Concept of Profit Maximization Model in Islamic Commercial Banking System and its Weakness

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Abstract

Islamic banking as a new banking model has become a universal phenomena in terms of acceptability, efficiency and effectiveness of its products and services. But, there is an issue, which borders on the operation of the Islamic banking system from the view-lens of profit maximization model. Thus, Islamic banking model based profit maximization (Profit and loss sharing concept) focuses on profit, with less emphasis on social welfare responsibility of the Ummah. This paper therefore aims to discuss the concept of profit maximization model under Islamic commercial banking system, and highlights the weakness of the model. In a bellicose tone, the paper aims to suggest the modus operadi of Umar Chapra Islamic banking Model, which embraces the use of profit maximization model with great emphasis of social welfare responsibility by Islamic banking system.

Keywords: Profit Maximization, and Islamic commercial bank.

INTRODUCTION

It is critical to acknowledge the fact that conditions for total implementation and success of Islamic banking in any country, includes re-shaping the society, re-structuring the economic system and re-framing the laws according to the teaching of Islam. This will then create a favorable environment for more and more financing under profit and loss sharing system of Islamic banking.

There are generally two different views that defined the structure and objectives of Islamic banking. Firstly the IDB model structure offered by mainstream Islamic economists as described by Chapra (1996). Secondly the model that viewed Islamic banking structure in a form of a normal commercial banking operations, conducted based on Shari'ah law to maximize profits as described by Ismail (2002), and shared by many Islamic jurists who tend to think less theoretically and deductively than the economists.

PROFIT MAXIMIZATION VERSUS CHAPRA MODEL

There are various Islamic models of banking developed from classical Islamic law. The most commonly used model is the profit maximization model, which is fashioned towards conventional banking system. Islamic banking system under profit maximization model provides a wide range of products and services to the customers. Products and services provided under modern Islamic banking system could be divided into two categories, namely fund-based and fee-based. The fee-based services provide the following: opening of bank account, safe-keeping of negotiable instruments (including shares and bonds and collection of payments), internal (domestic) and external transfer operations, hiring strong boxes (coffers), administration of property, estates and wills. Islamic banking model provides these services, and act as the agent or wakil of the client, and collect an agency fee or service charge.

Islamic banking model proposed by Ismail's framework is Islamic commercial bank whose activities of transactions are consistent with Islamic law. The bank operational financing products are shariah compliant with motive of profit maximisation (Lewis and Algaud 2001; & Satkunasegaran 2003). This view emphasized the importance of other debt-based financing product that are shariah compliant such as *murabaha* (cost-plus sale), *bai' bithaman ajil* (deferred payment sale), *bai' al-salam* (purchase with deferred delivery), *bai' al- istisna*' (commissioned manufacturing), and *ijara* (leasing).

Furthermore, the model argued further that, the bank's main responsibility is towards the shareholders and depositors only. The Social welfare responsibilities should be taken care by the government, and not the bank. The use of shareholders' funds or depositors' money for other social activities, which are not required by the law, may affect the profitability and viability of Islamic banking. This view is similar to the Western neoclassical worldview; particularly Friedman's concept of corporate responsibility who contends that society is served by profit maximization is the only legitimate and overriding objective of a commercial institution, provided that it operates within the prescribed rules of the game (Friedman 1967, 1996).

Indeed, Friedman's argument reflects the prevailing worldview of neoclassical economics which has long been entrenched in the notion of self-interested economic man. The root of this argument is the efficacy of Adam Smith's invisible hand in harmonizing self interested behavior to secure an end that is not a part of anyone's intention. The argument also depends on the ability of the rest of society to create the conditions necessary for the invisible hand to operate and to deal with the problems of externalities, inequalities, and instability, without the aid of business corporations (Boat right 1993).

