Global Journal of Business, Economics and Management: Current Issues

Volume 11, Issue 1, (2021) 001-009 www.wjbem.eu

Selected characteristics of Islamic banking in context of real sphere development

Pawel Mrowiec*, School of Finance and Law in Bielsko-Biala, Czeslawa Tanskiego 5, 43-382 Bielsko-Biala, Poland
Magdalena Wojcik Jurkiewicz, Department of Accounting College of Management and Quality Sciences Academic Tutor, Cracow University of Economics, Rakowicka 27, 31-510 Krakow, Poland

Suggested Citation:
Mrowiec, P. & Jurkiewicz, M. W. (2021). Selected characteristics of Islamic banking in context of real sphere development. *Global Journal of Business, Economics and Management: Current Issues. 11*(1), 001–009. https://doi.org/10.18844/gjbem.v11i1.4692

Received from November 23, 2020; revised from January 11, 2021; accepted from March 10, 2021.
Selection and peer review under responsibility of Prof. Dr. Cetin Bektas, Gaziosmanpasa University, Turkey.

Abstract

The objective of this study is to analyse the selected characteristics of Islamic banking in the context of real sphere development. It is hypothesised that Islamic economic principles could be applied to some extent to Western banking. To this end, selected features of Islamic and Western banking were analysed for their impact on the real sphere, including analysis of Islamic banks' assets in the years 2006–2015 and the transposition of these data to assets of ten top commercial banks in the world. A literature review related to the functioning of Islamic banking, content analysis and deduction method was used to achieve this purpose. The authors, as a result of the research carried out, contradict the hypothesis indicating that it is impossible to directly compare Islamic banking to conventional banking, as the scope of services provided, system assumptions and, above all, their complexity, determines a different approach to their management and monitoring. As a result of scientific research, the authors of the paper contributed to opening new research areas in the field of Islamic banking.

Keywords: Shari'ah laws, financial crisis, real sphere development, bank profitability.

* ADDRESS FOR CORRESPONDENCE: Pawel Mrowiec, School of Finance and Law in Bielsko-Biala, Czeslawa Tanskiego 5, 43-382 Bielsko-Biala, Poland. *E-mail address*: pawel.mrowiec@onet.eu

1. Introduction

The recent financial crisis of 2007 and 2008, the causes and effects of which are still being analysed (Mitrega-Niestroj, Puszer & Szewczyk, 2017; Mrowiec, 2016), pinpointed that modern banking needs changes. Banking is defined as a continuous construction site and its sole constant feature is its constant changes (Losiewicz-Dniestrzanska & Nosowski, 2017; Worimegbe, 2020). The scope of changes should be radical and the implementation of new legal regulations should focus on areas such as risk management, adequately secured bank risk and sales of complex financial instruments, including derivatives (derivatives market) and loans with special regard to a buyer's risk (Mrowiec, 2016; Ozdemir, 2020; Ozvurmaz, 2016; Wozniak & Wereda, 2017). However, the proposed changes are mainly limited to legal changes, except for changes related to banking ethics, and if new solutions are proposed, they relate to broadly understood European and American culture rather than to the achievements of other cultures, especially Islamic culture.

Islam in the culture of western countries, as Bidabad (2019) observes, is perceived primarily through a religious and social prism, and its economic aspects are completely ignored. According to the American Moody's agency, the value of the Islamic financial services sector currently amounts to USD 700 billion, with the growth prospect at a rate of 15%–20% a year (Olson & Zoubi, 2017). Moreover, the vulnerability of Islamic banks to financial crises is far lower. Masiukiewicz (2015) indicates that, in some areas, Islamic banking is characterised by higher ethics concerning, for example, the repayment of liabilities, which has an impact on the amount of provisions established, and thus the amount of the financial profit. Other rules, on which Muslim banking is based, include the absolute ban on usury; 'money in Islamic economy is not a capital, and therefore has no value – it is only a mean of exchange, on which cannot be earned'. It is an obligation to share the risk between banks and customers or it is the bank's obligation to support economic development. The above-mentioned principles shape the activities of Islamic banks while having an impact on the stability and development of the real sphere. Currently, in the post-crisis economy (Baykan & Uzunboylu, 2018), the application of some Islamic economic principles in Western banking should be considered. To this end, it is necessary to analyse selected features of Islamic and Western banking in terms of their impact on the real sphere.

