



## Role of The Islamic Banks in Reducing the Unemployment

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### **Abstract**

Islamic banking is one of the most important sectors that has its role in developing a country's economy. Islamic banks have a significant role in reducing unemployment. There are several contracts and instruments that link Islamic banks with their customers. The contracts that are used by Islamic banks enable customers to be part of the Islamic banking system. Thus, people who deal with Islamic banks can benefit from these banks in different methods. The research questions of this article are what the methods and contracts that are applied by Islamic banks for reducing unemployment are and how these methods are working. In that sense, there are several contracts and transactions that enable customers to be part of the Islamic banks, for example, *Musharakah* transaction and *Mudharabah* transaction. In these transactions, financial providers share both profit and loss with the Islamic banks, which is the main method for Islamic banks to deal with their customers. Islamic banks reduce the unemployment using such transactions. In addition, some other transactions also contribute to mitigating unemployment problems. In such case, Islamic banks should apply all modes of finance, such as *Musharakah*, sell-and-buy- back-transaction, and so on, so that a considerable number of jobs can be created. Moreover, in this paper, the role of Islamic banks in reducing unemployment will be discussed and evaluated.

### **1- Introduction**

The role of the Islamic banks cannot be denied in developing an economic system in any country. As conventional banks, Islamic banks have a crucial role in supporting and improving the financial sector. Recently, the number of Islamic



banks has increased very fast in the world, not only in Muslim countries but also in non-Muslim countries, such as the United Kingdom, for example, Islamic Bank of Britain.<sup>(1)</sup> The number of investors who invest their funds with Islamic banks has increased too. Due to the religious reason, Muslims deal with Islamic banks rather than conventional banks. Thus, Islamic banks have their vital role in reducing unemployment in the world.

There are many ways that can be used by Islamic banks to help investors and depositors to participate in investment with the Islamic banks. Those modes of finances that are currently undertaken by Islamic banks benefit both the bank and their clients and depositors. In that context, the purpose of this paper is to discuss the methods and the role of Islamic banks in reducing unemployment in the world. For the purpose of collecting data, secondary sources will be analyzed in this research to find out the way that Islamic banks follow in reducing unemployment in the society, such as books, journal articles, and websites.

To reduce unemployment, Islamic banks share profits with their depositors and investors in the business and these banks using several transactions and contracts. These contracts and transactions should be analyzed in order to figure out how these contracts work to serve society and how these transactions reduce unemployment. The most famous transactions will be discussed and analyzed in this paper for clarifying the techniques that assist clients to work with the Islamic banks or invest their funds with these banks.

## ***2- Philosophy of The Islamic Banking and how it is different from Conventional Banking System***

Interest is prohibited by the Sharia law according to the Quran and the Sunnah.<sup>(2)</sup> It is not allowed for the individual or companies to deal with any transaction that contains interest.<sup>(3)</sup> On the base of the principle of prohibition of the interest (*riba*), Islamic banks avoid dealing with products which include interest. Therefore,

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<sup>(1)</sup> Abdul Karim Aldohni, 'The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries' (2008) 22 Arab Law Quarterly 181.

<sup>(2)</sup> Practice and traditions of the Prophet Muhammad (peace be upon him).

<sup>(3)</sup> Syed Farhan Shah, Muhammad Wajid Raza, and Malik Rizwan Khurshid, 'Islamic Banking Controversies and Challenges' (2012) 3 Interdisciplinary Journal of Contemporary Research In Business 1019.