Under this profit maximization model, a variety of services being offered by conventional banks may also be offered by Islamic banks without any need for modification in the nature of the products, as long as, there is no debtor-creditor relationship involved in the process. If there exists a debtor-creditor relationship, then the element of riba is involved. Services leading to creation of a debtor-creditor relationship often involve a mix-up of fees for service rendered and interest or riba for lending of money. In a situation where loan is involved, it will be dangerous for Islamic bank to receive revenues or fees based on percentage of the loan value, in order to ward off suspicion of riba. But, loan is not involved; revenue or fee will be based on the benefit to the customer on one hand, and the efforts exerted by the bank or work done, on the other. And, where these two elements are involved, the fee is considered as amount for the benefit passed and cost incurred, and certainly not as a percentage of the value of loan.

It should be noted that the core business of conventional banking system is buying and selling of funds. For Islamic banks to run its business, it must find ways to buy and sell funds without engaging in transactions and contracts involving riba and gharar. The concept of Islamic banking is essentially based on the idea that Islam prohibits riba, but permits trade and profit-loss sharing arrangements. The two forms of profit-loss sharing are mudaraba and musharaka. In mudaraba, one party provides the capital, while the other party manages the business as wakil. Profit is shared in pre-agreed ratios and loss, if any, unless caused by the negligence or violation of the terms of the agreement, is borne by the provider of capital. In musharaka, partners pool their capital to undertake business. All providers of capital are entitled to participate in management but are not necessarily required to do so. Profit is distributed among the partners in pre-agreed ratios, while loss is borne by each partner strictly in proportion to the respective capital contribution.

In the recent past, Islamic banking system is premised on these two contracts for modeling financial intermediation, and the two-tier madaraba model of commercial banking is enforced. The two-tier mudaraba contract involves the depositors and the bank on one hand, and the bank and the parties to whom the finance is provided on the other. The mudaraba contract formed the basis of mobilization of funds from depositors, with the bank as the mudarib and the depositor as the rabb-al-maal. It also formed the basis of utilization and investment of these funds with the bank now as the rabb-al-maal and the entrepreneur or user as the mudarib. The difference between the profit-share received from the entrepreneurs (mudarib) under the first contract and the profit-share paid to the depositors (rabb-al-maal) under the second contract constitute the source of profits for the Islamic commercial bank. As Islamic banking model progresses, several alternative models emerged and a host of other Sharia'ah-compliant sources and uses of funds became part of the Islamic banking model.

To the scholars, who do not belong to the school of thought of profit-making ventures in the practice of Islamic banking system, they are clamoring for social welfare responsibility in Islamic banking system model. Wahbah Al-Zuhayli, a renowned Shari'ah scholar also endorses the socio-economic framework of Islamic financial institution in his famous book *Al-Fiqh Al-Islami wa- Adillatuh*, "*The primary goal of Islamic financial institutions is not profit-making, but the endorsement of social goals of socio-economic development and the alleviation of poverty*" (p.350). Therefore, for Islamic banks, while making profit from the business is acceptable, the accumulation of profit without utilisation for the betterment of the community is forbidden. With this regards, Islamic banks are likely to be sensitive to the needs of the society, promote more social welfare programs and activities, and make more contributions towards the needy and the poor.

In promoting balanced economic and social development goals, Al-Zuhayli further asserted that, Islamic banks must consistently adhere to the prescribed guidelines by the *Shari'ah*. These include transparency in the documentation and operation, having sense of accountability to diverse stakeholder groups and respect the *Shari'ah* rulings passed by the *Shari'ah* advisors even though the rulings are in conflict with their profit-making interest.

Based on the school of thought of social responsibility model of Islamic banking system, Muslim Ummah begins to identify the shortcomings of profit maximization model because the focus is mainly on profit, and the model, though, a two-tier mudaraba concept is premised on products and service offered by conventional commercial banking system, which are not prohibited in Islam. Few amongst the shortcomings of profit maximization Islamic banking model include:

i) Profit-centered commercial banking model;
ii) Unevenly distribution of wealth;
iii) Not catering for social welfare responsibility;
iv) Not focused on poverty alleviation; and
v) Transacting in banking activities which may involve suspicion.