1.1. Problem statement

In the contemporary literature, to the time of the past financial crisis, the dominant view was that banks act as public trust institutions. In the post-crisis literature, this view has been noticeably revised, or at least the thesis that banks work for their owners, who expect a satisfactory return on capital employed, rather than for customers has been verified. Thus, the involvement of banks is mainly focused on profitability, on which customer relations should be built based on the principles of mutual trust. In the market economy, the banking sector together with the real sphere forms a system of 'connected vessels', which means the interaction of these areas, in both the positive and negative sense of this word. In analysing the relationships between financial and real sectors over the last few years, there have been several periods in which the banking sector has not only contributed to the economic growth, but also to numerous examples of financial problems faced by European and American banks, resulting in their need to be supported with public funds, and thus causing a decrease in the real sector value. Islamic banks, however, have avoided financial problems. The objective of this research is, therefore, to analyse selected characteristics of Islamic banking in the context of real sphere development. It is hypothesised that Islamic economic principles could be applied to some extent to Western banking.

2. Methodology

This research is a qualitative research method which took the form of a literature review paper. Data were collected from past researches and publications and from financial reports of globally recognised institutions. Islamic bank assets for the years between 2006 and 2015 were also analysed. After the transposition of some of the Islamic bank practices to ten topmost global banks, a content analysis was applied to draw themes and assess the results. The deduction method of reasoning was also applied to this research in order to ascertain the acceptance or rejection of the hypothesis for this research.

3. Findings

3.1. Characteristics of Islamic banking highlighting differences in comparison to Western banking

The first banks, known as bank houses, were established as early as in the 12th century BC in Babylonia, and their further development took place in ancient Greece and Rome. The origins of banking were based on two products: promissory notes (gold deposit receipts) and loans (transfer of gold owned by another person in exchange for a fixed remuneration called usury). Therefore, from the very beginning, the banking rules were not in line with the Islamic law (Shari'ah – 'good road, road to source'), which adopts a different approach to the issue of interest rates. Under the Shari'ah, receiving a remuneration in the form of interest is prohibited, both as interest on loans and deposits (Aba, 2017; Garg, 2018). According to Eliza (2017), in Islamic banks, there is no principle of interest on the customer's capital, but the concept of partnership or participation in profits and losses resulting from investment (and only possible in the real economic sphere). The first Saving Associations, founded by Elnaggar, were established no earlier than in 1963 in the Egyptian village of Mit-Ghamr, modelled on the academic concept of a financial institution in accordance with the Shari'ah (Paul & Osmond, 2016). The first Islamic bank was founded in 1972 also in Egypt and was called Nasser Social Bank. Since then, there has been a dynamic development of Islamic banking (Figure 1). In 1975, the Islamic Development Bank was founded, which associated 56 countries supporting the Islamic financial market in 2008, including Muslim countries, in which the Shari'ah is also the state law.

