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THE EVOLUTION OF ISLAMIC INDUSTRIAL FINANCING:
CONSTRAINTS, POTENTIALITIES AND PROSPECTS FOR INDUSTRIAL DEVELOPMENT*

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Workshop on Industrial Financing Activities of Islamic Banks

The Evolution of Islamic Industrial Financing: Constraints, Potentialities and Prospects for Industrial Development.

Let us begin by posing the question: -Why industrial financing?- and consider the following reasons:

1. Industrial activity is likely to generate greater real value added per unit of finance.

2. Industry tends to employ more workers per unit of investment and thus spreads the fruits of development more widely.

3. Industry enhances the productive capacity of a country more than trading and property.

4. Industry generates more beneficial spin-offs (the so-called externalities) in the form of skills, technological progress, innovation, social cohesion, etc.

5. Industry helps develop other sectors in the economy directly as when industry processes raw materials, when industry demands commercial and other services, and indirectly through its spinoffs and external economies.

6. Where capital markets are underdeveloped as in most developing countries, industry tends to suffer most from lack of financing. The demand for industrial financing is thus considerable and can be profitable for investors provided risks are not grossly misjudged or miscalculated.

7. If Islamic financing continues to be concentrated in non-industrial activities, its beneficiaries would be a small segment of the population, and sooner or later it would run out of profit-making opportunities. It would also be mostly in direct competition with existing conventional financing, which is likely to be more established in trading and property development. Thus the profits in trading and property made by new Islamic financing would be to a greater degree a transfer from existing profit-makers rather than a generation of new profits and social value.

But it is not tenable to assume that financing commercial activity is of little importance. Historically, sustained industrial development has been preceded by considerable commercial sophistication. However, in many parts of the Muslim world through the centuries, quite advanced commercial financing and mercantile activity failed to spill over effectively into finance for industry, which frequently stagnated in traditional forms of handicrafts and artisans' workshops. The failure to develop finance for industry may be seen as a decisive factor in accounting for economic stagnation and decay in much of the third world. Compared to the progress of the industrial revolution in Europe and later Japan. Werever advanced mercantile financing and development in the Muslim world stopped short of moving into industrial development, sooner or later this set a limit to its further expansion and competitiveness vis-à-vis European mercantile organisations.

Thus it is not industrial financing or nothing. In effect, initialy , a new financing institution would normally find it easier to move into commerce and property, rather than industry. The reasons are obvious:

a) The risk and uncertainities may not be as great compared to industry.

b) Risk-evaluation skills are easier to develop.

c) A greater proportion of finance tends to be secured credit, advanced against the security of commodities or bricks-and-mortar.

d) Industrial financing,on the other hand, often entails a greater element of unsecured credit which requires evaluation of the viability of more complex production systems.

e) And above all for a new financier in commerce, finance is recoverable within months, in property within several years, but appreciably longer in industry.

It must be remembered, however, that a great deal of finance for industry, as in the form of leasing and financing working capital, is very similar to other forms of financing commerce. Moreover, industrial financing may also include activities which are part of agricultural production (e.g. plantations) as well as industrial activities which are based on farm production.

These qualifications apart, we are now beginning to consider the constraints and potentialities of Islamic industrial financing in relation to a kind of evolutionary process through which Islamic financing institutions may pass. We should identify the main stages in this hypothesised process.

The Main Stages:

1. The High-Mortality (or Abortive) Stage: is characterised by attempts to set up Islamic banks in isolated situations. These are sporadic, few and far between. Their chances of survival, let alone growth, are constrained by lack of a supportive Islamic credit system and by lack of operational skills. Their failure or death may have still bestowed benefits of experience to their successors.

2. The Self-Justification Stage: the Islamic banks which have been resilient enough to survive, may still encounter suspicion and disbelief that they can trive and prosper without interest-based operations. They are bound to seek the best risks and the shortest gestation periods. They are still constrained by lack of a supportive Islamic financing system and by shortages of trained personnel, especially in risk analysis and evaluation. The absence of appropriate domestic banking and monetary policies may impinge on them unfavourably. And so does international banking practice and exchange risk exposure. This is perhaps the phase when they need to (but they do not) develop links and appropriate co-operation between them, and begin to learn how to tap and effectively use domestic and international sources of expertise and technical assistance.

3. The Limiting/Transitional Stage: is characterised by decisions concerning whether to venture into industrial financing. One may identify three alternative strategies or types of response:

(A) The Islamic bank shies away from this field altogether, and thus ultimately limits its capability to optimise returns to savers' resources; consequently its access to further savings is limited, and so is its base of operations. This is the industry-shy financier who foregoes opportunities in industry and abdicates responsibility for industrial development. If others venture and succeed, he will probably be eclipsed or competed away.