Other areas of shortcomings include engaging the personnel that are serving with conventional commercial banking system. In most cases, these personnel know little or nothing about the Shari'ah principles of Islamic banking model. What they normally do is 'work-to-the-answer' syndrome of banking. The personnel for instance, will say, interest is not allowed in Islamic banking system, but trading with mark-up is allowed, therefore they will engage in financing in which the mark-up is higher than the rate of interest, being operated in the conventional commercial banking system. This is a big challenge through the use of profit maximization under Islamic banking system.

On the contrary, the proponents of Chapra model assumed a financial system based on Profit and Loss Sharing (PLS) instruments that will ensure the realization of socio-economic objectives envisaged by Islamic economics. An examination of the actual workings of Islamic banking in practice should therefore be studied with these distinctions in mind. It is time for the Islamic banks and financial institutions to resolve toward enhancing their equity share of financing on PLS basis. The dawn of an era of justice can, therefore, be visualized where the fruits of the Islamic banking system would be available to a large number of people leading to over-all social and economic prosperity.

Chapra model supports Profit and Loss sharing (PLS) in a way, and places greater social welfare responsibilities and religious commitments upon Islamic banks in order to achieve the Islamic economic objectives, including social justice, equitable distribution of income and wealth and promoting economic development of Islamic banks (Lewis & Algaud, 2001). Various Islamic economics scholars such as Sadr (1982); Siddiqi (1983, 1985); Ziauddin Ahmad (1984); Ahmad (2000); Siddiqui (2001); Haron, 1995, 2000; Ahmad, 2000; Rosly and Bakar (2003); Haron and Hisham (2003); Naqvi (2003) agreed to PLS view. The scholars further argued that PLS is the only principle representing a true spirit of Islamic banking system that differs from the interest-based system. The scholars consistently affirmed that Islamic banking model predominantly based on equity of PLS is similar with the spirit of Shari'ah and overall Islamic worldview.

Chapra scheme also contained proposal for loss-compensating reserves and loss-absorbing insurance facilities (1982). In line with Chapra Model, Mohsin (1982) presented a detailed and elaborate framework of Islamic banking in a modern setting. His model incorporates the characteristics of commercial, merchant, and development banks, blending them in a novel fashion. The model adds various non-banking services such as trust business, factory, real estate, and consultancy services, as though interest-free banks could not survive by banking business alone.

Islamic banks should not be solely profit oriented rather it must aim at promoting Islamic norms and values as well as protecting the needs of Islamic society as a whole without undermining its commercial viability. Wahbah Al-Zuhayli, a renowned Shari'ah scholar endorsed the socio-economic framework of Islamic financial institution in his famous book *Al-Fiqh Al-Islami wa- Adillatuh*, "*The primary goal of Islamic financial institutions is not profit-making, but the endorsement of social goals of socio-economic development and the alleviation of poverty*" (p.350). Therefore, for Islamic banks, while making profit from the business is acceptable, the accumulation of profit without utilization for the betterment of the community is forbidden. With this regards, Islamic banks are likely to be sensitive to the needs of the society, promote more social welfare programs and activities, and make more contributions towards the needy and the poor. In promoting balanced economic and social development goals, Al-Zuhayli further asserted that, Islamic banks must consistently adhere to the prescribed guidelines by the *Shari'ah*. These include transparency in the documentation and operation, having sense of accountability to diverse stakeholder groups, and respect the *Shari'ah* rulings passed by the *Shari'ah* advisors even though the rulings are in conflict with their profit-making interest.

ETHICS OF ISLAMIC BANKING SYSTEM

it is a known fact that the practice of Islamic economics, banking and finance has witnessed unprecedented growth in the last few decades due to the commitment, dedication and the scholastic and moral contributions on the part of Muslim scholars, economists, bankers and the Ummah at large; the institution has eventually survived the "integrity and credibility crisis" as noted by Ayub (2008, p.467). As such, a lot of efforts have been made to ensure that the various Islamic financial products are Shari'ah based and compliant in their formulation and operations. Therefore, the most pronounced differences between Islamic and non-Islamic financial products are the prohibition of interest (riba) transactions that involved gambling (maifsir/qimar), speculation/uncertainty (gharar) and unethical behaviours.

