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PROFIT AND LOSS SHARING AS AN OFFSHOOT FOR BANK STABILITY: A COMPARATIVE ANALYSIS

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ABSTRACT

The global crisis in 2007 has revived interest in the Islamic banking and finance industry. The profit and loss sharing (mudaraba and musharaka) attributes of Islamic banking and finance have shielded Islamic banks from the impact of a crisis. In other words, the Islamic banking system is stable by virtue of the profit and loss sharing principle. The relative stability of the Islamic banking model can also be deduced from the fact that the Islamic banking and finance system is effectively under the control of the authority of the central bank, which is not easily influenced by non-policy factors. This study concludes that a case for the superiority of Islamic banking has been made for example in Tunisia and Iran, where separate Islamic or interest-free counters were opened in all branches of commercial banks along with traditional or westernised interest-based banks. The substitution of western interest-bearing deposits by profit and loss sharing deposits connotes to the stability of the Islamic finance and banking system. The Islamic profit and loss sharing system does have merit and deserves attention from academics and policy-makers alike, especially in view of the financial crises and rampant bank failures.

Keywords: Bank stability, Mudaraba, Musharaka, Interest-based banks, Interest-free counters, Islamic finance and banking law, Financial crises, Superiority.

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Contribution/ Originality:

This study contributes in the existing literature on the Islamic finance and banking law and the traditional or westernised interest-based banking system. This study documents that a case for the superiority of Islamic finance and banking has been made for example in Tunisia and Iran.

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1. INTRODUCTION

What do we mean by financial stability? The important criteria are not the number of bank failures *per se*, but the degree to which liquidity and solvency crisis would reverberate beyond the respective individual institutions. This paper serves as an outcry for the questions as to what should be done, or what can be done to ensure stability? The main problem is that financial instability does not always come in small and medium sizes. Sometimes it arrives in large or giant economy-size packages and we cannot be sure that we are always prepared to deal with that. When a bank is finally driven to the wall, it can financially strap a good many of its trusted customers and it can drag a succession of not so strong neighboring financial institutions along with it Hollard Robert (1985).

No failure is acceptable. Financial stability comes down to no failures. In the words of Flannery it is alleged that financial stability is equivalent to bank stability (Flannery, 1985).

Bank failures result in unnecessary liquidation costs or disruption in productive technology. It imposes a cost on the economy and disrupting the payment system.

1.1. An Overview of the Islamic Economic System *versus* the Conventional Model

Under capitalism, if a loan is not paid on time, a penalty is levied to the extent that the borrower could end up paying double the principal. If there is a delay in payment, a penalty could easily be equivalent to the principal. Such severe and grossly exaggerated charges proved to be a clear case of exploitation and usury (Swartz, 2010).

The hoarding of wealth under a capitalistic system will stop the circulation of money and therefore creates imbalances in its distribution. The practice of hoarding wealth and its investments in usurious bank accounts, lie at the root of capitalism. Islam disproves of hoarding of surplus wealth. The capitalist believes that spending impoverishes him, while Islam economic and business values inculcate the belief that spending promotes individual and social prosperity. It is obvious that Islamic economic and business values present an antithesis to capitalism. It believes that the hoarding of wealth and lending on interest concentrate in the hands of a few individuals. The result is that the purchasing power of the masses declines daily, and that industry, trade and agriculture will eventually fall into a state of depression. It is thus evident that the national economy will reach a breaking point and finally all avenues of productive investment of hoarded wealth are closed to the capitalist themselves.

Islamic economic and business values condemn particularly the injustice of a lender being guaranteed of a positive return without assuming a share of risk with the borrower. Interest charges render the full adjustment of loans almost impossible and the poor person continues taking one loan after the other to get out of the vicious circle without any success. Although, he/she has already paid much more than the original (capital) amount, the outstanding amount continues to rise due to the application of interest charges. The result will be that the payment of installments of loans, reduce a substantial portion of their income and the miserable persons

(debtors) are unable to meet even their basic needs and that of their families (Swartz, 2010). This ethical principle of Islam evokes respect from Muslim and non-Muslim alike.

The Islamic economic and business value system redistributes the consequences of uncertainty over all parties to a business. Debt-financing of the conventional system, in contrast, relieves the financier from uncertainty by shifting it on the real investor (equity holder) who then alone bears the entire risk of the enterprise. I believe that the Islamic or interest-free financing, by spreading the same risk over more heads, would promote stability.