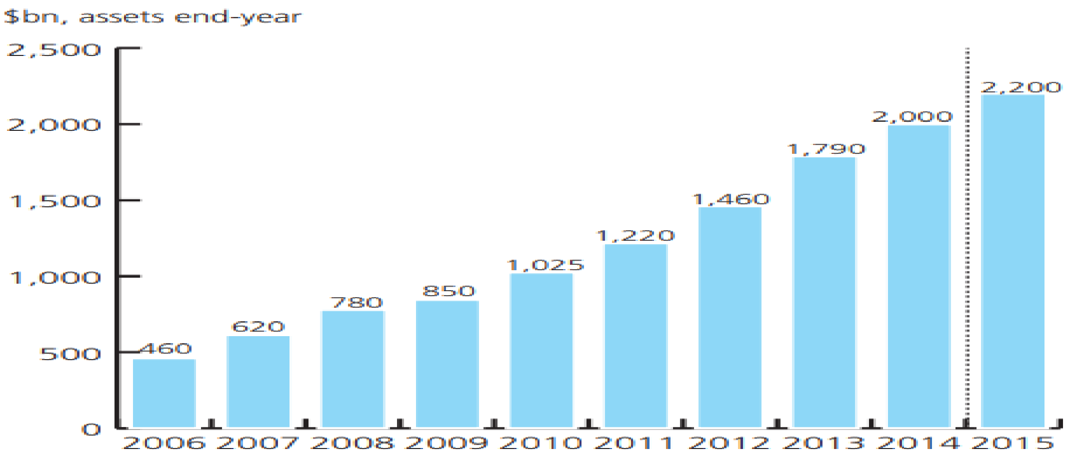

Figure 1. Value of Islamic banks' assets in 2006–2015 (in billion USD)

Source: The UK, leading western centre for Islamic finance, London 2015, p. 17.

At the end of 2015, the total value of Islamic banks' assets was more than USD 2,200 billion. For comparison, the assets of credit institutions in Poland at the end of 2015 were approximately USD 41 billion less than the value of Islamic banking assets in the world in 2006. In the years 2006–2015, Islamic banks around the world developed faster than the banking sector in Poland, while the assets of the banking sector in Poland showed a steady upward trend during the period, even during the financial crisis of 2007 and 2008. It should also be noted that the assets of credit unions have been showing a declining trend since 2014. In the years 2014–2015, the assets of credit unions decreased by almost 30%. Furthermore, it should be noted that the assets of Polish banks are incomparably lower than the assets of the largest banks in the world (Table 1).

Table 1. Assets of largest commercial banks in 2011 and 2016

Item	Bank name	Country	Assets (USD billion)
2011			
1	BNP paribas	France	2.667
2	Deutsche bank	Germany	2.546
3	HSBC holdings	United Kingdom	2.455
4	Barclays	United Kingdom	2.332
5	Royal bank of Scotland group	United Kingdom	2.275
6	Bank of America	USA	2.268
7	Credit Agricole	France	2.129
8	JPMorgan chase	USA	2.118
9	Industrial & commercial bank of China (ICBC)	China	2.032
10	Citigroup	USA	1.914
2016			
1	ICBC	China	3.475
2	China construction bank	China	3.018
3	Agricultural bank of China	China	2.817
4	Bank of China	China	2.613
5	Mitsubishi UFJ financial group	Japan	2.597
6	JPMorgan chase	USA	2.490
7	HSBC holdings	United Kingdom	2.374
8	BNP paribas	France	2.196
9	Bank of America	USA	2.187
10	China development bank	China	2.182

Source: Global Finances (2017), http://www.relbanks.com/worlds-top-banks/assets of 30 June 2017

Table 1 shows that each of the top ten banks in the world has assets greater than the value of assets of all Islamic banks.

With regard to the world's largest banks, attention should be paid to the dynamically developing banking system in China (Chen, Matousek & Wanke, 2018). In the list of the largest world's banks, the first four positions are occupied by Chinese banks with total assets of nearly USD 12,000 billion. Moreover, the value of the global Islamic banking market is incomparably lower than the value of the traditional banking market (commonly referred to as Western banking, although it also includes Chinese and Japanese banks). It should also be highlighted here that Western banks see great potential in Islamic banking as they decide to open branches offering banking products and services in accordance with the Shari'ah. These banks are Citibank, TSB, HSBC and Deutsche Bank.

Many research scientists of Islamic economy point to its strengths. According to Al-Kaber (2015), Islamic banking should be characterised with the following features:

- Awareness: parties to a contract should knowingly and voluntarily agree to the terms and conditions of the contract;
- Clarity: parties need to know what the contractual consequences are;
- Capacity: parties to a contract should be convinced that they are able to fulfil their commitments. This condition is not met when, for example, someone sells a product without having it
- Obligation: parties wish to fulfil the terms of a contract honestly and do not seek an excuse to be relieved from this obligation.

