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Challenges Facing Islamic Banking in the 21st Century

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ABSTRACT

Despite its considerable achievements over the last twenty years, Islamic banking faces a number of serious challenges to its viability and growth in the 21st century. In order to meet the challenge of conventional Western banks entrance into the industry, incumbent Islamic banks will have to build strategic alliances and consolidate into larger institutions. The Islamic banking industry as a whole also needs to engineer new and more sophisticated financial products and diversify from just fixed-return to variable-return modes of Islamic financing. It must also determine *Shari'ah* compliance more efficiently and support R&D and the training of new talent. The success of Islamic finance further depends on the establishment of equity institutions to provide equity capital and the development of secondary and inter-bank markets. Finally, a strong legal and institutional framework is necessary for accounting, supervision, and to provide a lender of last resort.

I. INTRODUCTION

Twenty-five years ago, Islamic banking was considered wishful thinking. However, serious research in the past two and a half decades has shown that Islamic banking is not only feasible and viable, but an efficient and productive way of financial intermediation as well. A number of Islamic banks have also been established during this period in heterogeneous social and economic milieu. The successful operation of these institutions and the countrywide experiences in Pakistan, Iran, Sudan and partly in Malaysia are sufficient to show that Islamic banking offers an alternative method of commercial banking. The fact that many conventional banks, including some major multinational Western banks, have also started using Islamic banking techniques is further proof of the viability of Islamic banking. Islamic banks have succeeded in mobilizing large amounts of funds. While the estimates about the exact magnitude of the Islamic banking market vary, it can be safely assumed that it presently exceeds US$100 billion and is poised for growing further in the future. However, it will require much more strenuous efforts to maintain a reasonable rate of growth in the future.

The commendable achievements during the last twenty years should not lead us to ignore the problems that Islamic banking is facing, and there is no dearth of these. While many of them are a result of the inappropriate environment in which Islamic banks are working, there are others which have arisen from the practices of Islamic banks themselves. Islamic banks must have a critical look at their activities, correct their mistakes, identify their long run comparative advantage, and exploit it to the fullest possible extent. It must be realized that in the long run, Islamic banking has to rely on its strength as an alternative model for its viability and survival, rather than on the sympathies of its clients or government support. It is in this spirit that we discuss below the major challenges facing Islamic banking as it enters the twenty-first century.

II. INCREASED COMPETITION

So far, Islamic banks have had a fairly large degree of "monopoly" over the financial resources of the Islamically motivated public. This situation is changing fast. Islamic banks are now facing ever-increasing competition. An important development in Islamic banking in the last few years has been the entry of some conventional banks in that market. Although it is difficult to know with certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short list may contain some of the giants of international banking business such as Chase Manhattan, Citibank, ANZ Grindlays, and Kleinwort Benson, along with others such as Union Bank of Switzerland, Girozentale of Australia, and ABC International. In addition to these, several commercial banks are offering Islamic banking services in many Muslim countries. Bank Misr in

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Egypt and National Commercial Bank in Saudi Arabia have opened Islamic branches. In Malaysia, commercial banks have been permitted to open Islamic banking windows.

This development is a clear recognition of the viability of Islamic banking as an alternative model, but has at the same time increased competition. Does it augur well for the future of Islamic banking? The answer will depend on how Islamic banks react to this development. In general, competition is supposed to be good for the growth of any industry. It forces inefficient firms to either shape up or ship out. It reduces costs and improves services to consumers. It promotes innovation and brings improvements in product quality. There is, however, one exception to this rule. This is the well-known infant industry argument which claims that small firms in their infancy may be protected from harsh, ruthless competition until they can stand on their feet and be able to face competition from their bigger counterparts. One can argue that Islamic banks may well deserve this treatment. The conventional banks and particularly the western banks have a large advantage over Islamic banks in terms of their size, experience, market coverage, and long standing in the industry. This makes Islamic banks vulnerable to unequal competition.

While it may be difficult to settle the point on theoretical grounds, the stark reality is that even if one could invoke infant industry entitlements for Islamic banks, there is in practical terms no institutional arrangement to put those into operation. Governments usually offer infant industries benefits such as tax breaks or subsidies. No such possibility exists at present. Therefore, the survival of Islamic banks essentially depends on their own efficiency and performance.

III. Building Bridges and Strategic Alliances

The competition from conventional banks is expected to increase further in the near future due to globalization. Due to liberalization, world markets are rapidly converging into a single market place. To benefit from the opportunities offered by globalization, Islamic banks need to improve the quality of their services and develop suitable products.