Islamic banking is also moving into an increasing number of conventional financial systems. It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom or Japan. Over the last decade, this industry has experienced growth rates of 10-15 percent per annum. Despite this rapid expansion Islam is still an uncharted territory for most practitioners and policy-makers (Solė, 2007).

Scholars like Karim and Amal El-Tigani (1989) Ali align profit and loss sharing with interest-free banking which denounced a guaranteed pre-determined rate of return. The depositor shares in the profits made by the bank as well as in the losses incurred by it.

1.2. An Adumbration or Harbinger of what Profit and Loss Sharing is

Mudaraba is a transaction used mainly to finance projects deemed eligible for financing. The bank offers the whole capital whereas the client offers labor, time and effort. Since the bank and the customer are partners, they share benefits of the project equally. In the event of incurring loss, the bank assumes the loss of capital. Under mudaraba the partner to the business owns his/her share in the profits. If he/she evokes the co-operation of capital owner(s) in the business venture, he/she must also share in the losses incurred at the time of the contracting of the mudaraba agreement (Siddiqi, 1985). A musharaka contract serves as a financing tool for shareholders and other parties involved. It aims to protect shareholders and their investment. Under musharaka the partners may choose and negotiate on opting to limited liability or unlimited liability. No partner is liable for the partners' financial liability unless permission for that responsibility is given by the other partners on behalf of the partnership. This in my view is the advantage of applying musharaka in venture capital and private equity funding whereby the flexibility of Islamic law gives partners the option to choose and negotiate on opting to limited liability or unlimited liability.

According to Ismael and Achmad (2010) Tohirin these two financial tools relies on a spirit of co-operation (2010). The Islamic economy and finance and business values have contrived these financial instruments in order to exclude the need for western-interest loan arrangements. The Islamic economic system denounces, on the one hand, the western entrepreneurs' primary concern for profit maximization and, on the other hand, extolls the Muslim entrepreneur's pursuance of religious and societal goals in their business practice. As a result of this stratagem of proponents of the Islamic finance and banking system refutes debt financing arrangements.

Under a debt arrangement, when the venture does well, the lender only receives the fixed interest payment. Thus lenders are only motivated to finance projects of lower risk in order to ensure their repayment. On the other hand, if the venture goes poorly, the entrepreneur is still obliged to pay the fixed debt payment. Thus, the entrepreneur is often motivated to engage in riskier projects in order to maximize his profits and to ensure debt repayment (Hassan and Hippler, 2014).

I am convinced that the debt-driven moves are the result of inadequate market discipline due to the absence of risk-sharing instruments. This has leaded to the financial crisis in 2007, which caused western banks to have been bailed out of three to four trillion dollars by the US, UK, Europe and a number of other countries. Islamic banks have lower credit and liquidity risk than their western/conventional counterpart. Its profit and loss-sharing financial instruments (mudaraba and musharaka) are structured to produce a profit instead of a fixed return (on investments) (Swartz, 2013). These profit and loss-sharing instruments whereby the financier and the borrower share in the profits as well as the associative risks ensure that no partner to a business venture can be exploited. These sentiments can reverberate in the banking and finance corridors of the business and industrial world.

2. RESEARCH PROBLEM

The recent global crisis has renewed the focus specifically on the resilience of the Islamic banking industry during that crisis. The profit and loss sharing (*mudaraba* and *musharaka*) arrangements or instruments of Islamic banking and finance have shielded Islamic banking from the impact of the global financial crisis (Hasan and Dridi, 2010). Comparing the performance of Islamic banks to conventional banks would suggest (as will be articulated in the study) that Islamic banks performed better than conventional banks given the large losses incurred by the latter in Europe and the United States because of the crisis. However, such a comparison would not lead to reliable conclusions about financial stability. For example, this comparison might not reflect the moderate impact of the crisis on the countries of the Gulf Co-operation Council (GCC) and Jordan. The paper therefore reveals a rather parochial nature regarding to comparison and thus appeal to researchers in the field to explore a more holistic assessment to the global financial crisis.

Two questions need to be addressed, for example, have Islamic Banks fared differently than Conventional Banks during the financial crisis and what challenges have the crisis highlighted as facing Islamic Bank's going forward. To answer these questions, this study focuses on the performance of the two groups of banks in respect of regulatory frameworks, shocks and policy responses. The paper also examines variables to explain the performances of the banks included in the sample.