Despite the dynamic development of Islamic banking, factors which adversely affect its development can also be identified. Kasiak (2016) mentions:

- Theoretical reference to the principles of Islamic religion without using them in practice;
- Low quality of banking services and their high costs compared to traditional banks;
- No clear objectives and policies of some Islamic banks;
- No fully developed, homogeneous legal framework supporting the Islamic financial system;
- No single, large centre that could be named the Islamic financial centre;
- Slow pace of innovation (Haouam, 2020). The Islamic product market offers only traditional instruments with short- and medium-term payments. (In the author's opinion, it is also an advantage because it does not offer complex banking products with high investment risk.)
- No homogeneous procedures and accounting standards that are essential for disclosure, customer confidence, monitoring and supervision;
- No control of the correct functioning of the banking system by the central bank and no Guarantee Fund institution.

The differences between Islamic banking and conventional banking are significant, and Table 2 shows the most important ones.

Table 2. Comparison of basic features of Islamic banking model and conventional banking

Islamic banking	Conventional banking
Social product responsibility (bank and customer work together, dividing both profits attained and loss incurred).	Cause-related marketing in the area of prospecting (mainly identification of needs and expectations) sales and service processes.
The source of profit for a bank is not interest, but the production of goods and share in profits from their sale.	The bank's profit includes interest and commission incomes.
Asset-based intermediation.	Debt-based intermediation.
Profit and loss sharing.	Risk transfer to other market participants, the purpose of which is to reduce the bank's risk.
Emphasis on the investment project's profitability.	Emphasis on the security and creditability of a customer.
Higher costs associated with searching for the most profitable ventures.	Lower costs associated with searching for the most profitable ventures.
The principle that you cannot sell something you do not have.	Almost everything can be sold (including derivatives).
Greater connection with the real economy.	Smaller connection with the real economy.
Dynamic growth of asset in recent years.	Much larger assets.
Banks called too big to be ignored.	Banks called too big to fail or too big to be disciplined.
Based on the value of the Islamic system which aims to create a relationship of cooperation between individuals and society by striving for harmony and eliminating conflicting ventures. In the economic field, the Shari'ah advocates a free market economy while objecting to over-enrichment of one person.	Based on the principles of Protestantism, where the system of values is based on work and professional solidarity. In accordance with the principles of Protestantism, it is believed that man should be constantly busy, the economic success is considered as a result of God's grace, and poverty as a result of laziness, idleness and other flaws. Protestantism also praises saving, modesty, condemns extravagance and sumptuousness. A man according to Protestantism should accumulate capital.

Source: Own study based on Kil (2020), Wlodarczyk (2015), Magdalena (2018).

In the authors' opinion, it is impossible to directly compare Islamic banking to conventional banking, as the scope of services provided, system assumptions and, above all, their complexity determines a different approach to their management and supervision.

3.2. Development of islamic and conventional banking and development of real sphere.

The relationship between the banking sector and the real economy is undisputed, although the proper identification and assessment of cause and effect relationships between them are problematic for research scientists. According to the European Central Bank (www.ecb.int), the relationship between banks and the real economy can manifest itself in the following situations:

- As the economy slows down, companies, as a result of a decline in sales, start having difficulties with repaying investment loans, and households, as a result of rising unemployment rates, contend with the repayment of housing loans, thus banks incur losses.
- If prices of assets, such as securities, land, structures, buildings and production equipment, decline drastically or change rapidly, the uncertainty in the financial markets will increase resulting in investors' losses, and if investments are financed by banks, it can also affect their financial results.
- If banks provide large loans to one industry, a downturn in such a branch can contribute to a significant increase in overdue receivables and thus a decrease in financial results.
- If banks invest large amounts of free cash flow in stocks or bonds, they may experience a significant deterioration of their financial performance if prices fall in the securities markets.