Technological innovations are also playing an important part in financial integration and globalization. Electronic banking and the widespread use of computers in banking have transformed the way banking is done. The communication revolution through electronic correspondence has reduced the cost of international communication. The globalization of financial markets has led to a greater and greater integration of capital markets. The liberalization of foreign exchange markets has further reinforced this trend. Paper currency is being replaced with plastic cards and electronic ledgers are replacing accounts books. The saving of one country can now be invested in other countries by the click of a mouse. The day is not far away when customers will be able to “navigate” on the Internet between competing banks, unit trusts, mutual funds, and even business firms.

Islamic banks cannot remain aloof to these developments. They must carefully watch these developments and adjust their strategies accordingly. In order to operate in global markets, they have to form strategic alliances with other banks. It will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested doing banking on Islamic principles. Such strategic alliances will benefit both sides. Islamic banks will benefit as the western banks bring their efficiency, market research, innovative capabilities, sophisticated banking, and result oriented approach to Islamic banking, which may lead to the development of new products and the provision of better services to consumers. On the other hand, the conventional banks will benefit from the indigenous infrastructure, closer consumer contacts, and Islamic credentials of Islamic banks.

It may be worthwhile to point out here that there are some genuine concerns about the operations of large multinational banks in Islamic banking practices. Naturally, their motives are purely commercial: they view it as a lucrative business opportunity. That is fair enough. However, doubts have been expressed as to whether conventional banks are playing by the rules of the game and whether they are able to follow the percepts of Islamic banking correctly. In all major Islamic banks, there is a *Shari‘ah* board which regularly reviews the operations and contracts of the bank to determine their compliance with the requirements of the *Shari‘ah*. Such elaborate arrangements do not exist in conventional Western banks in most cases. Even if some of them have *Shari‘ah* advisors, a credibility gap remains. Alliances with well established Islamic banks might help remove this gap. Irrespective of whether these doubts are in fact true are not, common perceptions have important implications for business. Conventional banks stand to benefit significantly in this respect by working together with Islamic banks.

IV. Need to Increase the Size of Islamic Banks

Size is an important variable in determining the efficiency of a bank. It determines the scale and scope efficiencies. Economists have shown that larger banks are in a better position to reach the optimum mix and scale of output. As a result, they are more efficient than smaller ones. The estimates with respect to the saving in costs due to scale economies range from 20% to as high as 50%. The literature on banking and finance indicates that there are substantial scale inefficiencies for small banks. Full efficiency has been found at a level of US$500 million in assets. The inefficiency loss for banks below US$100 million in assets amounts to about 10%. Scope diseconomies for small banks have been found to range between 10% and 20%, with huge scale economies for larger banks.[i]

The available data shows that Islamic banks and financial institutions are significantly below optimal size. The average size in assets of these institutions[ii] was US$395 million in 1996. This figure is misleading, however, because of extreme variations between the maximum size (US$8.6 billion) and the minimum size (only US$72,000). The standard deviation works out to be US$1.2 billion (about four times the average) which points to the presence of extreme values in the data. In order to see a better picture, Table 1 summarizes the position of Islamic financial institutions (IFIs) in a frequency distribution in terms of size in assets in 1996.

TABLE 1. ISLAMIC FINANCIAL INSTITUTIONS BY SIZE OF ASSETS (1996)

Assets (US$ Millions)	Frequency Distribution
0-50	39
51-100	13
101-200	4
201-300	3
301-400	8
401-500	1
>500	10
TOTAL	78

Source: *Directory of Islamic Banks and Financial Institutions*, 1996 (Jeddah, Saudi Arabia: International Association of Islamic Banks)

It may be observed that only eleven institutions are above the average figure. If we then exclude Tabung Haji, Malaysia, which is a special purpose institution, only ten financial institutions can be considered to be of optimal size from an economic point of view. More than 60% of the institutions are below even the critical minimum size of US$100 million. From these statistics, it can easily be concluded that Islamic banks and financial institutions have not reached an optimal size to be able to achieve efficiency.

There are more reasons than just efficiency to advocate larger size. A large capital base is one of the important factors influencing positive credit rating. It reflects shareholders' commitment to their business. That comes handy in the case that a bank wants to raise additional capital. The small size of Islamic banks is also a major factor contributing to the lack of portfolio diversification. The resources at their disposal are not sufficiently large to minimize risk through portfolio diversification.

In order to increase the level of efficiency and deal more effectively in financial markets, it is thus desirable that the size of Islamic banking operations be substantially increased. In this regard, serious consideration should be given to mergers.

V. FINANCIAL ENGINEERING

Financial markets are becoming more sophisticated and competitive. In order to exploit the quickly changing market environment and to face increasing competition, financial engineering and innovation are imperative. Financial experts have to keep an eye on the needs of various types of individuals and businesses on both the demand and supply sides. They also need to consider varying tastes for risk. Since the needs and tastes vary from person to person, a wide variety of products need to be developed to cater for all needs and tastes. In an Islamic framework, they must also observe *Shari'ah* rules and guidelines.