The conclusions of this research are based on purely theoretical grounds and are therefore void of any empirical substantiation. Darrat (1988) suggests that empirical evidence generated

from actual data (theoretical grounds) may be the only way to resolve the issue for the claim of the stability of Islamic interest-free banking. I fathom that the Islamic system is rather stable by virtue of the profit and loss sharing principle.

I primarily based this study on the work(s) of Darrat (1988), but the insight of other authors also plays a very important role in reaching the research result and conclusion. A case study of Tunisia is made in Tunisia in order to reflect on the financial stability of Islamic banks in contradistinction to western/conventional banks. It is recorded in literature that Tunisia presents a good case to test the hypothesis at hand, because the Tunisian government, although Islamic in orientation, has not announced any plans towards Islamizing its financial system. It would therefore be interesting to see whether such a move on the part of the Tunisian government would be beneficial from a purely economic standpoint. I will thus examine whether the absence of profit and loss sharing principle from the Tunisian economy would enhance (or hamper) the stability of her financial system.

3. METHODOLOGY

The historical records of interest and non-interest transactions in, for example, the Tunisian economy over the past 25 years (1960-1984) is going to be examined. We shall estimate the public's demand for interest- and non-interest-bearing financial transactions in order to reflect on the structural stability of their functions. As mentioned earlier, the non-interest component, however, has a penchant for profit and loss sharing transactions.

With regard to the testing of the stability characteristics of banks, the Fisherian equation of exchange has been deployed: MV=Y. This equation connotes to the following explication: If V is temporarily stable and if M is under the control of the monetary authorities then policy actions become very effective in controlling aggregate economic activity. The inverse to this equation will trigger economic mayhem. An unstable pace could lead to overall financial and economic instability. The pace of a money transaction is defined as V=Y/M. This equation is applied to the behavior of the pace of interest- and non-interest-bearing money supply in Tunisia over the period 1960-1984. Almost all of the demand deposits in Tunisia are non-interest bearing (MNI) (profit and loss sharing nature), while interest- bearing money (MI) is defined as the public's time and savings deposits at commercial banks (Darrat, 1988).

From the period 1960-1984 in Tunisia, the pace of interest-bearing money (VMI) has undergone a dramatic change over the years. It fell from 83.50 percent in 1960 to 6.50 percent in 1984. The year-to-year change in VMI shows a standard deviation of 17.41 percent. In terms of change (growth rate), the VMI has been declining by about 11 percent per year, with an annual fluctuation in these changes of more than 15 percent.

The behavior of non-interest pace of money (VMNI) appears to have been very smooth and stable. The VMNI appears to be almost constant. It ranges from 5.05 percent for 1965 to 3.25 percent for 1983. The year-to-year change in the level of VMNI is very small with a standard

deviation of only 0.19 percent. The annual percentage change in VMNI is also negligible with a standard deviation of only 5.1 percent. It is evident that the pace of non-interest-bearing money (Islamic banks) (under the hegemony of profit and loss sharing) is much smoother and more stable than that of interest-bearing money (western/conventional banks).

A second empirical method data over the period 1960-1984 in Tunisia (the historical dimension) had also been utilized by Farley and Hinich (1970) to test for structural stability.

The results of both testing (the Fisherian equation and the Chow/Farley-Hinich techniques) emphasize that the public's demand for non-interest-bearing assets is structurally stable over time, but the public's demand for interest-bearing assets suffers from structural instability over time. Such a finding renders the presence of interest-bearing monetary assets a potential nuisance. In contrast to interest-bearing monetary assets, non-interest-bearing monetary assets exhibit a well-behaving pace and demand a structurally stable public relationship.

From the standpoint of the Fisherian and the Chow/Farley-Hinich measures, the Islamic interest-free (profit and loss sharing) system does have merit and deserves more serious attention from academics and policy makers alike, especially in view of recent financial crises and rampant bank failures.

Earlier in this research it has been adumbrated that Islamic banking systems may be more stable than Western conventional systems. This contention, however, applies for the case of Tunisia, a country with no significant history of Islamic banking. What would be the position in the case of, for example, Iran, a country with some history of Islamic banking?