Nearly all the conventional economic theories work under Islamic financial system, but the most suitable theory is to adopt economic theory that is not in conflict with the Quranic injunctions, and the traditions of the Holy Prophet (SAW). According to INCEIF (2006), the role of financial institutions in economic development remains very important considering the evidence from recent empirical studies, which suggests that deeper, broader and better functioning financial system can stimulate higher economic growth, which is highly desirable by Muslim countries. Therefore, the emergence of Islamic banking as a prominent and leading Islamic financial institution was in response to two exigencies i.e. the religious and economic. The religious exigency implies that all economic and financial transactions must be free of interest; whereas the economic exigency denotes the provision of a new outlook on the role of banking in promoting investment or productive activities, influencing distribution of income and adding stability to the economy at large.

In an Islamic financial system, guiding rules are derived from the Qur'an and Sunnah (i.e., saying and actions of Prophet Muhammad S.A.W). The Shari'ah spells out the Qur'anic teachings in three dimensions, namely: Aqeedah (faith and belief), Akhlaq (ethics and morality) and Mu'amalat (transactions). There are two types of guidelines that are expected to be noted and followed in the various spheres of life in Islam and they are: (i) legal and (ii) ethical guidelines. On the former, the Qur'an prohibits the taking and receipt of interest (*riba*) in all financial dealings (see: Q2:275) and also, wealth creation by means of investment in legally allowed as long as it is not in unlawful areas such as gambling (*maisir*) or speculative/uncertainty (*gharar*).

On the ethical side, the Qur'an enjoins trustworthiness (*amanah*) (2:282) and prohibits deceit (*khud`a*) and greed (*hirs*) in profit taking. These commands and prohibitions are meant to generate harmony in economic activities such that justice prevails and social cohesion and harmony are achieved. Importantly therefore, both the legal and ethical dimensions of the Shari'ah are embodied in the rules and regulations governing the Islamic financial system, which are:

i. Prohibition of *riba* (usury or interest)
ii. Prohibition of gharar (deceptions).
iii. Prohibition of maysir (gambling); and
iv. Prohibition in engaging production of prohibited commodities such as liquor, pork, and pornography.

For Muslims, Islamic financial System of profit and loss sharing (PLS) coincides with their belief in the prohibition of interest and mobilizing of surplus funds for investment and creating new opportunities. As for non-Muslims, the Islamic bank does not contradict their faith, while it provides the society with alternatives ideas for capital venture and other instruments of investment. Besides, the most important development in modern banking is the art of mobilizing funds for investment. Islamic banking is a system that provides financing and attracts savings on the basis of profit/loss sharing.

ISLAMIC VIEW POINT OF CONVENTIONAL NEO-CLASSICAL AND KEYNESIAN THEORY

The general consensus is that money buys goods and goods buy money; but goods do not buy goods (Clower, 1969, pp. 207-208). Therefore, money has become the universal instrument of trading, by the intervention of which goods of all kinds are bought and sold, or exchanged for one another (Smith, 1776, pp.4). Adam Smith is considered as "better monetary economist" (Laidler, 1981, pp. 184). The conventional economic theories are in tandem with the Shari'ah principles in many regards as it is practised in the Islamic economic system.

The founding fathers of classical monetary theory are Adam Smith and Hume. The classical monetary theory of Adam Smith spanned across a century, thus, 1770s to 1870s. The two scholars did a great job on money, credit and real economy. In addition to the scholastic work of Adam Smith and Hume, Henry Thornton is one of those scholars whose ideas shaped monetary theory, especially for his innovation of the complicated phenomena that were taking after the inconvertible monetary system in 1797. He worked extensively on monetary policy and links between money, credit and the real money. Most importantly, he developed the concept of a theory of central banking. His study is equally limited because the study cannot convince other contemporaries to look beyond the conventional wisdom at the turn of event in the 19^{th} century.