Until now, Islamic financial tools have essentially been limited to classical instruments developed centuries ago and their variants. These classical instruments were developed to meet the needs of the societies in which they were developed. While they may serve as useful guidelines for Islamic contracts, there is no reason to be restricted only to them. In the Islamic theory of contracts, parties are free to agree on any terms as long as known Islamic rules and principles are not violated. There is a well-known *Hadith* stating:

> "Muslims are free to determine the conditions of their contracts except a condition that make something that is permissible forbidden, or something that is forbidden permissible."[iii]

Islamic *fiqh* has laid down general guidelines for *ijtihad*, or dealing with new situations. In the present context, the principles of *istihsan* (taking the easier way from those permissible), *masalih mursalah* (safeguarding public interest), *raf' al-haraj* (elimination of hardship) and *darura* (granting concessions in case of necessity) are particularly relevant. In addition to these principles, *ijtihad* must be guided by the need to preserve the basic objectives of *Shari'ah*. Within that overall objective, those principles, provide guidelines for dealing with issues arising from the unfolding complexities of applying the rules of *Shari'ah* to new situations. It may be appropriate to add that *ijtihad* can be practiced only by highly qualified *Shari'ah* scholars, who are aware of its concept and methodology and must remain within the general spirit and objectives of *Shari'ah*.

In light of the principles of *ijtihad*, a "needs approach" to financial engineering is desirable—of course within the known principles of Islamic finance. In this regard, the example of *bai' salam* is very important to remember. In general, it is not allowed to sell anything that is not in one's possession. But in the case of *salam*, the Prophet (PBUH) allowed such a sale because of the "need" of the people, but laid down clear rules to protect the interests of both parties. The financial needs of both individuals and businesses have changed. Engineers in modern finance have designed several new instruments such as mortgage, options, derivatives, hedging, insurance pension plans, and credit cards, to meet these needs. We must examine what needs are being fulfilled by these instruments. If the needs are genuine (Islamically speaking), then we must either adapt them for our purposes or invent Islamic alternatives for them. The process of adaptation is well recognized in Islamic *fiqh* and has never stopped. However, its speed needs to be greatly enhanced. Classical contracts have been modified in a number of cases to meet current needs. The most potent example of this is the initiation of Islamic banking on the basis of *al-mudarib udarib* principle, which provides that a *mudarib* (agent) may himself appoint another agent to actually run the business. Islamic banking is not modeled strictly on the conditions of the classical contract of *mudaraba*. A number of these conditions were found to be impractical. Therefore, the basic principle of *mudaraba* was used while modifying its conditions in light of the current situation.

The principle of *al-mudarib udarib* essentially allows for sub-contracting. If the principle is acceptable, there is no reason to restrict it only to *mudaraba*. Contracts can similarly be designed on the basis of *al-muajjar uajjir*, *al-mustasna yastasna*, etc. In other words, the original contractee may arrange to fulfill the obligations under the contract through third parties. That the principle is acceptable from an Islamic point of view is unquestionable. A number of examples of its application can also be given. For example, in the *istisna'* (construction on orders according to agreed specifications) contract, a constructor may accept to do work against a certain price and offer the work to someone who would carry it out for a lesser price and/or with more efficiency. In leasing, the lessee who possesses the usufruct may sell these against a higher price (rent). In a delivery-deferred (*salam*) trade, the intermediary, before taking delivery of the commodity, may enter into a counter-contract with another party parallel to the first one. Again, the role of an intermediary is quite evident.

While it is possible to modify classical contracts to suit modern conditions, a much broader scope for financial engineering exists in developing new contracts. These contracts could be hybrids of old contracts or may be entirely new. However, the approach to examining the "*Shari'ah* compatibility" of new contracts must change. There is no need to insist in the process of this examination that a contract fulfill all the requirements of, say, a *mudaraba* or *salam* contract as contained in classical *fiqh*. The contract should be taken on its own. What is important to check is that no conditions of the contract violate any Islamic rule. A checklist of such rules may be prepared and given to financial engineers. This checklist would include things like the prohibition of *riba*, *gharar*, and a few other do's and don'ts. The scope for financial engineering—and for that matter, for innovations in other fields—is quite wide. It is important that those experts who know the needs and niceties of the trade take up this task.

VI. *SHARI'AH* ASPECTS

Because of the religious dimension of Islamic banking and finance, no new product can be adopted until it is cleared by *Shari'ah* scholars. Even after a new product is put into use, *Shari'ah* auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of *Shari'ah*. This is important not only for religious reasons but also for purely business considerations because the clients of Islamic banks will not have confidence in their operations unless *Shari'ah* scholars clear their activities. With this backdrop in mind, the expertise of *fiqh* scholars in understanding the prerequisites of modern financial products and in evaluating these products becomes very important.