Islamic banking called interest free banking system which is the main difference from the conventional banking system. Islamic banking can be defined as follow: "Financial institutions are businesses primarily providing financing and other services, the traffic and circulation of cash payments adjusted with the implementation of Islamic law".<sup>(4)</sup> Islamic banking system is a system that is controlled by the Shariah principles which operate under the principle of Islamic law. The concept of Islamic banking is based on Shariah rules and regulations which basically is different from conventional banking in the way of profit-making and the structure. The Shariah philosophies are those rules and regulations that are derived from Quran, Sunnah, Ijma (Consensus of Muslim Jurist) and other sources of the religion of Islam such as Qyas (Analogy to derive a decision).<sup>(5)</sup> Islamic banking is different from conventional banking as the later one is based on interest while Islamic banking is interest-free<sup>(6)</sup> Thus, riba or interest is the main source of profits for the conventional banks while riba is prohibited by the Islamic banks. Another difference between Islamic banking and conventional banking is that Islamic banks apply profit-and-loss-sharing (PLS) principle<sup>(7)</sup> which allows their customers to be part of the bank. On the other hand, conventional banks do not allow their depositors to be a partner with the banks. In that context, depositors in conventional banks have fixed amount of interest according to their deposit in the bank. However, Islamic banks open ways for their depositors to have opportunities to use their money in any project with the Islamic bank as their partners. Another difference is that Islamic banking takes its law from Quran, sunnah and other sources of the Shariah while conventional banking system applies positive laws which are enacted by the lawmakers. In addition, the concept of the conventional banking system is money versus money on the riba bases and the

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<sup>(4)</sup> 'Definition of Islamic Banking' <<http://islamicbankwiki.blogspot.com/2011/08/definition-islamic-banking.html>> accessed 4 March 2018.

<sup>(5)</sup> Syed Farhan Shah, Muhammad Wajid Raza, and Malik Rizwan Khurshid, 'Islamic Banking Controversies and Challenges' (2012) 3 *Interdisciplinary Journal of Contemporary Research In Business* 1019.

<sup>(6)</sup> Maldives Islamic Bank, 'Difference between Conventional and Islamic banking' <<http://www.mib.com.mv/blog/guide-to-islamic-banking/difference-between-conventional-and-islamic-banking>> accessed 4 March 2018.

<sup>(7)</sup> Habib Ahmed, 'Islamic Banking and *Shari'ah* Compliance: A Product Development Perspective' (2014) 2 *Journal of Islamic Finance* 17.



profit is guaranteed. While in Islamic banking the profit is not guaranteed as the depositors share profit and loss.<sup>(8)</sup>

Furthermore, Islamic banking is different from conventional banking in its structure. In that context, Islamic banks have Sharia supervisory boards for ensuring that all products and transactions are compliant with the Sharia rules.<sup>(9)</sup> On the other hand, conventional banks do not have Shariah supervisory board as they do not apply Shariah rules. The Shariah supervisory board in each Islamic bank contain Sharia experts who have knowledge in Shariah, law and financial transactions. However, most of the Sharia supervisory board's member does not have sufficient knowledge-of financial transactions and commercial law. They only have Shariah background which is not sufficient to enable them in supervising the Islamic banks' operation.

### **3- How Islamic Banks operate**

Islamic banking is a system that works according to the Sharia law. The most important principle of Islamic banking is profit-and-loss sharing (PLS), where customers are part of the bank. Thus, customers share the profit and loss with the Islamic banks according to an agreement between these two parties.

Another principle of the Islamic banking is the prohibition of riba. Islamic banks cannot deal with interest, which is against the Sharia rules. Receiving and paying interest lead to the termination of the transactions. In Islamic banking business, customers can be an employee of the Islamic banks, directly or indirectly. For example, in Musharakah transaction, the depositor directly works with the bank while in Salam transaction, the clients work indirectly with the Islamic bank. In addition, in Mudarabah transaction, customers can invest in the Islamic bank as a financial provider while the Islamic bank works as the manager of the fund. Therefore, Islamic banks have an important role in reducing unemployment. Following are numbers of contracts and transactions that are applied by Islamic banks to assist their clients and to reduce unemployment.

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<sup>(8)</sup>Ali Mushtaq, 'Concept of Islamic Banking and Why Islamic Banking'

<<https://www.linkedin.com/pulse/concept-islamic-banking-why-ali-mushtaq> >accessed 5 March2018.

<sup>(9)</sup> Sheila Nu NuHtay, Zafar Abedeen, and Syed Ahmed Salman, 'Towards Standardization of Shari'ah Screening Norms and Practices' (2013) 2 International Journal of Humanities and Social Science Invention 26.



