Access to Finance and Collaterals: Islamic Versus Western Banking

ABDEL HAMID ABDOULI
*Arab Authority for Agricultural
Department and Investment, Dubai*

ABSTRACT. Islamic banking would contribute to the emergence of a just and growing economy by enabling small enterprises to obtain finance on participatory basis in which a collateral is not necessary. This is in sharp contrast with the conventional banking which insists on tangible collaterals, discriminating against small units and favoring the propertied rich. As a result income distribution deteriorates further, whereas Islamic banking will improve income distribution.

Introduction

With the increasing demand for the growth of more labor-intensive activities in developing countries, a great deal of attention is being given to the potential of small scale enterprises as an alternative to larger more capital-intensive firms, However, it has been widely confirmed that, under the present Western Banking system. small manufacturers and farmers, as compared with larger production units, face much greater difficulties in obtaining short term, medium or long term credit through institutional channels, The major constraint to access to finance is the lack of tangible collaterals.

In the long run this banking policy will further widen the already large income gap between upper and lower classes of the society.

By taking intangible assets, such as education, skills, and experience, as collateral as tangible assets, Islamic Banking breaks this discriminative barrier and offers an equal opportunity to all potential producers to improve their well-being and that of the society.

The purpose of this paper is (1) to show, through a simple economic model, the long run impact of Western Banking system on income distribution, and (2) to indicate that, by the nature of its operations, Islamic Banking is more likely to contribute towards the emergence of a just and growth-inducing economic development. In section two we will briefly discuss the lending attitude of Western Banking institutions and its impact on small enterprises/farms. In section three we will present the economic model used to show the long-run impact of such policy on income distribution. Section four will highlight the nature of Islamic Banking, and in section five we will conclude the paper by stating the relevant findings of the study.

Poverty and Access to Finance

It has been widely claimed by development economists that in developing countries, a strong focus on small firms in policy and resource allocation is a priority (World Bank 1980, 1983, 1986, IBRD 1977). However, the lack of special lending institutions adapted to small borrower conditions does not help statements translate into effective actions (Furness 1975, Harlander 1977).

From the viewpoint of financing institutions, small enterprises are less attractive as borrowers than larger ones because of the smaller profit potential for the lenders and the high risk involved through the lack of equity and tangible collaterals.

The profit potential in lending to small scale enterprises is less than in lending to larger ones because of higher lending costs, greater risk, and the fact that small enterprises typically do not make significant use of the other revenue-yielding services offered by financial institutions such as letters of credit, guarantees and so on. Moreover, lending to a large number of heterogeneous and widely dispersed enterprises is intrinsically more demanding of time and effort than dealing with a smaller number of more established and more familiar firms. There are basic problems of contact and communication: in poor countries, many enterprises, especially small firms, are not conveniently accessible. Bank personnel tend to be separated from small entrepreneurs and farmers by differences in language, literacy, and culture. Even without such barriers, the personnel of financial institutions are likely to find new small borrowers unfamiliar with documentation and accounting conventions. Moreover, the small businessman's fear of authority often exacerbates a mutual distrust between him and the banker, making it more difficult to build the bridge between financial needs and access to them.

Concerning the issue of tangible collaterals and their requisite character in access to finance, it has been observed that the existing banking institutions prefer to grant credit facilities to those clients who apart from enjoying a good business reputation are also able to offer sufficient collateral security. This may be in the form of personal property, goods and chattel merchandise, stock-in-trade ... etc. Although this practice seems quite reasonable from the risk point of view, the non-property holders are unjustifiably deprived of obtaining the necessary financial accommodation. The existing practice of demanding collaterals for the purpose of granting financial accommodation stems from the fact that Western Banking institutions are primarily concerned with the profitability rather than the social imperatives. The imposition of tangible collaterals as a necessary condition left small businessmen and farmers trapped in a vicious circle:

they cannot get access to finance unless they offer sufficient collaterals, they cannot possess tangible collaterals unless they build a strong productive base, they cannot improve their productive base unless they get access to finance.

This conditional access to finance tends to favor those entrepreneurs/farmers who are already better-off. The net outcome of such phenomenon would be a further deterioration of the income distribution which would end up highly skewed towards the wealthier portion of the society. We will illustrate this phenomenon with the following model.

Description of the Model

Variables of the model

     Y = value of output
     C = consumption
     S = savings
     I = investment
     B = borrowed capital
     W = value of wealth
     E = cumulative effect of initial wealth endowment
     R = inequality index

Subscripts t, u, l stand for time, upper class, and lower class respectively.