To Hume, he used the analytical apparatus known as the Price-Specie-Flow mechanism- that linked the internal money supply to automatic, international forces and relieved analysts from any worries about its determination. But, to Smith, he owned to the extension of the "invisible hand" argument to money, credit and finance. Later theoreticians became indebted to Ricardo for turning the quantity theory into the cornerstone of monetary theory.

In the 1930s, Keynes started a revolution in economic thinking of modern macroeconomics, and he became the most influential economist of the 20th century. According to Keynes (1979), “Capitalism is the astounding belief that the wickedest of men will do the wickedest of things for the greatest good of everyone”. The Keynesian general theory argues that demand, not supply, is the key variable governing the overall level of economic activity. Aggregate demand, which equals total unhoarded income in a society, is defined by the sum of consumption and investment. Lastly, Keynes expressed a preference for inflation over deflation. He is characterized as being indifferent or even positive about inflation.

In opposition to the conventional economics theories, Islamic economics focused on comparative economic systems as well as neo-Classical and Keynesian modelling with a highly stylized moral and ethical individual who shuns excessive greed and consumerism in place of mainstream economics, which is about selfish utility and profit, maximize (Haneef, 1995). Islamic banking emerged in the Islamic economists’ literature as a financial system based exclusively on profit-and-loss sharing, which was argued to be more equitable and stable (Chapra, 1996; Siddiqi, 1983). Islamic economists focused on the Islamic prohibition of riba or usury, which they interpreted as a prohibition of all interest-based lending, in accordance with earlier interpretations of Judeo-Christian canon.

Classical Islamic jurisprudence interpreted interest-based lending as the cornerstone of fractional reserve depository banking, as riskless- and therefore illegitimate and inequitable-return for idle capitalists. Indeed, the importance of credit and risk for any financial analysis remains conspicuously absent from the writings of the Islamic-economics faithful. The preferred financial model, they postulated, would be based on the ancient silent-partnership model known in Islamic writings as mudarabah, corresponding to the Jewish heter iska and the Christian-European commenda (Udovich, 1970).

An “Islamic bank” is envisioned as a two-tier silent partnership. Thus, deposits seeking a return (as opposed to fiduciary deposits, for which 100% reserves are required) will not be guaranteed loans to the bank, but rather silent-partnership investments in the bank’s portfolio. In turn, the bank’s investments of those funds would not consist of loans and acquisition of debt instruments, but rather profit-and-loss sharing investments in other silent partnerships. Thus, the Islamic bank serves as financial intermediation function (pooling of return-seeking savings and diversification of investments) through profit-and-loss sharing. This idea continues to serve as the cornerstone of Islamic banking today.

Potential loss of return-seeking deposits is assumed by Islamic banking proponents such as the Islamic Financial Services Board (IFSB) to encourage depositor monitoring and risk-mitigating market-based discipline. Thus, the grossly inadequate depositor-protection measures supported by the industry should focus on transparency of operations and profit-distribution mechanisms (IFSB, 2006).

CONCLUSION

It has been shown that Ismail’s profit maximization concept made amendments on conventional economic theories to be in tune with the Islamic Shari’ah principles in order to operate Islamic banking system to maximize profit. In spite of the fact that Islamic commercial banks are operating products based on Murabaha and Mudarabah concepts, the model seems to be operating Islamic banking system with major reason of making profit. But, the doctrines of Islamic banking system transcends beyond profit-making ventures. Hence, this formed Islamic scholars to be looking for improvement on Ismail’s profit maximization model.

Umar Chapra (1996) proposed a well accepted model for the operation of Islamic banking system. But, the practioners of the system are finding it difficult to use the model effectively and efficiently because of the social welfare responsibility aspect of the model. The aspect is not just the creation of Chapra, but it is the dictates of the doctrine of Islamic banking system. Therefore, the operators of Islamic banking system should be encouraged to be using Chapra model in the operation of Islamic banking. This model enables Islamic banking system to attain its fullest benefits to the humanity.

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