#### **4- Major Islamic Banking Contracts and Transactions**

There is number of contracts and transactions that are applied by Islamic banks to deal with their customers and these contracts help Islamic banks' clients to invest with the banks. To reduce unemployment, Islamic banks should apply a large number of tools and instruments to assist their customers to be part of these banks.

The most important transactions and tools used by Islamic banks are Musharakah transaction, zero-return loan, sell and buy-back contract, Mudharabah transaction, Istisnaa, and Salam:

Musharakah transaction (partnership): two or more parties provide capital for a business. The parties share profit and the loss according to the percentage of the capital provided in the contract. In such transaction, it is possible that either all parties can manage the business or some parties which provide capital only act as sleeping parties<sup>(10)</sup>.

One way in Musharakah transaction is that the Islamic bank act as a manager of the capital and the customers or capital providers act as sleeping parties. Thus, capital providers share the profit and loss with the Islamic bank. It is noted that capital providers have jobs since they can invest their money with the Islamic bank. Besides managing the fund and the transaction, the Islamic bank shares the capital with their customers. Hence, the Islamic bank acts as a manager and as a capital provider. On the other hand, another way of the Musharakah transaction is that the Islamic bank acts as a fund provider and the customer acts as a fund manager. However, in both ways of Musharakah transaction, the clients participate in the business.<sup>(11)</sup>

1- Zero-return Loan: it is one of the products that are provided by Islamic banks for needy and poor people. According to the zero-return loan, the borrower pays back the Islamic bank only the principal, i.e. without any interest.<sup>(12)</sup> Although it is one of the most important products in Islamic banking most of the Islamic banks do

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<sup>(10)</sup> Md. Abdul Jalil and Muhammad Khalilur Rahman, 'Financial Transactions in Islamic Banking are Viable Alternatives to the Conventional Banking Transactions' (2010) 1 International Journal of Business and Social Science 225.

<sup>(11)</sup> Institute of Islamic Banking and Insurance, 'Musharakah on Sharia Ruling' <[http://www.islamic-banking.com/Musharakah\\_sruling.aspx](http://www.islamic-banking.com/Musharakah_sruling.aspx)> accessed 5 March 2018.

<sup>(12)</sup> Abdus Samad, Norman D. Gardner, and Bradley J. Cook, 'Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain' 76



not apply it in practice.<sup>(13)</sup> It is applied in some countries such as Malaysia and Bahrain. The extent of participation in zero- return loan was considered and found to be 8.09% in Malaysia and 0.08% in Bahrain.<sup>(14)</sup> In this mode of finance, the Islamic bank provides a free-return loan to the client or someone who has a project. In that case, the project owner gets benefit from this zero-return loan and at the same time numbers of workers can work in this project, i.e. they find a job. Thus, through a zero-return loan, Islamic banks can reduce the unemployment. This type of product is not applied widely by Islamic banks in the world in practice. It just remains as a theory. However, the zero-return loan is one of the most beneficial types of tools that should be used in practice for reducing unemployment.

2- Sale and Buy-Back Contract: it is a contract between two parties with a promise to sell and buy back in a future. The sale-and-buy-back agreement is a mode of finance that is applied by Islamic banks to help their clients to get some money. There should be an agreement between the Islamic bank and its client that specifies the price and the date. In addition, the tenor must not exceed one year and there should be two different contracts between the parties, i.e. the bank and the clients. Furthermore, the ownership of the property shall be transferred from the seller to the Islamic bank.<sup>(15)</sup> In sell-and-buy-back contract, the Islamic bank purchase a property from the customer which is the seller and pays the seller immediately. Then the Islamic bank resells the property to the customer at a higher price, but the customer makes the payment to the bank in installments.

It is noted that through the sell-and-buy-back contract, the clients can earn some cash from the Islamic bank and can use the money for a small business or a project. In that case, the Islamic banks have an important role in reducing unemployment. This type of contract is used widely in Malaysia as it is one of the countries that has developed Islamic banking system. Although, there are some arguments among

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<sup>(13)</sup> Due to the reason that Islamic banks do not earn any profit from zero- return loan contracts, most of the banks do not make this type of contract. Therefore, zero- return loan contract remain in theory rather than practice.