(B) The Islamic bank rushes into industrial financing inadequately supported by the essential expertise, and thus aborts the development of a capability in industrial financing, and may even jeopardise its own viability as an institution. This is the example of the reckless or naive industrial financier.

(C) The third is the example of the judicious financiers who venture into selective industrial financing, appropriately supported by expertise. They systematically build up an expanding capability in this field, thus enlarging the scope for further access to savings which are directly attracted by demonstrated success in achieving optimum returns from financing industry, as well as other sectors. The experience and contacts gained in industry open up new opportunities in other fields of financing. The cliché "nothing succeeds like success" may sum up this achievement.

Thus the transitional/limiting stage is a crucial one, and may lead to a passive, negative or positive outcome. It is naturally difficult to ascertain in advance how long it would take to achieve a turning point. But is should not be too difficult for the appropriate expert. upon closely examining the Islamic bank's technical resources and risk portfolio, to forecast the consequences of branching out into industrial financing. The main constraint in this stage is again the know-how available to the financier, and his capability to use effectively outside expertise. The danger is to be unaware of the uniqueness of the technical resources essential for industrial development financing as distinct from other conventional sectors. The financier has to see his role as a developer of industrial entrepreneurship and management, as a co-ordinator of numerous forms of technical assistance to the firms invested in, and not simply as a provider of secured credit. (All this is quite consistent with Islamic precepts of finance.) But no financier can effectively ensure crucial technical assistance to different types of industry without judicious use of outside expertise. Such expertise is usually international, and typically in short supply.

The Fourth Stage: May be identified as one of viable diversification, but with a degree of specialisation in a set of industries, a group of countries, and perhaps several international and regional financial markets. The Islamic bank's financial instruments attain a degree of international marketability. The bank itself becomes a valued source of international expertise in its areas of specialisation.

The purpose of putting forward the above four stages of evolution is not to claim a deterministic or inevitable sequence of events, but rather to suggest insights into organisational developments essential for removing constraints and exploiting potentialities. In particular, the dynamics and implications of the transitional/limiting stage need to be investigated, since this is the phase which makes or breaks.

When we come to consider prospect of industrial development based on Islamic financing, it is clear that the current stage of development of Islamic banks is decisively relevant. Prospects need to be distinguished from potentialities. It is the industrial financing institutions which act as catalysts and translate potentialities into prospects.

The potentialities for industrial development in the Muslim world are considerable and may be indicated by the extent of mobiliseable savings and the potential demand for industrial finance. The potentialities of Islamically inclined savings have been recognised. The prospects of motivating and tapping such savings for industrial development depend primarily on the evolutionary stage reached by existing Islamic banks, and the awareness and vision of the leaders in the Islamic finance movement. The challenges are enormous and we need to ascertain how these challenges are perceived in Islamic banking circles.

There is little evidence yet of systematic action on the part of individual Islamic banks to forge links between them, to form effective associations which may help organize productive areas of co-operation. Nor is there much evidence yet of awareness of the need for technical assistance.

The holding of this UNIDO workshop on the industrial financing activities of Islamic banks may be a spark and a step in the right direction. In assessing the prospects, one can easily be unduly influenced by one's assumptions and prejudices (misinformation) as well be dispelled by professional exchanges in this UNIDO Workshop. If the demands for technical services are correctly identified, this in itself may be no mean achievement.

This paper has been deliberately assertive, with minimum mention of qualifications and exceptions, in order to stimulate discussions in the Workshop.

To recapitulate, we have drawn the following distinctions and comparisons:

1. The real economic/social benefits of industry compared to trading and property development.

2. Mercantile finance and organisations historically failing to extend into industry in the Muslim world (and the third world generally) as compared to Europe and Japan.

3. A comparison of the reasons why finance tends to flow more easily into trade and property rather than industry.

4. The distinction between secured and unsecured credit.

5. The distinction of the "depth" of technical resources and expertise essential for developing an industrial financing capability.

6. The three types of strategy/response to financing industry on the part of Islamic financiers; a) the industry-shy financier; b) the reckless/naive industrial financier; and c) the prudent industrial financier.

7. The distinction of Islamic banks according to their evolutionary stages: i) the high-mortality stage; ii) the self-justification stage; iii) the transitional/limiting stage; and iv) the viable diversification stage.

8) We have drawn attention to the importance of becoming aware of the dynamics and implications of the transitional/limiting stage.

But we have left out of the paper a great many other factors of importance relating, among other things, to the development of particularly Islamic financing techniques and instruments, the influences of the business and political environments in which Islamic banks operate, the regulation of Islamic banking practices, and the role and activities of the Islamic Development Bank, which is a case study in its own right.