming prominent. It makes no effort to ensure growth with equity.	It gives due importance to the public interest. Its ultimate aim is to ensure growth with equity.
Since income from the advances is fixed, it gives little importance to developing expertise in project appraisal and evaluations.	Since it shares profit and loss, the Islamic banks pay greater attention to developing project appraisal and evaluations.

Source: Zaharuddin and Rahman, 2007.

4. Problem Statement

Despite progress during the last three decades, witnessing a revolution in providing finance for alleviating poverty across the globe, the battle is far from won. The contracts between borrower and lender will only be honoured if the element of trust exists in such transactions. The basis of trust depends on two critical elements: first is the applicant's reputation as a person of honour (Diamond, 1991); and second is the availability of enough capital or collateral against which claims can be made in case of default (Holmstrom and Tirole, 1993). However these two elements poised important impediments to the poor especially in the rural areas to access into credit market. The poor are usually perceived by the "profit-orientated" banks as high-risk borrowers due to inherent difficulties in assessing their creditworthiness at the same time their inability to provide collateral to pledge against

any potential risk. Most formal intermediaries like commercial banks also regard low-income households as "too poor" to save, thus further accentuates the risk of supplying credits to them (Adams and Vogel, 1986; Sinclair, 1998). Furthermore, no insurer is willing to insure against possibility of non-repayment due to natural and commonest hazards afflicting small producers in developing countries; for example, drought, livestock disease and breakdown of equipment (Hulme and Mosley, 1996). This study therefore tends to examine the adoption of Islamic banks and whether it can serve as another means for poverty alleviation in Nigeria.

5. Methodology

The study is exploratory in nature based on review of relevant literature and write-ups done earlier on Islamic Banking.

6. Findings

The study revealed that Islamic Banking will be an inevitable means of poverty alleviation as it was evident to possess the following: Better business ethics –banks will only entertain economically viable financing requests, Instead of being lenders, Islamic banks will provide financing by coming in as traders (murabaha), lessors (Ijara) or partners (mudaraba; musharaka) thereby providing Technical-No-How and also there will be greater transparency in their transactions with clients – depositors as well as fund-seekers–due to compliance with the avoidance of gharar (ambiguity)resulting in clear contracts for every transaction

7. Conclusion and Recommendation

There is no doubt that poverty in Nigeria is wide as a result of unemployment or low income that cover only a fraction of the cost of living. Those that intend to go into business could not do so because of lack of capital and those that intend to borrow from banks failed due to lack of collateral. Turning to microfinance banks for loan have caused ailment to many because of their (microfinance bank) repayment terms and condition. The study therefore concluded that Islamic Banking is another means for poverty alleviation because the bank (Islamic banking) will not only provide the capital but will provide the financing by coming in as traders or partners proving the technical-no-how and all other techniques the borrower might lack thereby improving the investment. Based on this conclusion, the study now recommended that Islamic Banking should be highly encourage by the appropriate body(ies) in order to assist in the war against poverty in Nigeria

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