<sup>(14)</sup> *Abdus Samad, Norman D. Gardner, and Bradley J. Cook, 'Islamic Banking and Finance in Theory and Practice: The Experience of Malaysia and Bahrain' 79*

<sup>(15)</sup> Bank Muamalat, Deposit, sale and buy back agreement, <  
<http://www.muamalat.com.my/business-banking/treasury-and-capital-markets/deposit/sale-buy-back-agreement.html>> accessed February 2018.



scholars regarding whether the sell-and-buy-back contract is acceptable or not under the Shariah law, this contract is allowed by the central bank of Malaysia to be practiced by Islamic banks in that country.

3- Mudharabah transaction (profit sharing): it is another transaction that is used by Islamic banks to assist their customers to participate in the business. In Mudharabah transaction one person, which is called the capital provider, provides the fund while another which is called the entrepreneur, manages the fund. Hence, the profits are shared between the parties according to their capital and the loss is shared between the parties according to a ratio.<sup>(16)</sup> In the case of Islamic banking there are two ways of using Mudharabah transaction as a tool of finance. First, the Islamic bank acts as the entrepreneur and the customer acts as the capital provider. Second, when the Islamic bank acts as a capital provider, the customer uses the capital for commercial purposes. Thus, the profits will be divided at a specified ratio between the bank and the customer according to the contract that they agree on.<sup>(17)</sup> In that context, Islamic banks reduce unemployment by enabling their customers and capital providers to participate in the business. In the second type of Mudharabah, the Islamic bank provides funds to their customers for making projects so that numbers of jobs are created for people in that project and as a result, the Islamic bank assists in reducing unemployment.

4- Istisnaa (Partnership in Manufacturing): it is one of the contracts that is applied by the Islamic banks to help their clients. The parties of the partnership in manufacturing contract are the bank and the factory. According to this type of contract, one party purchases the resources while the other undertakes the role of manufacturing the goods in accordance with their contract. Hence, Islamic banks use the partnership in manufacturing contract for financing constructions and

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<sup>(16)</sup> Md. Abdul Jalil and Muhammad Khalilur Rahman, 'Financial Transactions in Islamic Banking are Viable Alternatives to the Conventional Banking Transactions' (2010) 1 International Journal of Business and Social Science 225.

<sup>(17)</sup> Ramin Cooper Maysami, 'Islamic Banking and the Conduct of Monetary Policy' (Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University. 1999. P47).



manufacturing projects.<sup>(18)</sup> The partnership in manufacturing contracts come into existence when a manufacturer builds an asset at the request of a buyer. The contract should contain full details of the agreement between the parties, such as the price of the asset to be manufactured. The buyer has the right to revoke the contract at the time of delivery if the asset does not conform to the specifications or is incompatible with what has been agreed upon in the contract. The schedule and method of payment of the partnership in manufacturing transactions are flexible; the parties have the right to mutually agree on the payment type. It is not necessary for the price to be paid in advance or at the time of delivery, and it is possible for payment to be made by installments according to the agreement between the customer and the manufacturer.<sup>(19)</sup> It is noted that the Islamic banks can support people financially via the partnership in manufacturing contract to provide funds to their clients and create jobs for jobless people.

5- Salam Transaction (trust sale): it is an advanced payment for the delivery of goods at a future time as arranged through the agreement between the seller and buyer. *Salam* is used particularly to finance the agricultural needs of farmers. In practice, farmers sell their crops before harvest to the purchaser in order to be able to buy the necessary seeds and fertilizers.<sup>(20)</sup> The nature of the *Salam* contract is unique and different from other contracts as it is used for perishable goods. According to the *Salam* contract, the price should be paid in full when drafting the contract with specifications of the subject matter in terms of quality and quantity. In addition, the exact time and place of delivery of the goods should also be clearly stated in the contract.<sup>(21)</sup>

In practice, Salam is applied by Islamic banks to provide funds for farmers. The Islamic bank pays the farmers before the delivery of the goods and the farmers can use the fund for immediate needs. The farmers also agree to deliver the crops to the

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<sup>(18)</sup> Abbas Mirakhor and Iqbal Zaidi, 'Profit-and-loss sharing contracts in Islamic finance' in M Kabir Hassan and Mervyn K Lewis (eds), *Handbook of Islamic Banking* (1<sup>st</sup> edn, Edward Elgar 2007) 52.