The advocates of Islamic banking claim that the Islamic banking system is superior to the conventional (western) banking system (Abizadeh and Ken, 1997). The studies of these advocates/scholars are rather theoretical and their claim of stability requires empirical verification. Only a single study by one of these scholars/advocates (Darrat, 1988) is not enough to empirically verify the superiority of Islamic banking. The objective of this study is to postulate the relative stability of Islamic banking or any banking sector. The study seems to be rather parochial in reflecting on only a summary of the contentions of scholars like Mahmood Yousefi *et al.* The latter, in their test for the structural stability hypothesis, also utilized the Chow test.

It is alleged by Mahmood Yousefi *et al* and Darrat that the Islamic system yields stability (Yousefi, 1997). They also admit that the relative stability of the Islamic model can be deduced not only form its profit and loss sharing structure, but also from the fact that the Islamic system is effectively under the control of the authority (central bank) and is not easily influenced by non-policy factors. Waqar Khan concurs with the abovementioned scholars that the more effective the methods of monitoring, the more superior the Islamic financial system would prove to be in practice (Khan, 1989). Monitoring, however, has also its disadvantages for investors and bankers of both Islamic and western banks.

In order to demonstrate the relative stability of Islamic banking, a researcher would need either: (a) to compare the stability of an alternative banking system in different countries, or (b)

the stability of alternative banking systems in the same country. The latter requirement has been chosen and Iran was selected as the object of analysis (Yousefi, 1997). The results of the Iranian case proved positive and hence confirmed Darrat's conclusion or notion that the Islamic model is relative stable in contrast to the conventional interest-bearing system.

A case for the superiority of Islamic banking has been made in Tunisia and Iran (the former country has no or rather a poor history of Islamic banking, while the latter practice Islamic banking). The fact that the stability of the Islamic system could be affirmed by both countries is conclusive evidence of its stability status.

Khan (1990) agrees with Darrat by using a fairly robust technique to establish the stability of interest-free money (Islamic banks). Khan singles out Pakistan as his experimental subject. Two time frames (*e.g.* 1959-60 and 1986-87) are postulated, but we will rather use the periods from 1980-82

Khan asserts that separate interest-free counters were opened in all branches of the commercial banks along with the traditional interest-based counters. The public response to the profit and loss or interest-free system was overwhelming. Khan alludes that on the first day of the PLS deposit schemes, commercial banks received Rs 92.7 million in the PLS account. The growth of the PLS deposits has been impressive, so that by the end of fiscal year 1983-84 it stood at Rs 20.738 million which was 17.8 percent of total deposits. Khan believes the impressive growth in PLS deposits in a short interval of time may have been caused by the substitution of interest-bearing deposits by PLS deposits. The contribution of interest-bearing deposits fell from 58.2 percent in 1980-81 to 24.4 percent in 1981-82, while the contribution of interest-free deposits remained the same. Khan emphasizes therefore the stability of the profit and loss or Islamic finance and banking methods.

But Khan's study on how Islamic banks in Malaysia performed in liquidity, profitability and solvency is far from satisfactory. Issues such as profitability, liquidity, risk and solvency are important to depositors and investors. Samad & Hassan contend that in Islam, business is an *Ibadah* (worship) and from a business point of view, Islamic banks are not only a firm but also a moral trustee of the depositors. As a custodian for the depositor's deposits, Islamic banks are likely to be more liquid and solvent compared to interest-bearing conventional banks (Samad and Hassan, 1984-1997). Samad & Hassan also state that interest-free products such as *mudarabah* (trust profit sharing) and *musharakah* (joint venture profit sharing) are likely to increase over the years. Projects undertaken under *mudarabah* and *musharakah* are constantly supervised and monitored by Islamic banks. The chances of failures in Islamic banks are therefore minimized (Samad and Hassan, 1984-1997). An analysis of empirical results by Salam & Hassan, read as follows: the reason for low risk of Islamic banks is that its investments in government securities are much larger than the conventional banks, and Islamic banks have more equity capital compared to assets. Larger equity capital indicates a higher shock absorbing capacity for the Islamic bank. By comparing interest-free Islamic banks with interest-bearing conventional banks,

Islamic banks appear to be more liquid and are thus less risky and more solvent (Samad and Hassan, 1984-1997).

Cases of superiority and or stability of Islamic banking and finance have been made by Ashfaque Khan in Pakistan and by Samad & Hassan in Malaysia.