Specification of the model

$$Y_t = a_1 + a_2 I_{t-1} \tag{1}$$
$$C_t = c_1 + c_2 Y_t \tag{2}$$
$$S_t = Y_t - C_t \tag{3}$$
$$I_t = S_t + B_t \tag{4}$$
$$B_t = b_1 W_t \tag{5}$$
$$W_t = w_1 + w_2 Y_t \tag{6}$$

Equations (1)-(4) are clear by themselves. Equation (5) indicates that access to finance B_t is directly proportional to the amount of wealth processed by the borrower.

In equation (6), the value of output, Y is assumed to contribute linearly to the amount of wealth W. Note that equation (5) is of most interest to our analysis because it reflects the lending attitude of the Western Banking system. That is, access to finance is strictly dependent on tangible assets. Without loss of generality and in order to avoid cumbersome manipulations, the intercepts a_1, c_1, and w_1 will be suppressed throughout the substitution process. Substituting and arranging terms leads to:

$$Y_t = a_2^t (1 - c_2)^t Y_0 + \sum_{i=1}^{t} a_2^i (1 - c_2)^{i-1} b_1 W_{t-i} \tag{7}$$

We can further isolate the term pertaining to the initial endowment of wealth W_0 and get:

$$Y_t = a_2^t(1-c_2)^t Y_0 + \sum_{i=1}^{t-1^0} a_2^i(1-c_2)^{i-1} b_1 W_{t-i} + a_2^t(1-c_2)^{t-1} b_1 W_0 \tag{8}$$

The cumulative effect of initial endowment W_0, on output from period 1 to period t is clearly specified as follows:

$$E_t = a_2^t(1-c)_2^{t-1}b_1W_0 + a_2^{t-1}(1-c_2)^{t-2}b_1W_0 + .. + a_2b_1W_0 \qquad (9)$$

$$E_t = b_1W_0a_2\sum_{i=0}^{t-1}a_2^i(1-c_2)^i \qquad (10)$$

$$\text{let } A = a_2(1-c_2)$$

$$E_t = b_1W_0a_2\sum_{i-0}^{t-1}A^i \qquad (11)$$

using the identity:

$$1 + X + X^2 + ...X^{t-1} = (1-X^t)/(1-X) \qquad \text{for } X \neq 1$$
$$= t \qquad \text{for } X = 1$$

we get:

$$E_t = b_iW_0a_2\left[(1-a_2^t(1-c_2)^t)/(1-a_2(1-c_2))\right] \qquad (12)$$

sine c_2 is the marginal propensity to consume, $(1-c_2)$ is less than one and E_t would depend on the value of a_2:

$$(1) \text{ if } a_2 < 1 \Rightarrow a_2(1-c_2) < 1$$
$$\text{as } t \to \infty, E_t \to (b_1W_0a_2)/(1-a_2(1-c_2))$$

and since b_1, W_0, and a_2 are > 0 by definition, then E_t is > 0

(2) if $a_2 > 1$ we identify two cases:

$$*a_2(1-c_2) > 1 \quad E_t \to \infty \text{ as } t \to \infty$$
$$*a_2(1-c_2) < 1 \quad E_t \to (b_1W_0a_2)/(1-a_2(1-c_2)) > 0 \text{ as } t \to \infty$$

let us now define the index of inequality between the income of the upper class and that of the lower class:

$$R = (b_1a_2W_{u0})/(1-a_2(1-c_{2u}))/(b_1a_2W_{10})/(1-a_2(1-c_{21}))$$
$$= W_{u0}/W_{10}\left[(1-a_2(1-c_{21}))/(1-a_2(1-c_{2u}))\right]$$

where W_{u0} and W_{10} are the initial wealth endowments of the upper and the lower classes respectively, c_{2u} and c_{21} their respective marginal propensities to consume.

Since c_{2u} is normally less than c_{2l}, we assume

$c_{2l} = c_{2u} + h$ with $h > ()$

then by simple substitution we get:

$$R = W_{u0}/W_{10}\left[\left(1 + a_2\,h\,/\left(1 - a_2\left(1 - c_{2u}\right)\right)\right)\right]$$

Hence, under the Western Banking system, income inequality between the upper and the lower cases would depend, among other things, on (1) the ratio of wealth endowments and (2) the consumption behavior of both classes (through the parameters h and c_{2u}.

