Cooperative banking as the solution for Islamic banking woes

By Rosana Gulzar Mohd

In my short years in Islamic finance, I have sunk to the lowest low and been inspired to the highest high. The sad thing about Islamic finance is that it can be so much better. It could have benefited from more deliberate thought at the initial stage. And I suspect it could have done with sincerer intention from the industry's architects. The issue with Islamic finance today is that it is trying to be something it is not or put another way, it is being shoved down the wrong tube. After studying Islamic finance for two years, my conclusion is that the commercial banking model is ill-suited for this form of finance. This is why we keep hearing that it is like squeezing a square peg into a round hole. In classrooms, we learn of its higher ideals such as mutuality, the sharing of burdens and rewards and participativeness. But in reality, anyone who has worked in a bank, 'Islamic' notwithstanding, knows that the only thing management cares about is profit (why are you behind target this month?) and expansion plans (how many branches are we opening, which lucrative market have you identified for expansion etc). The mentality and personalities in banking are just not the types who will stop to ask if the mamak stall owner can get financing if he wants to open another one or whether his children can get access to quality education or whether his parents can get the medical treatment they need. Social welfare? What's that again? Of course there are notable exceptions but they are few and far in between.

What lifts me out of the doom and gloom that is Islamic finance today is when I learn about its theories in school. Therein lies the dichotomy or the divergence in Islamic finance. In theory, we learn that it is about selflessness, sharing and the uplifting of less advantaged groups in society for the communal good. One article particularly, by Adi Setia, describes it well. In '*Mu'amala and the revival of the Islamic Gift Economy*', he says:

"This principle of reciprocal giving and receiving is enshrined in the Qur'ānic verse: *hal jazā' al-iḥsān illā al-iḥsān* = Is the recompense of goodness aught save goodness? (al-Raḥmān: 60). In a community in which everyone gives, everyone receives also, and most times, everyone receives in return much more than what he or she has given out in the first place, hence none is left out, none is marginalized or alienated or ostracized, but everyone belongs as a way of truly humane living, well-expressed in the South African traditional sociocultural concept of ubuntu.”

“In contrast, neoliberal privatization is a system in which public wealth is retained (or enclosed, hence the so-called “enclosure of the commons”) and dedicated for the provision of private profit, in which the larger communal interest is only of an ad hoc, marginal and incidental consideration, despite sweet-sounding political rhetoric and elaborate economic jargon to the
contrary. In the case of *waqf*, we have the “pouring-out” economy, whereas in the case of privatization we have the “trickle-down” (i.e., cream for the rich, and crumbs, if any, for the poor) economy.”

“This governing vision of mutuality, participativeness and partnership , or common interest and common good instead of self-interest, can be contrasted to the generally one-sided affair in conventional banking (including so-called ‘Islamic’ banking) in which capital is merely rented out by one party, say the bank, to another, the businessman/entrepreneur, through various elaborate mark-up instruments, thus ensuring guaranteed returns to the bank without obliging it in any way to participate in the risks inherent in the enterprise, risks which are to be borne exclusively by the businessman/entrepreneur.”

This of course is not the only issue with ‘Islamic’ banking under the commercial banking model. My studies have in fact led me to another banking model which I believe is a much better fit for the Islamic values of mutuality and participativeness. You know *gotong royong*? Something Malaysians are very good at. I find a lot more *gotong royong* in the cooperative banks of Europe.

While there are some differences in the models of cooperative banks in various regions of the world, a basic common feature is that they are owned by members, who in turn tend to be their depositors and borrowers. That’s mutuality built right into the system. This form of ownership then sets the tone for a business model that is more Islamic than ‘Islamic’ commercial banks. For example, because cooperative banks are owned by members who may be their borrowers, profit maximisation is not the main objective. Their raison d'être is in fact to charge reasonable enough rates so that those who cannot get financing from blood-sucking

commercial banks can do so through the cooperative banks. And yes, they are not Islamic in form but I think they are more Islamic in spirit.
Bankers of cooperative banks are also known to have close relationships with their customers. A Turkish German once told me that his neighbourhood banker would come regularly for tea. When he notices a child in the household is old enough for a bank account of his own, the banker will ask the parents if he should indeed open one for him. Germany by the way is home to the largest network of cooperative and savings banks in the world. This close relationship has important implications. One it answers a call by some quarters for a move towards relationship-based banking as opposed to the transactions-based frenzy that characterises commercial banking and has been blamed for the crises. Secondly, it addresses a key issue that has been plaguing Islamic finance since its modern birth: How to implement profit and loss sharing (PLS) contracts such as *musharakah* and *mudarabah* which are at the heart of an ideal Islamic financial system when early attempts failed due to moral hazard and adverse selection issues.

Moral hazard is a risk that arises due to the information asymmetry between banks and customers. The latter ultimately know more about their business operations and prospects than the banks. So the opportunity arises to disadvantage the bank by for example under declaring profits or overstating prospects. Adverse selection occurs when the bank wrongly chooses a project to finance because of the information asymmetry which arises especially when the relationship is at arms length. The mutual stake established in cooperative banks through the link between members and borrowers means that both parties are incentivised to understand each other better for their long-term survivals. And there is reduced risk of non-payment because everyone knows each other. Their interests are aligned.

To summarise, **key features of cooperative banks in Europe** are:

- Owned by members, who in turn tend to be their depositors and borrowers
- Less profit-maximising than commercial banks
- Well-rounded range of objectives such as:
    - Ensuring access to financing for those who cannot get it through commercial banks (Lending may thus be at below market rates)

    - Accumulate capital as part of intergenerational endowment (sounds like an in-built *waqf*?)
- Long-term business horizon vs the 'I'll be gone, you'll be gone' short-termism in commercial banking
- Close relationship with customers (Mutual stake between member and borrower means there is incentive to understand the businesses that the bank is looking to finance)
- Egalitarian features (belief that everyone deserves equal rights and opportunities):
    - 'One person, one vote' rule (means member's influence is not dependent on size of shareholding or savings)
    - Profit payout for deposits is based on profitability of the cooperative and not the local interest rates or members' size of shareholding (sounds like how the 'Islamic' investment account should be remunerated?)
- Profit payout on deposits is capped (because of the capital accumulation feature)

Of course cooperative banks have issues of their own, just like anything in life. To gloss over them would be irresponsible so my next article will address the key issues and then we can start discussing the features of an Islamic cooperative bank. While most of the features are highly compatible with the Shariah, certain modifications are necessary. For example, we cannot charge interest rates, even if they are below market rates, can we? And I would prefer to not cap the profit payout in the spirit of genuine PLS but I also like how a portion of the profits are diverted to the *waqf*-like endowment because we can then provide vital social services such as quality education and medical through the Islamic cooperative bank. The mamak stall owner might be our happy first customer. I can be the advisor/consultant for this new banking model. That will be fun. So send me your comments and questions while I get on with my research and wait for inspiration to write you another article on cooperative banks in Europe.

Suggested readings

Setia, A. (2011). Mu'amala and the revival of the Islamic gift economy. *Islam & Science (17037603)*, *9*(1).
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Fonteyne, W., & Hardy, D. C. (2011). Cooperative banking and ethics: past, present and future. *Ethical perspectives-Katholieke Universiteit Leuven*, *18*(4), 491-514. https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0ahUKEwjTvviHne_SAhUKerwKHTmbBIIQFggbMAA&url=http%3A%2F%2Fwww.ethical-perspectives.be%2Fviewpic.php%3FLAN%3DE%26TABLE%3DEP%26ID%3D1346&usg=AFQjCNFZjr36EVOJgoe3fG66i8TyWAViPA