3.1. Profit and Loss Sharing – An Adumbration

The central tenet of an Islamic financial system is the prohibition of interest. As a result thereof, Islam encourages trade, which connotes to the permission of profit. In order to facilitate trade transactions, Islamic law has developed specific forms of financial arrangements which are called *mudaraba* and *musharaka* – two of the most prominent banking and finance structures which serve as offshoot for profit and loss sharing. These two financial instruments provide principal means of earning profit without Islamic banks resort to the charging of interest. In *mudaraba*, one party (the bank) provides the necessary financial capital and the other (the agent-entrepreneur) the human capital needed for performance of the economic activity undertaken. The resulting profit is then shared between the parties in accordance with a sharing rule specified beforehand. The depositor would be treated as if he were a shareholder in the bank and therefore entitled to share of the profits made by the bank. If the bank's operations resulted in an overall loss, such losses would also be shared by the depositor (and the bank) (Khan and Mirakhor, 1987). On the other hand, it must be stated that the nominal value of investment deposits is not guaranteed and will fluctuate according to the performance of the bank. It is alleged by Khan & Mirakhor that the Islamic system with its profit and loss sharing attributes can respond more easily and rapidly in the face of a banking crisis. If a shock can cause a divergence between the real value of assets and liabilities, than a bank which cannot absorb losses through its reserves and borrowings, may well result in instability and possible collapse (Khan and Mirakhor, 1987). *Musharaka*, on the other hand, is a form of business arrangement in which a number of partners pool their financial resources to undertaken a commercial-industrial enterprise and share in the resulting profits (or losses) corresponding to their share in the financial capital of the enterprise. Overall, the use of profit and loss sharing arrangement in the place of interest makes commercial banks in an Islamic economy more akin to investment banking. The Islamic financial system therefore replaces debt financing by equity financing which are a direct function of profits (Khan and Mirakhor, 1987).

Unlike as in the Islamic profit and loss sharing system, the nominal value of deposits, in the western model, is pre-determined in the short run, so that changes are not necessarily reflected in the real value of shares unless there is a corresponding change. This move excites banks to try to postpone bankruptcy by resorting to liability-management techniques and by raising interest rates to bid for deposits. Such actions reflect myopic behavior on the part of banks and can easily lead to instability. By resorting to liability management (the raising of interest rates to retain deposits) a myriad of unstable processes can be set in motion (Khan and Mirakhor, 1987).

In the light of these observations, it can be postulated that the Islamic model, which is based on the profit and loss-sharing system, may well prove to be better suited to adjusting shocks that may result in banking crisis. Under the Islamic model, pre-determined interest rates are excluded and therefore shocks to asset positions are immediately absorbed by changes in the value of shares (deposits) held by public banks. It renders the real values of assets and liabilities to be equal at all times. In the western model, since the nominal value of deposits is fixed, shocks can cause a divergence between real assets and real liabilities. This rigidity can lead to possible instability in the western banking system.

3.2. Stability of Islamic Monetary Instruments under Dual Banking System

Kaleem (2000) criticizes Darrat (1988) Tunisian model which echoes the monetary stability of Islamic banking. He reiterates that Tunisia has no history of Islamic banking and therefore the validity of Darrat's study is not authenticated. Kaleem also asserts thus that no study has been made so far to analyze the effectiveness of Islamic profit and loss sharing in case of dual banking in Malaysia. According to the purview of this research Kaleem would have asserted that Samad & Hasan's assessment lack a comparative analysis. For that purpose he suggested such analysis for Malaysia (Kaleem, 2000). According to Kaleem, the Malaysian authorities introduced an interest-free profit and loss sharing banking system in 1993. Under this scheme all conventional banks were asked to participate and offer profit and loss sharing financing techniques by opening separate Islamic counters in their branches. This new financial structure not only widened the network of Islamic banking within a country but also increased the effectiveness and performance of Islamic financial instruments. Now the banks offering Islamic financial instruments not only have to compete among themselves but also with conventional financial instruments (Kaleem, 2000).

Kaleem (2000) cites Darrat (1988), who identifies two prerequisites of which only one will be discuss here, namely, controllability. He alludes that effective control of monetary authorities over their financial instruments may attribute to the stability notion of a banking system. The notion that traditional interest-based banks have full control over their instruments is refuted by some economists. The latter argue that it is not possible for a country held under fixed exchange regime to have full control over their instruments. Kaleem (2000) follows Darrat (1988) by assuming that monetary authorities have more control over Islamic financial instruments (Kaleem, 2000). It can be concluded that Islamic monetary instruments are under high level of control, which means the effectiveness of Islamic financial instruments in achieving stability and to counter the impact of financial crisis.