Almost all Islamic banks have their own *Shari'ah* boards or *Shari'ah* advisers. A survey of the members of these boards would reveal that hardly any of these scholars has formal training in modern finance. This puts a serious constraint on the ability of *Shari'ah* scholars to issue well-informed rulings on financial products and activities. The *Shari'ah* scholars are themselves conscious of this difficulty. They are using a number of ways to acquire the necessary background information before issuing a *fatwa*. One of these ways is to discuss an issue in meetings or workshops attended by both *Shari'ah* scholars and financial experts. Institutions such as the Islamic Research and Training Institute and Islamic universities are playing an active role in organizing such workshops. However, these workshops have no mandate to issue a *fatwa*. For this purpose, the meetings of *fiqh* academies, the most prominent among which is the OIC *Fiqh* Academy in Jeddah, play a more important role. These academies also commission a number of studies by specialized experts on specific issues before discussing them and making a decision. In the absence of the required expertise in the field of finance among *Shari'ah* scholars, this approach of "group *ijtihad*" or *ijma'* is playing an important role in safeguarding against serious mistakes in adopting doubtful instruments.

The situation is, however, far from ideal. As any participant of the workshops and meetings of *fiqh* academies can easily notice, the interaction between *fiqh* scholars and experts of modern economics and finance does not proceed smoothly. The two groups have such different backgrounds and speak such different technical languages that communication between them is very difficult. It is therefore understandable that *Shari'ah* scholars are cautious in giving rulings. As a result, the decision-making process has become very slow and tends to be over-conservative.

The past record shows that *Shari'ah* bodies have done a commendable job in evaluating the applications of traditional contracts and safeguarding against the use of some and the misuse of others. When it comes to evaluating modern financial contracts or Islamic substitutes for them, however, *Shari'ah* bodies have found it quite difficult to issue verdicts. This is basically due to an acute shortage of scholars with dual specialization or at least a working knowledge of both modern finance and *Shari'ah*.

VII. TEACHING, TRAINING, RESEARCH, AND DEVELOPMENT

Teaching, training, and research are the wherewithal for the development of any discipline. This is all the more so for a discipline like Islamic banking and finance that is still nascent. As mentioned above, there is a serious shortage of scholars who possess even a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly, most managers of Islamic banks are not very well trained in the use of Islamic modes of finance. Unfortunately, very little effort has been made to meet these requirements.

In the area of teaching, Islamic universities in some Muslim countries, particularly Pakistan and Malaysia, have initiated some teaching programs to produce graduates with this dual specialization. However, a close examination of their curricula would reveal that they are not well designed to achieve this objective. This may also be confirmed by the fact that the Islamic banks have not been able to find a reasonable number of suitable managers from the graduates of these universities, nor could anyone of them find a place in the *Shari'ah* board of any Islamic bank. Similarly, hardly any of the graduates of these universities has produced any research that has found favor in practice.

In the area of research, neither Islamic banks as a group nor any of they individually spend any sizeable funds on research. Some Islamic banks have small units for research, but none of this research activity is designed toward product development. It is therefore not surprising that the speed of development of new financial products within the Islamic banking industry is very slow. Islamic universities and the few research institutions working here and there have not received any financial assistance from Islamic banks, nor has there been any coordination between Islamic banks and the seats of higher learning for any worthwhile research project.

Another very important component of useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. Some attempts have been made in this regard but have not received active support, either financial or otherwise, from Islamic banks. As a result, there is no consistent data series on the activities of Islamic banks for a reasonable number of years available anywhere. Whatever little information is available is also subject to a number of qualifications.

In the area of training, a small effort was made in the 1970s by establishing a training institute in Cyprus. Due to certain reasons, this institute has been closed. The managers of Islamic banks may be attending short-term courses either on the job or elsewhere, but there are not many formal training programs meant to prepare the employees of Islamic banks for the needs of the system. Most of the employees of Islamic banks, including their managers and financial experts, come from conventional environments and lack the necessary expertise in and commitment to Islamic banking. An institution is what its employees make it. It is therefore extremely important to have people with the right kind of skills and commitment to run Islamic banks.

VIII. Need for Diversification in the Use of Islamic Modes of Finance

The Islamic financial system has presented a number of financial instruments. Broadly speaking, they may be classified into fixed return and variable return or profit sharing modes.[iv] Each of these categories has its merits and demerits. In practice, however, the use of profit-sharing modes has been very limited. For reasons mentioned below, it would be desirable over the long run period to gradually diversify the use of various modes, especially increasing the share of profit sharing modes.

