CHAPTER - IV

PROBLEMS AND PROSPECTS OF ISLAMIC BANKING

The purpose of this chapter is to discuss some of the complex problems which the Islamic banking system is facing. Some of these problems are bank specific such as the theoretical issues relating to Islamic banking are still unresolved. There is another set of problems which arises out of the fact that these banks are 'Islamic' with a specific aim; to promote social and economic development in Muslim countries. What is important is that most of these banks are privately owned, working along with the interest-based banking system. In this regard, critics argue that introducing interest-free institution into the current capitalist system of finance is not less than a novel innovation within the system.

The aims and objectives of Islamic banking system and how much these are different from the prevailing system have always been the central debate among Muslim scholars. Some of them propose that an Islamic financial institution should be truly 'revolutionary'. It should not try to manoeuvre with the system for maximum advantage but should try to alter the whole system.¹

The development of Islamic banking in some Muslim countries is facing some other obstacles. In some countries, Islamic banks have to keep a certain portion of their deposit, with the central banks. If this ratio is very high, it may have adversely affected the expansions and development of these banks. Such a high ratio in the central bank put a drain on the resource of Islamic banks in the sense that it could be used profitably if it remained in the Islamic banks.\(^2\) Uptill now various reports and studies done on the performance of Islamic banking indicate that some of the problems and difficulties in its progress are: firstly, the Islamic banks still perform their duties in economic, administrative, legal, cultural and social situations where non-Islamic features prevail. Secondly, Islamic banks follow a system, a philosophy and practices which do not meet with nor run parallel to the practices of hundred of western banks surrounding them and living with them in the same community. Thirdly, there are legal problems such as the laws of those countries where Islamic banks operate require that banking should not be the subject of any risks. Their loans stipulate certain restrictions in this respect.

\(^2\) See the current survey done by an Indian economist, Ausaf Ahmad, Development and Problems of Islamic Banks\(^1\), (Jeddah: Islamic Research and Training Institute, 1987).
Fourthly, there are some theological difficulties where opinions diverge and unanimity is difficult to attain. Thus there is little co-ordination among Islamic banks in this respect. Finally, the one pertinent issue is that the nature of investment at present found with Islamic banks. Scholars have cautioned that short-term portfolios adopted by Islamic banks is dangerous for the system as a whole. They also feel that there is a problem of obtaining fast investment of liquid cash when available and the prompt arrangement when needed.  

The mechanism of Islamic bank is based on investment through partnership and requires a certain period of time for the study of the project to finance. In a survey it has been found that Islamic banks invest generally in the project with quick returns. This is because the banks have to pay a sizeable profit every year on the deposits and they cannot afford to have no profit for some time if they are competing with the interest-based banks. This means that long projects are not likely to be picked-up by these banks. If this is true then this is not only reducing the long run efficiency of Islamic

banks but will also effect the growth in developing countries if there are no banks to finance such deposits. Hardly anyone disagrees that to shift to an interest-free system, one of the crucial requirements will be to develop an institutional framework that can provide adequate financing for long term.

Some economists in their studies have found that there are two main tasks for the Islamic banks management: The first is the protection against "too optimistic" expectation and resulting damage in the bank's proceed from profit-sharing financing. Secondly, the opening up of new innovative opportunities for high profitable engagements. According to them, an interest bank can often standardise its credit investigation and confine itself to an examination of the securities for credit. But an Islamic bank can hardly ever resign on additional examination of the profit calculation, since its revenues are not fixed and independent of entrepreneurial profit but depend on them directly. The problem with these examination is not so much one of calculation techniques but one of well founded knowledge in those markets wherein the entrepreneurial partners intend an engagement with

Ahmad El-Najjar, the Secretary General of the International Association of Islamic Banks, mentions several obstacles in the progress of Islamic banks. According to him the major obstacles which the Islamic banks are facing can be removed by greater cooperation and persistence to encounter such problems. These difficulties stem from, firstly, the circumstances created by their existence in places and regions where they operate in an economic, legal administrative, cultural and social atmosphere of a non-Islamic nature. Secondly, their existence as a minority institution in the states where they operate. In a country where hundreds of other conventional banks exist there may be only just one, two or atleast three Islamic banks. Thirdly, from following a unique practice that neither be coverage nor can be assimilated within the system, philosophy or practice of hundred of Non-Islamic banks.