On the strength hereof, and in some way in contradiction to his own views, Kaleem concludes that Islamic monetary instruments are equally useful for monetary policy purposes, because they prove their worth in case of dual banking in Malaysia (Kaleem, 2000).

3.3. Shocks

Khan (1986) affirms that a profit and loss sharing or interest-free banking system is relatively more stable than the traditional or interest-based system in the face of certain types of shocks. I am not trying to imply that the interest-free system is always more stable, or that the traditional or interest-based system is necessarily unstable. I only suggest that there may be situations in which an Islamic profit and loss sharing system can adjust relatively faster to shocks than would the traditional interest-based system (Khan, 1986). In order to absorb shocks, interest-free or profit and loss sharing banking employs its profit and loss sharing paradigm, which is based on (as mentioned earlier in the research) *mudaraba* (profit-sharing) and *musharaka* (joint venture).

Chong Beng and Ming-Hua (2005) assert that under the profit loss sharing system, the assets and liabilities of interest-free banks are integrated in the sense that borrowers share profits and losses with the banks, which in turn share profits and losses with depositors. They therefore argue that profit and loss sharing systems are theoretically better poised than conventional interest-based banks to absorb external shocks, because the bank's financial losses are partially absorbed by the depositors (Chong Beng and Ming-Hua, 2005).

Khan cited Simon, who states that the basic flaw in the traditional interest-based system is that, as a crisis developed and earnings fell, banks would seek to contract loans to increase reserves. He alleges that each bank could do so only at the expense of other banks. In the process some banks would become insolvent and be forced to close. Khan cited Mayer (1972), who contends that banks tend to switch from techniques of asset management to those of liability management in the face of a crisis. It means that if banks raise interest rates to attract or retain deposits in problem situations, and if the total stock of deposits is fixed in the short run, the process would clearly be unstable and would eventually lead to bankruptcies (Khan, 1986).

Khan alludes, on the one hand, that a profit and loss sharing system would be stable in the context of real shocks. On the other hand, he says that interest-bearing banks may try to postpone bankruptcy by resorting to liability-management techniques and raising interest rates to bid for deposits. Khan opines that the interest-based banking system adjust slowly to shock and could easily become unstable (Khan, 1986). The profit and loss sharing system proves to be better suited to adjusting to shocks that result in banking crises. In an interest-free system, shocks to asset positions are immediately absorbed by changes in the values of shares (deposits) held by the public in the bank. The real values of assets and liabilities of banks in such a system would be equal at all points in time. In the traditional interest-based system, since the nominal value of deposits is fixed, such shocks can cause a divergence between real assets and real liabilities. In other words, there is a rigidity in the traditional conventional banking system that prevents instantaneous adjustment and this rigidity can lead to possible instability.

3.4. Profit and Loss Sharing as Equalizer for Economic Stability

Profit and loss sharing financing does not change the level of uncertainty. It only redistributes the consequences of uncertainty over all parties to a business. Debt-financing, in contrast, relieves the financier from uncertainty by shifting it on to the real investor (equity holder) who then alone bears the entire risk of the enterprise (Zarqa and Anas, 1983).

Zarqa holds that profit and loss sharing financing – by spreading the same risk over more heads, would promote stability. Each party absorbs its modest share of a loss without significantly upsetting its normal activities or defaulting on its obligations, hence no panic reactions are generated among other business units (Zarqa and Anas, 1983).

Zarqa concludes by saying that a profit and loss sharing system contributes appreciably to economic stability, while an interest-based system predisposes the economy to instability. With regard to Zarqa'a notion of the latter, we will apply his assessment to the Illinois crisis of the bank failures of 1930 and 1980. Charles P. Kindleberger says that general cause of bank failures in the 1930s was the decline in prices, which led to debt deflation. Falling prices of second-grade bonds, mortgages and securities provoked the first banking crisis in 1930 (Kindleberger Charles, 1985). This cause a sharp rise of interest rates after 1979 which led to forced mergers and failures (Kindleberger Charles, 1985). Increases in interest rates knock down prices of long-term fixed obligations such as bonds and mortgages. It also necessitates banks to liquidate assets, possibly at a loss, or to buy funds in the market with certificates of deposit at higher rates. This actuates a run on the liquidation of a bank's certificates of deposits when the holders of these liabilities become worried about the bank's solvency (Kindleberger Charles, 1985). Kindleberger concludes by saying that the sharpness of the rise of interest rates in 1979 in the effort to halt inflation started a process of bank loss that produced the troubles of 1982, 1983 and 1984 and 2007 (Kindleberger Charles, 1985).