Theoretical discussions on Islamic banking and finance have established that a system based on profit sharing is not only viable but also has a number of advantages over the interest-based system:[v]

1. A fixed charge on capital is unjust since the results of a productive enterprise in which capital is invested are uncertain. It would be more just if capital shared the actual profits of the enterprise.
2. Allocation based on profit sharing pays more attention to investment profitability, while allocation based on interest pays more attention to credit-worthiness. We can therefore expect the former to be more efficient than the latter.
3. A system based on profit-sharing will be more stable than a system based on a fixed charge for capital since the cost of capital in a sharing system automatically adjusts itself to variations in productivity under changing business conditions. A shock to the assets position is automatically absorbed on the liabilities side when both of them are based on profit sharing.
4. Since assets are created in response to investment opportunities in the real sector of the economy, it will be the real sector that determines the rate of return to the financial sector rather than the other way round.
5. Money creation in a profit-sharing system would be based on investment, thus preventing an oversupply of money. This will keep inflation in check.
6. A switchover from interest to profit sharing is more conducive to economic growth, as this would increase the supply of risk capital as well entrepreneurship. New entrepreneurs will be encouraged because of the possibilities provided by risk sharing.

Some scholars have argued that the almost exclusive reliance on fixed-return modes is one of the most serious problems facing Islamic banking as an alternative model that is distinguished by risk sharing. Nejatullah Siddiqi, for example, laments:

> "We cannot claim, for an interest-free alternative not based on sharing, the superiority which could be claimed on the basis of profit-sharing. What is worse, if the alternative in practice is built around predetermined rates of return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provided in the modes of finance based on *murabaha*, *bai' salam*, [and] leasing and lending with a service charge are all predetermined as in the case of interest. Some of these modes of finance are said to contain some element of risk, but all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around these modes of financing can hardly claim superiority over an interest-based system on grounds of equity, efficiency, stability, and growth."[vi]

He considers this problem to be the main problem of contemporary Islamic banking, so much so that it can be characterized as an identity crisis of the Islamic financial system.

There are several reasons why fixed-return modes have become more popular than variable-return modes in practice. They have a number of desirable features such as simplicity, convenience, and safety. Banks further prefer fixed-return modes (i) due to moral hazard and adverse selection problems in all prinipal-agent contracts (e.g., there is need for closer monitoring of the project in the case of *mudaraba*—this requires project monitoring staff and mechanisms, which increase the costs of these contracts); (ii) the structure of deposits of Islamic banks is not sufficiently long-term on the liabilities side—discouraging bankers from getting involved in long term projects; and (iii) profit-sharing contracts require a lot of information about the entrepreneurial abilities of the customer, and this may not be easily available to the bank. There are many corresponding reasons due to which businessmen do not prefer profit-sharing contracts. These include, among others: (i) the need to keep and reveal detailed records, (ii) it is difficult to expand a business financed through *mudaraba* because of limited opportunities to reinvest retained earnings and/or raise additional funds, (iii) the entrepreneur cannot become the sole owner of the project except through diminishing *musharaka*, which may take a long time.

While it would be desirable that the predominance of fixed-return modes, such as *murabaha* and leasing, on the asset side be moderated in order to have a more diversified portfolio, the problem should however not be blown out of proportions so as to label it as a crisis of identity. Nobody denies that *murabaha* and leasing are permissible modes of financing. It may also be noted that if these modes are used properly, some risk sharing is involved. The fact that these risks are insurable and are actually insured against should not bother anyone. Insurance itself is a scheme for the wider sharing of risks and uncertainties. The owner of an asset shares in the ultimate risk by paying the insurance premium. The only thing one should ensure is that the cost of insurance is borne by the owner of the "asset."

It needs to be emphasized that, under present circumstances, tools like *murabaha* are indispensable: they provide investors high liquidity with low risk. Until the proper institutional setup is built and needed products—including those for managing risk—are developed, it may not be advisable to drastically increase the use of risky modes. *Murabaha* is serving a useful purpose; however, several problems have been noted in the way it is being used. Serious attempts should be made to cleanse the "quasi-*murabaha*" being practiced by some banks at present of its undesirable features in order to make it "genuine" *murabaha*.

Nevertheless, an overwhelming use of these fixed-return modes by Islamic banks in the absence of other Islamic financial institutions which could provide more profit sharing opportunities has led to some undesirable results for the Islamic finance scene. These include:

A. Defaulters and the Issue of Penalties

By using fixed rate modes of financing, Islamic banks have been able to minimize the impact of business risks on their cash flows. But precisely because of the same reason, i.e., the use of debt as compared to equity, they land themselves in a serious problem. *Murabaha* deals create debt obligations against buyer firms. Now while it is permissible to charge a higher price in credit sales as compared to cash sales—the wherewithal of *murabaha* mode of financing—this creates a fixed liability once the deal has been entered. If the buyer then defaults on his payment, banks cannot charge anything extra because that would mean taking *riba*. There is thus a built-in incentive for immoral buyers to default.