Naggar rightly thinks that Islamic banks have their own conceptual mainspring - defining the objectives, procedures and

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practices in which they are involved. But there is hardly any collision with hundreds of non-Islamic banks which co-exist with them. However, he makes a distinction between two systems of banking. Unlike the Islamic banks, the existing non-Islamic banks originally germinated in Europe, with the prime concern to gain control over resources and livelihood of people, through the utilisation of funds. Hence, the realisation of these two factors justified the adoption of any means or methods available serving that purpose. Islamic writers put much emphasis on the objective side of the Islamic banks. That is, unlike the Western commercial banking system, Islamic banks are "governed by controls derived from Allah's course", while conventional bankers are controlled only by hard competition. In this regard Ahmad El-Naggar believes that Islamic banks constitute an integral part of society, in harmony with its other constituents' on the march towards achieving 'Allah's course' while commercial banks

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6 Islamic writer's major objection towards existing commercial banking is that it depends on the philosophy of trading in money based on regarding money as a commodity. The commercial banks demand a price before funds render their function and here lies, as they argue, the essence of the riba or usurious system and source of much of the flaws and mal-functions of the money system. For a detailed treatment of Islamic concept of money and Banking see, M. Umar Chandra, 'Money and Banking in an Islamic Economy', in Monetary and Fiscal Economics of Islam, ed., by Mohammad Ariff (Jeddah : International Centre for Research in Islamic Economics, King Abdul Aziz University, 1982), pp. 145-76.
are not related to their own society except through profit making. In practice, Islamic banks work in the field of investment as they hold the belief that money is but a means to an end. Hence they do not trade in it. Conventional banks work in buying and selling money which they treat as a commodity and not as a medium of exchange. This gap between the two broadens dramatically when it comes to their objectives. Contrary to this objective is the final goal of the conventional banks crystallized in realizing profit even when it is gained at the expense of man. These differences between Islamic and non-Islamic banks will necessarily lead to other variances in relation to operational mechanism, methods adopted, style and procedures. Another problem Islamic banks face in their localities is that of a legal nature. Due to the regional or local laws in the countries where these Islamic banks operate, they may expose to risks in the course of undertaking its activities. Some of the problems faced by Islamic banks stem from the lack of a well-defined legal system specifying the domain and limitations property rights and contracts that fully correspond to the established banking system and Islamic law. This strengthens the environment of uncertainty,

limit long term investment, and force the banking system to concentrate its asset portfolios in short term transactions. Similar problems relating to legal framework is the Islamic jurisprudence which lacks consensus. A recent study by IMF says: 'that these problems' appear in different form in two countries i.e., Pakistan and Iran. In Pakistan as is mentioned, it has forced the government to establish special banking tribunals to deal with contract on Islamic modes, since the regular court system, as well as existing contracts and corporate laws cannot handle Islamic based contracts. According to the study this is a short term remedy, and problem will continue to persist and become more complex until the legal system and the underlying corporate and contract laws have become more attuned to the legal requirement of the new banking system. Iran in the Islamic Republic of Iran, where legal system is fundamentally based on Islamic law, the difficulty lies in the absence of a legislative definition of rights and limitations of private property which would explicitly determine the extent and intensity of the private enterprise activities in the economy.  

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8 For a brilliant report on Islamic banking in Iran and Pakistan; Zubair Iqbal and Abbas Mirakhor, Islamic Banking, (Washington: International Monetary Fund 1987), Occasional paper No.49.
Liquidity problem is also a big hindrance to be overcome by Islamic banks. Because the operation of Islamic banks is mainly based on financing through Musharikah (participation) an adequate span of time is required during which the study of the project is finalised, and funds are naturally highly illiquid. Now the challenge for the Muslim writers is to develop a programme for the study of Islamic finance which relies only on the Qur'an and the Sunnah. So far Muslim writers have merely borrowed empty economic boxes from the West and filled them with ideas which are Islamic in appearance.

Ghaisem Salehkhow, the executive director of the International Monetary Fund finds some pertinent obstacles that are on the way of Islamic banking. He says that most difficult obstacle for the Muslim writers is the diversity of political system adopted by Muslim countries. Muslim regimes are so diverse that they cannot even present a united front to their enemies. This, more than any other difficulty, hinders the task of introducing an Islamic social system. Islamic measures are introduced merely to serve political exigencies, and are not the result of a considered Islamic philosophy.