Table 3 presents the inter-correlation between the average annual growth rate of the real gross-added value of the financial sector and Gross Domestic Product (GDP) of the United Kingdom from 1956 to 2010. The exception in this period was 2008 when the rate of development of the financial sector was 5%, and the real sphere development was already negative and amounted to −0.1%, suggesting that the financial crisis was already taking over the real economy in 2008. In subsequent years, it directly affected the banking sector.

Table 3. Annual return on real gross-added value of financial sector and GDP of United Kingdom from 1856 to 2010.

Period	Financial institutions sector	GDP
1856–1913	7.6	2.0
1914–1970	1.5	1.9
1971–1996	2.7	2.2
1997–2007	6.1	3.0
2008	5.0	~0.1
2009–2010	−4.1	−1.6

Source: http: //www.nbp.pl/systemfinansowy/rozwoj2014_prezentacja.pdf

Mishkin and Eakins (2019) note that effective banks improve material prosperity (social position), increase consumer prosperity (allowing for a more favourable distribution of consumption over time) and contribute to increased production and productivity in the economy. If, however, the banking system functions defectively, it can slow down economic growth and even cause an economic crash and lead to economic instability (Borsuk & Barembruch, 2018; Yavas & Celik, 2020).

4. Discussion

The economic growth is an increase in the capacity of a given society to produce goods and services that meet human needs, the primary measure of which is the rate of growth of GDP. The impact of the Western banking sector on the real sphere has been the subject of numerous scientific studies, such as of Hafnida and Abdullah (2016), who showed a positive correlation between the financial market and economic growth. A different position was taken by Olszewska (2018) who proved that the domino effect in the process of the spread of financial crises resulted in a negative correlation between the real sphere and the banking sector.

There is also a correlation between Islamic banking and the real sphere, and even banks are statutorily obliged to support the real economic sphere. The difference is that Islamic banking operates under a reduced systemic risk, so the materialised risk is not so much transferred to the real sphere as in the conventional economy. Therefore, it is reasonable to reduce systemic risk in Western banking, primarily by reducing product risk and adapting it to appropriate customer groups rather than just focusing on capital adequacy.

This research also found out that most western banks have assets that are worth more than the assets of the Islamic banks combined. This means that the western banks are more successful than the Islamic banks. The application of Islamic banking principles to the Western banks may, therefore, be difficult to achieve since they are already successful, and majority of businesses are focused on being successful (Tandogan, 2018).

5. Conclusion

The approach to the management of conventional banks in the post-crisis economy should be changed mainly by limiting systemic risk. Islamic banking generates less systemic risk, which results primarily from other sociocultural determinants that the authors consider inviolable. However, the primacy of the social dimension of banking over the economic dimension is worth pointing out here.

Conventional banking focuses primarily on economic assumptions, putting the needs of an individual to the backdrop. In terms of the liberal economy, capital is a self-multiplying value. In this case, the basic value is rather the capital, which is to serve man, than the man. The deliberations are aimed at increasing social values in modern western banking, utilising the experience of Islamic banking and so-called social economy remaining outside the mainstream of the economy.

6. Recommendations

This research recommends that western banks reduce systematic risk in order to reduce product risk. In order to reduce systemic risk, the following aspects should be considered:

- Reduced sale of derivatives by banks only to corporate customers operating in the form of capital companies and individual customers classified in banks as VIPs, while the customer classification itself would be at banks' discretion.
- Statutorily reduced interest on overdue receivables, which will be a departure from the typical mechanism of increasing the amount of penalties for late repayment of loans, force banks to behave more conservatively at the pre-loan stage.
- Increased loan repayment flexibility in the form of mandatory suspension of repayments of up to three loan instalments at the request of a customer under certain circumstances, such as loss of employment or an unforeseen accident preventing work, temporary deterioration of the company's economic and financial standing etc.
- The obligation to provide bank customers with more information on credit risk, making it dependent on the volume of an obligation incurred, while information campaigns would be tailored to customer segments.

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