Islamic jurists have been discussing this problem. It is generally agreed that penalties, both physical and financial, can be imposed against defaulters but that the bank cannot benefit from these penalties. Some contemporary scholars have argued that the banks can be compensated because the defaulter has caused a damage and that Islam permits, rather encourages, the compensation of damages. However, the issue still remains unresolved due to a lack of consensus among jurists.

B. Illiquidity of Assets

Another problem caused by the predominance of debt-based modes of financing is that it is difficult to transform these financial modes into negotiable financial instruments. Once a debt has been created, it cannot be transferred to anyone else except at par value. This renders the whole structure of Islamic financial market highly illiquid. This is one of the major obstacles in the development of secondary markets in Islamic financial instruments. Unless equity-based modes become more popular or other negotiable instruments are developed, Islamic financial markets will remain undeveloped. Some attempts are being made to develop negotiable instruments based on *ijara*, *salam*, and *istisna'*. However, these have not been used to any significant extent so far. The major hope for developing Islamic secondary markets lies in a wider application of equity-based financial instruments and the securitization of some of the existing instruments.

C. Short Term Asset Structure

Banks everywhere prefer short-term investments. This is so because they work on the basis of small reserves. They need to have the ability to liquidate their assets fairly quickly if the need arises. In the case of Islamic banks, the short-term structure of their assets is even more pronounced. This also has to do with the predominance of *murabaha* among the modes of finance. *Murabaha*, a trading practice, is by its very nature a short-term contract. When turned into a financial instrument, it does not lose that character. Even though it is conceivable to design an installment sale *murabaha* contract spreading over many years, the needs for which the *murabaha* contract can "genuinely" be used are mostly short-term. Therefore, *murabaha* deals entered into by Islamic banks have been and are going to be largely short-term ones. Since *murabaha* comprises a very large percentage of Islamic banks' investments, the structure of their assets has also become short-term.

Is this a problem? This may not be so as far as the banks themselves are concerned. Because the liabilities of the banks are short-term, it makes sense to have short-term assets. From the point of view of the financial system as a whole, however, there are needs for financial resources on a long-term basis (e.g., venture capital). In the conventional framework, these needs are met by other financial institutions such as securities markets. In the absence of such institutions in the Islamic framework, Islamic banks are looked upon to provide an alternative not only to commercial banking activities but also to the need for securities markets. There can be no interest-based bonds in Islamic banking. The Islamic financial system has to provide an alternative for them. For this purpose equities need to be a major activity in the Islamic financial market. The problem assumes a more critical dimension in view of the fact that in most of the Muslim countries, the major domain of Islamic banks, well developed securities markets do not exist. Unless the use of profit sharing modes is increased, Islamic finance cannot fulfill its promise of eliminating interest from the financial markets. But is it the sole responsibility of Islamic banks?

IX. NEED FOR ESTABLISHING EQUITY INSTITUTIONS

It must be emphasized that providing the above-mentioned needs is the responsibility of the Islamic financial system as a whole. It is unfair to expect that Islamic banks should provide an alternative for all kinds of needs. In all businesses there is a need for long term finance. In the conventional system, this is provided through long term bonds and equities. Securities markets and specialized equity institutions perform this function. In addition to the general public, the most important sources of these long-term investments are investment banks, mutual funds, insurance companies, and pension funds.

Unfortunately, in most Muslim countries, which are the overwhelming domain of Islamic banking, security markets are not well established. Similarly, the number of specialized equity institutions and other institutions that traditionally provide equity capital through stock exchange—i.e., pension funds, mutual funds, and insurance companies—is negligible. Recently some mutual funds and *mudaraba* companies have been established in some Muslim countries, but there number is very small and they are not well known to the general public. Moreover, information about their performance is extremely limited.

Pension funds are mostly restricted to the public sector. There are hardly any private or even corporate-sector pension funds. The number of Islamic insurance companies is less than a dozen throughout the Muslim world. Islamic banks have shied away from big exposures in equity investments for practical reasons that cannot be ignored. In view of the importance of long term capital for economic growth, the establishment of institutions providing equity capital is a prerequisite for the survival and success of Islamic finance.

It may be mentioned here that even in conventional finance, there is an increasing trend toward the use of equities as a source of business finance. All over the world, savers are deserting traditional bank accounts and low yielding government bonds by the thousands and moving en masse into equities. As a result, stock markets are witnessing high rates of growth as well as substantial increases in stock prices. A massive reallocation of wealth is taking place. Institutions like mutual funds and pension plans are ballooning.

Savers are now increasingly recognizing the benefits of profit-based instruments. The appeal of rate-based investment is waning. Although stock market investments have not become any less risky over the years, savers are beginning to accept the historical evidence that in any five year period since World War II stocks have with one exception produced higher returns than bank accounts, bonds, or bullion. There is now a worldwide trend for establishing equity institutions such as mutual funds. Islamic financial markets have to take note of these recent developments in international financial markets.