An obstacle in the progress of Islamic banks is wholly psychological. Najjar says that usurious mentality is still
controlling the attitude of most people. The depositors expect a yield, at least equal to the usurious interest if not more. The financed client is also expected to pay a yield equal to or more than usurious interest rate. Only a minority will commit to the priority of religious legality and alter obstinance from prohibitions few only realize the pioneering role rendered by the Islamic financial institutions of banks for the application of 'Allah's courses' in an investment completely conflicting with the principles they are based on. According to Ahmad El-Najjar:

'There are no barriers or obstacles, no matter how complex and multifarious, that can obstruct noble faith and un­failing persistance in applying Allah's course. Secondly, that all banks are called upon to exert more case, atten­tion and moral responsibility to the future development of Islamic banking. Thirdly, both Islamic banks and their associations are responsible for pay­ing more concern to the publication of Islamic banks and to the classification and explication of their objectives and activities. Fourthly, that public media, in Islamic countries should be urged to give more attention to right enlight­ment with regard to the goals of Islamic banks and the sole they under­take in realising the development of our Islamic communities and lastly, that government of all Islamic countries should be requested to devote more attention to Islamic banks and in particular with regard to the organisation of the
Another common obstacle is the misunderstanding that the abolition of riba will establish an Islamic banking system. Even then a successful Islamic banking system would not inevitably usher in a new Islamic social order. The existence of any type of injustice in the name of economic or social progress invalidates any claim to be truly Islamic. Some even go so far as to deny that the disruption of commercial banking has never been the aim of Islamic banking and that to liberate the banks from interest rates is Islamic objective. They even claim that it would be in the interest of commercial banks to allow Islamic banks to flourish.

It is a common complaint among some Islamic writers that Muslim countries have developed expensive life-style which are not

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9 Ahmad El-Naggar, "Islamic Banks: achievements and obstructions in focus", Arabia (London), March 1985, p.68. The author hints that Islamic banks have achieved a lot of progress hitherto, having offered several practical models to ensure and emphasise the validity of Islamic application in the field of financial transaction. The establishment of the International Association of Islamic Banks, and the higher body of Fatwa and Shari'ah supervision can also be counted among their achievements. On the top of that they have realised that the establishment of a number of specialized institutes and training centres for the study and application of Islamic principles in the economy.

10 Islamic Banking: the theory behind the practice", Arabia, (London), September 1986, p.43.
keeping with their values as their resource endowments and conspicuous consumption leads not only to corruption but also unhealthy monetary expansion, inflation, balance of payment deficits and a heavy debt servicing burden. In this regard M. Umer Chapra says:

An important reform in the reduction of governments wasteful spending without this reduction they cannot fight corruption or minimise their internal or external borrowing and deficit financing. However, the problem is that when governments are able to resart to interest-based borrowing they are under no compulsion to reduce their spending. The abolition of riba should force them to explore all possible ways of economising so that they realise maximum benefits with minimum spending.11

An interest-free economy is prone to a number of problems. The adverse public reaction to losses suffered by financial institution; the availability of very short-term loans not amenable to profit and loss-sharing; instalment credit; and government borrowing needs. These problems are of domestic nature but even at international level most countries are

burdened by a heavy foreign debt. They have to continue to service this debt and to borrow in order to finance their deficit.

Some exponents of Islamic banking believe that banking system cannot succeed unless all the political and socio-economic forces of an Islamic country are made to converge in this direction. Given this convergence, the banking system can be reformed to make a rich contribution. The rationale behind the idea is that since the deposits held by the banks belong to the public, credit should be allocated in such a way that it helps realize general social welfare. This can be attained by ensuring that 'Credit allocation leads to an optimum production, import and distribution of goods and services needed by the majority of society, and that benefit of credit goes to an optimum number of businesses'. These writers advocate socio-economic reform and give much emphasis to the moral uplift of Muslim society. They argue that "To talk of Islamisation without moral reform would be absurd. This does not mean that we should not abolish riba until society has been morally reformed; the two can be undertaken simultaneously. This will, however, necessitate a gradual movement towards Islamisation."