3.5. Profitability of Profit and Loss Sharing Banking

Profit and loss sharing methods contribute to the growing interest of Islamic banks. Hassan & Bashir warn against a variety of risks that banks are exposed to. The extent of these risks depends on the portfolio characteristics of individual banks. The variety of risks to which banks are exposed justifies looking at performance measures of profit and loss sharing aspects of bank operations (Hassan Kabir and Abdel-Hameed, 2005). In their comparative approach between profit and loss sharing and conventional interest-based banking the asset quality ratios for conventional (Western) banks and Profit and Loss Sharing banks are being compared. The comparison between the two groups of banks indicates that interest-free banks (Islamic banks) have a better quality of the loan portfolio. It means that profit and loss sharing banks have better assets quality compared to conventional interest-based banks (Hassan Kabir and Abdel-Hameed, 2005). It seems that profit and loss sharing banks seem to be better capitalized than conventional interest-based banks. Since most of the interest-free banks' loans are on the form of profit and

loss sharing, the loan-performance relationship depends on the expected change of the economy. During a strong economy, only a small percentage of the profit and loss sharing loans will default, and the bank's profit will rise. On the other hand, the bank could be severely damaged during a weak economy, because several borrowers are likely to default on their loans. Banks should therefore capitalize on favorable economic conditions and insulate themselves during adverse conditions (Hassan Kabir and Abdel-Hameed, 2005). Hassan & Bashir is also of the opinion that regulation can affect conventional banks profitability. They aver that if regulators reduce the constraints imposed on banks, banks may have taken on more risks. If banks taking on the higher degree of risk are profitable, then depositors and shareholders gain. If, on the other hand, the banks fail, depositors lose. Islamic profit and loss sharing banks operate in an environment where these traditional supervisory measures are already used (Hassan Kabir and Abdel-Hameed, 2005).

3.6. Challenges for Profit and Loss Sharing

Islamic banks' loans are of low risk and only contribute modestly to the bank's profits. Bank regulators may use this as an evidence for prompt supervisory action. This will have a positive impact on the profitability of Islamic banks. But despite the fact that most Islamic finance and banking institutions involved in profit and loss sharing claim immunity against the financial crisis, the sources of the current crisis is of the notion that interest-free finance can potentially encounter the similar fate (despite its relative stability). Profit and loss sharing banks are doing business with other banks. Their fairly stability has impressed other banks even in non-Muslim countries, particularly those in Europe. But they face challenges. According to Chong & Liu the profit and loss sharing system subjects interest-free banks to greater market discipline. On the strength hereof, interest-free banks are required to put in more effort to distinguish good customers from bad ones, because they have more to lose then their conventional interest-based counterpart (Chong Beng and Ming-Hua, 2005). As investment account holders deposited their funds in the bank rather than investing them, the expectation would be that if investment account holders are paid no return on their investment accounts, this would trigger them to withdraw their funds. Such an action would threaten the bank's solvency, thereby threatening the soundness and stability of the financial system (Archer and Karim, 2006).

4. CONCLUSION

From the standpoint of financial stability, it appears that the Islamic interest-free system does have merit. On the strength of the stability that profit and loss sharing inclined to with regard to banks, a case for the superiority of Islamic banking has been made for example in Tunisia and Iran and Malaysia. The paper has resolved that Islamic interest-free banking is in fact less risky in terms of external shocks than conventional banks. These characteristics made Islam banks less vulnerable to risk than conventional banks. Due to its conservative

characteristic, Islamic banks have limited access to liquidity, so that it enable investors stable and competitive returns. On these grounds, investors are given a greater incentive to exercise tight oversight over bank management, since they share risks. The crumbling for example of the US mortgage and the upheaval of the financial markets in Europe and Asia has generated interest among non-Muslim investors to use Islamic banking. The global credit crisis has given Islamic banking a chance to show its steel.

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