<sup>(19)</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2<sup>nd</sup> edn, John Wiley & Sons (Asia) 2011) 82.

<sup>(20)</sup> Muhammad Hanif, 'Differences and Similarities in Islamic and Conventional Banking' (2011) 2 International Journal of Business and Social Sciences 27.

<sup>(21)</sup> M Iqbal and P Molyneux, *Thirty years of Islamic Banking: History, Performance and Prospects* (1<sup>st</sup> edn, Palgrave Macmillan 2005) 25.





bank on a specifically agreed date. Thus, through this type of contract, Islamic banks provide jobs for farmers and those people who work with these farmers.

### **5- Role of Islamic Banks in Creating Jobs**

The most important purpose of establishing the Islamic banks is to serve the society. Islamic bankers should believe that they have rewards from Allah first and then benefit from their business. In that context, Islamic banks use numerous transactions to deal their customers and their depositors in the banking business, such as zero-return loan and Mudarabah. For example, when a person has a business idea or a project but does not have sufficient fund to support his project, the Islamic bank can be a financial provider without receiving or paying interest or riba. Hence, the Islamic bank makes an agreement with the client so that it can participate in the project. The bank offers fund for the project and the client can run the project or the business.

In practice, Islamic banks can be the partners with their clients and their investors. In some transactions, both the Islamic bank and the depositor provide funds such as Musharakah transaction, while in some other projects the Islamic bank provides the fund and the customer works as a fund manager as can be seen in Mudarabah transaction. In all cases, Islamic banks have their crucial role in providing funds to their clients and participate in developing a country's economic system. Thus, Islamic banks have an important role in reducing unemployment and creating jobs by supporting small and medium projects.<sup>(22)</sup>

Another transaction that is applied by Islamic banks to serve the society and provide jobs for people is the zero-return loan. According to this contract, the Islamic bank gives a loan on the base of the zero-return loan to the client or needy person who has a project but does not have sufficient money. Consequently, the client uses this fund for his project or business. The project owner and workers who work on this project can have their jobs. At the end of the project, the client or the project owner returns the money to the Islamic bank without paying any interest.

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<sup>(22)</sup> Islamic banks support medium or small projects rather than big projects, in order to help large number of projects and customers.



## 6- Conclusion

The role of the Islamic banks in reducing unemployment is very important in the financial industry. There are many methods and contracts that are applied by the Islamic banks to assist their depositors or clients to have their own income. For instance, partnership in manufacturing, Mudarabah, Salam are the most popular contracts that are used by Islamic banks to provide funds to their clients. In addition, there are opportunities for investors to invest their money with Islamic banks according to the aforementioned contracts. Thus, both Islamic banks and their depositors have opportunities to benefit from such transactions. Profit-and-loss-sharing is the fundamental principle for the Islamic banking. In this context, the investor shall share in both loss and profit in order to avoid interest. Interest-free is the main principle of the Islamic banking which is different from the conventional banking system. As in the conventional banking, the clients get profit on the interest bases which is prohibited under Sharia law system. Therefore, the conventional banking system cannot reduce unemployment as Islamic banks.

In theory, there are several transactions and contracts available for the Islamic banks to help their clients participate in banking operations and create new jobs for the customers. Nevertheless, in practice, few of these contracts are applied by Islamic banks due to the lack of protection law. Though, Islamic banks still work closely with their customer to create new jobs for them. If all existing Islamic banking products are applied by Islamic banks, the number of jobs for the customers will be increased. However, due to the lack of trust between Islamic banks and their clients, few transactions and products are applied by Islamic banks. Nonetheless, in general, Islamic banks still have an important role in reducing unemployment in the society.

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