The situation is also ripe for establishing equity-based institutions and instruments. There is an historic opportunity for taking advantage of the privatization programs going on in many Muslim countries. A number of public companies, many with good track records and bright prospects, are being offered to private parties. Islamic banks and financial institutions can take advantage of this opportunity. It must be noted, however, that leading *Shari'ah* institutions have ruled that it is not permissible to take equity stake in companies who deal in interest in even small proportions. While this rightly reflects the serious concern that Muslims must garner against the use of interest, this puts a serious constraint on the placement of funds. It closes an important market to Islamic banks and also exposes many big corporations in Muslim countries to foreign ownership. The matter needs serious consideration with a view to find an acceptable solution on the basis of a common need.

X. Establishment of Secondary Markets and Interbank Market

Banking thrives on the existence of a secondary financial market. Commercial banks invest in very short-term financial papers, which they can convert into cash very quickly at negligible conversion cost. There are several ingredients of a secondary financial market: financial papers, dealers, and financial institutions. Various kinds of financial papers such as securities, bonds, shares, debentures, commercial papers are the financial instruments. Merchant banks, investment banks, mutual funds, investment funds, etc. are the financial institutions. Steps need to be taken for establishing and/or strengthening secondary markets.

Most Islamic banks exist as single entities. The strength of commercial banking is derived not from individual institutions but by taking all banks together. Interbank transactions among Islamic banks are minimal because in most countries the number of Islamic banks is very small. The evolution of short-term financial assets that Islamic bank may hold and transact among themselves shall go a long way toward making an Islamic money market a reality.

Islamic banks lack such short-term instruments in which they can profitably invest for very short periods. Modern commercial banks can lend each other millions of dollars even for a day. They can also calculate interest on a per day basis. An Islamic alternative to the very short-term placement of funds has yet to evolve.

XI. Appropriate Legal Framework and Supporting Policies and Procedures

The commercial, banking, and company laws in most Islamic countries are fashioned on the Western pattern. Hence these laws may contain provisions that are in conflict with Islamic banking methods. Even if parties structure their agreements according to an Islamic contract, the laws that govern the interpretation and enforcement of these agreements usually are wholly ignorant of this form. It is simply impractical for parties to incorporate into their agreements all the relevant Islamic rules, making Islamic contracts more costly to conclude. In case any disputes arise, the local laws will usually be enforced, which in many cases would involve the violation of some Islamic rules. In this context, one of the most serious problems is the lack of a proper legal framework to deal with cases of delayed payments and bad loans. These conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. Even in those Islamic countries that do not opt for a complete Islamic banking system, it is necessary to enact some laws to facilitate the operation of a mixed system.

It should also be mentioned that the successful operation and healthy growth of Islamic banking requires not only an appropriate institutional framework but also a correct policy-mix from the government. Muslim governments need to do more to create a more congenial environment for Islamic banks. In many cases there are practical obstacles in the way of Islamic banking. Structural adjustments, particularly in fiscal and monetary areas, are needed to provide Islamic banking enough room to operate effectively.

A. Supervisory Framework

The supervision of Islamic banks is as important as that of the conventional banks. There are three main reasons why the regulation and supervision of banking industry are important: to increase the information available to investors, to ensure the soundness of the financial system, and to improve control of monetary policy. Asymmetric information in financial markets exposes investors to many risks and hazards. It can also lead to the widespread collapse of financial intermediaries, referred to as financial panic. Because depositors may not be able to assess whether the institutions holding their funds are financially sound or not, they may want to pull their funds out of both sound and unsound institutions if they have doubts about the overall health of the financial intermediaries. The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy.

Asymmetric information also leads to the problems of moral hazard and adverse selection in financial markets. In this regard, there is the need to make the activities of banks as transparent as possible. The present situation of Islamic banks leaves much to be desired in this respect. In many cases the most essential information is not made public. More transparency in various aspects of the activities of Islamic banks will increase the confidence of clients and will help avoid panics.

To protect the interests of the public and the economy from financial panics, most governments have created elaborate regulatory bodies. As a matter of fact, the banking industry is one of the most heavily regulated industries all over the world. Against this background, let us see the supervisory framework of Islamic banks.