The contribution of wealth discrepancy to the income inequality raises the fundamental question of whether intangible assets such as education, experience, and skills are less collateral than tangible assets. The answer depends very much on the banking system prevailing in the society, Islamic versus Western Banking systems.

Islamic Banking and Collaterals

Under the Islamic economic thrust for distributive justice, there is no provision that a financially privileged position could be used to allow continued asymmetric gains. Islamic Banking institutions are obliged to give priority to the needs of society and the common interest over individual profit and private interest. When the primary concern of the banking institution is not the maximization of profitability as such but rather the social imperatives, the tangibility of assets, as a requisite to access to finance loses its importance. Moreover, the granting of credit to an educated, yet financially poor person could be even more beneficial on both social justice and long run growth.

In order to understand the role of intangible assets in access to finance, it is essential to highlight the specific nature of Islamic Banking as opposed to the Western Banking.

Even though Islamic Law does not recognize corporations in the Western sense, companies are based mainly on partnership. The two methods that fully satisfy the requirements of the Islamic Law are *Mudarabah* and *Musharakah* (Khan 1986, Khurshid 1980).

The *Mudarabah* contract is formally a silent partnership with a clear distinction between the capital provider and the entrepreneur who controls the management of the project. The bank provides the entrepreneur with funds to be invested in a productive economic activity in return for a predetermined share of the profits earned. Financial losses are borne exclusively by the lender. The borrower, as such, loses only the time and effort invested in the venture. This arrangement, therefore, effectively places human capital on par with financial capital.

The *Musharakah* contract is formally a limited partnership, whereby both the bank and the customer provide capital for a specific project. Losses are shared according to capital contribution.

Another form of Islamic Banking is the *Murabaha* contract. Here, the financial institution purchases raw materials, goods or equipment at cost and sells them to the client on cost-plus-negotiated margin basis. Other transactions are rental financing, whereby the bank acquires equipment or buildings and makes them available to the client on a straightforward rental basis. The client, however, has the possibility of acquiring ownership of the rental equipment or buildings by paying installments into a saving account.

The practice of the above operations clearly removes the long-practiced discrimination by the banking institutions against the non-propertied class in matters of financial accommodation. Moreover, the large number of fresh graduates in some Muslim countries (45% in Sudan, 50% in Tunisia and Egypt) who have found themselves deprived of their chances to improve their own well-being and that of the society that invested so much in their education, would further participate in and share the fruits of economic endeavors.

Unlike Western Banks, Islamic Banks are, by the very nature of their operations, directly affected by the performance of their clients' enterprises through the profit loss sharing process. As such, the promotion of these enterprises would be more successful when financial support is accompanied by technical assistance, managerial device, and the search for market outlets. This mutual involvement of Islamic financial institutions and entrepreneurs would enhance not only the operational impact of these institutions but also the integration among all members of the society, rich and poor classes, small and large producers, and rural and urban sectors.

Conclusion

We have tried to link in this paper the issue of income distribution to the nature of operations of the banking institutions. We showed that the common practice of Western Banking Institutions of granting credit facilities to those clients who are able to offer sufficient tangible collateral security, would further deteriorate the already uneven income distribution between upper and lower classes.

Because of the nature of its operations, Islamic Banking does offer a new dimension in lending. Since it is a system based on participatory financing, Islamic Banking would not depend on tangible collaterals as much as Western Banking. Such access to finance, not totally dependent on wealth endowment, would eventually lead to a better distribution of income and a larger improvement of the will-being of those who for none of their fault were endowed with niggardly resources.

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فرص الحصول على التمويل وعلاقتها بالرهن والضمانات
بين النظامين المصرفيين الإسلامي والغربي

عبدالحميد عبدولي

الهيئة العربية للاستثمار والإنماء الزراعي – دبي

المستخلص : يمكن للنظام المصرفي الإسلامي أن يساعد على ظهـور اقتصـاد عـادل ونـام مـن خلال إتاحته الفرصة للمشروعات لتحصـل على التمويـل بصـيغة مشـاركة، وهـي صـيغة لا تستلزم تقديم رهن. وهذا يختلف اختلافًا بينًا عن النظـام المصرفي التقليـدي الـذي يصـر علـى طلب رهون مادية، مما يجعله ينحاز ضد المؤسسات الصغيرة، ونحو ذوي الغنى والثروة، الأمـر الذي يسيء إلى توزيع الدخل. في حين أن النظام المصرفي الإسلامي يتوقع منه أن يساعد علـى تحسين توزيع الدخل.