In most countries, Islamic banks are put under the supervision of the central bank of the country and are given the same treatment as given to normal commercial banks. There are only a few instances where special Islamic banking legislation was approved to define a new relationship between an Islamic bank and the central bank.[vii]

Most Islamic banks in the contemporary world operate in a mixed environment in which interest based banks function side by side with Islamic banks. The central banks subject Islamic banks to the same controls, conditions, and regulations that they apply to interest based banks. As long as the instruments of regulation and control used by the central banks remain free of interest, no objection may be advanced against them, at least on Islamic grounds. There are certain factors, however, that require that Islamic banks be treated on a different footing. Some of these factors are the following:

1. Islamic banks, like all other commercial banks, are required to keep some of their deposits with central banks. Central banks usually pay interest on those deposits which Islamic banks cannot accept. An alternative is needed to ensure that Islamic banks get a fair return on their deposits with the central banks.
2. Central banks function as lenders of last resort to commercial banks providing loans at times of liquidity crunch. Although most Islamic banks function under the supervision of a central bank, they cannot benefit from such a facility because funds are usually provided on the basis of interest.
3. Legal reserves imposed on deposits with conventional banks are meant to meet possible withdrawals whose rates vary between demand, saving, and time deposits. This may apply to the same extent to Islamic banks only in the case of demand deposits. The saving and investment deposits of Islamic banks, however, are of such a nature that withdrawal before their term is not as common as in conventional banks. They must therefore be subjected to reserve requirements at ratios lower than those imposed on their counterparts with conventional banks.
4. Islamic banks do not enjoy the stability provided by deposit insurance. In most developed countries, the deposits of commercial banks are insured. Hence a depositor at an Islamic bank bears a greater risk in the sense that if an Islamic bank collapses then the depositors will lose all their money because deposits are not insured. It is true that Islamic banking is based on the concept of *mudaraba,* where the provider of the capital (*rabb al-mal*) has to bear all the loss in the case that the business venture in which the *mudaraba* funds are invested fails. Under such circumstances, one may argue that any insurance scheme would be against the very idea of Islamic banking. However, nobody would argue that Islamic banks should expose themselves as well as their depositors to unnecessary risks that can otherwise be taken care of. In fact, the very fact that other commercial banks, which operate in the market, have deposit insurance puts Islamic banks at a disadvantaged position when it comes to competition between conventional and Islamic banks.
5. In countries where the central bank conducts open market operations, Islamic banks are not able to participate in these operations because of the interest-based nature of the securities bought and sold. Islamic banks are thus constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of Islamic banks.
6. A lack of understanding of the correct nature of Islamic financing techniques may also be partially responsible for the rather inappropriate policies of central banks toward Islamic banks. This is particularly true of *musharaka* and *mudaraba*. In debt financing, the granting of a loan by a bank is a one-time activity, no matter what the size of the loan. But *musharaka* and *mudaraba* are ongoing activities, and the participation of an Islamic bank in these activities continues as long as the project financed is in operation. This may have important implications for the reporting as well as control and regulation of Islamic banks by central banks.

B. Accounting Standards

Islamic banks function in different types of social environments and heterogeneous economic milieu. They have to put up with different types of official requirements regarding accounting practices. This results in a dissimilarity of accounting practices among different Islamic banks, to the extent that any meaningful comparison between the balance sheets or profit and loss accounts of two different Islamic banks becomes a very difficult task if not an altogether impossible one. Furthermore, the concepts used in the balance sheets or profit- and loss-statements are not rigorously defined.

During the last few years some headway has been made to overcome this problem. In order to introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks have, under the guidance of the Islamic Development Bank, established a technical cum juridical organization called "Accounting and Auditing Organization for Islamic Financial Institutions" (AAOIFI). The organization, now functional and based in Bahrain, is composed of a supervisory committee and a Financial Accounting Standards Board responsible for preparing, issuing and amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board. However, it will be sometime before any perceptive change in the accounting practices of Islamic banks is observed unless the banks pay more attention to this aspect.

[i] See Allen N Berger, William C. Hunter and Stephen G. Timme, Berger and Humphrey 91, P. W. Bauer and D. B. Humphrey, "Efficiency And Productivity In U.S. Banking," in H. O. Fried, C. A. K. Lovell and S. S. Schmidt, eds., *The Measurement of Productive Efficiency: Techniques And Applications*," Oxford University Press, Oxford, 1992.

[ii] Reference is being made here only to Islamic banks in the private corporate sector. Banks in Pakistan, Iran, and Sudan are excluded due to their special position in view of countrywide Islamization processes in these countries.

[iii] Tirmidhi, Part 3, Kitabul Ahkam.

[iv] It should be noted that the fixed return modes of finance being used by Islamic banks are clearly distinguishable from conventional, interest-based modes. Transactions of the former modes are always done through real commodities, while in the latter they are carried out through intertemporal exchanges of money.

[v] For a more detailed list of benefits of profit-sharing system, see, Abbas Mirakhor, "Progress and Challenges of Islamic Banking", *Review of Islamic Economics,* vol. 4, No.2 (1997)

[vi] M.N. Siddiqi, *Issues in Islamic Banking*, The Islamic Foundation, UK (1983), p.52.

[vii] This was done in the cases of the establishment of Jordan Islamic Bank and of Bank Islam Malaysia Berhad.