12 'Islamic Banking File', interview to Arabia (London) November 1985, pp. 65-66. According to author, another important reform is to inculcate people with the habits of simple living and the moreover, the reduction of government's wasteful spending.
They are in continuous search to find out ways and means to achieve an interest-free economic system. A number of books have been written on interest-free banking; but the economy as a whole, has been given little attention. There is a view that operation of an interest-free economy is far more complex than the operation of individual interest-free banks. Umar Chapra, a leading Pakistani exponent of Islamic banking says that implementation of Islamic economy is rather a complex issue, because complexity arises from the necessity of realising the socio-economic goals of Islam. This cannot be realised unless there is an equitable distribution of income and wealth, and in fulfilling the needs of all individuals in society. The conventional banking system has been a major cause of the concentration of income and wealth. It has also contributed significantly to an expansion of necessary wants and the diversion of scarce resources towards their satisfaction, thus leaving insufficient resource for need fulfilment. The Islamic system should, in sharp contrast with this, reflect the ethic, values and goals of Islam.  

His book *Towards a Just Monetary System* discusses the impact of prohibition of interest on the economy, and attempts to find answers to the problems posed by the creation of a fully Islamised economy. This book answers a number of questions about an interest-free economy that have not been adequately answered so far. Some of these questions, for example, are: what is the rationale behind the prohibition of riba? Can an economy run efficiently without interest? What will be the impact of the abolition of riba on resource allocation, savings and investment, economic stability and economic growth? What are the changes that will have to be introduced in the nature and operation of central and commercial banks? What are the auxiliary institutions which will need to be established in an Islamic economy? How will monetary policy be conducted? What are the new tools of monetary policy that will have to be developed? What reforms would have to be introduced in the social and economic lives of Muslim countries to enable the Islamic system to function effectively and to help to actualise the socio-economic goals of Islam.
When there is a question of changing the whole system, these issues have to be settled in advance. One burning issue is that of service charge by Islamic banks. There is still a debate whether a service charge be levied on pure loans. If the answer is in affirmative, how this is to be calculated and what direct and indirect costs need to be calculated in the calculation of this charge. How to envisage the cost in future without involving the interest element. This is a problem which both the Islamic Development Bank and the Islamic commercial banks will have to face when they advance pure loan. Another issue that muslim writers raise is 'how to decide a margin of profit in trading i.e. if a bank is supplying money to buy some merchandise, should it or should not it charge any profit on it and if the answer is in affirmative, what should be the rate of profit? In many cases such purchase may be a riskless. If this is true then can the mark-up charged by the bank be considered as profit and not riba? "How should the rent of physical capital be calculated so that it does not include the interest element?" 14

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14 M. Fahim Khan, 'Islamic Banking as Practised now in the world', op. cit., p. 274.
Use of Funds by Islamic Banks:

Some of the Islamic banks are facing the problem of surplus liquid funds. The exact magnitude of this problem is not known with certainty, but it is believed in the Islamic banking circles that the problem of excess liquidity is quite serious. This problem is in fact the result of the situation that construction loan in which some of the Islamic bank participated through Murabahah operations and realized "quick" profits is over and there are no more avenues for productive investment in the economy. The growth in the resources of Islamic banks and reduction in the demand for credit due to recession of the Gulf region have been identified as two main reasons for excess liquidity problem in the Islamic Bank.  

15 In 1980, the Islamic Development Bank introduced an investment deposit scheme whose main purpose was to raise resources of the Bank and to offer an investment scheme to prospective investors that functions in conformity with the Shari'ah and provides reasonable return to investors. The proceeds of investment deposit scheme are invested in the foreign trade financing scheme which is short-term by its very nature. The investment deposit scheme became very popular and a number of Islamic banks deposited their surplus liquid funds with the IDB in this scheme. The total deposit in the investment deposit scheme grew at a fast rate. Consequently IDB had to refuse some of the deposits under this scheme. In the present circumstances, the capacity of IDB to absorb deposits is constrained by its very liquid position. Therefore, a number of alternatives are being explored at the IDB as well as at the level of Islamic banks. One suggestion is that foreign trade financing operation in which IDB bears all the risk, should be modified in such a way that depositors (Islamic Banks) also share the risk of foreign trade financing. In effect, the proposal is that contract between IDB and depositors of investment deposit scheme should be modified from Mudarabah to Musharakah in which all parties share risks. This will increase IDB's capacity to absorb deposits. For details see, Ausaf Ahmad, Development and Problems of Islamic Bank, op. cit., p.65.
It has been pointed out that areas of possible cooperation between non-riba banking and western banking is the growing surpluses of some Islamic countries. For the last three hundred years, the process of capital money flow has been virtually dominated by Western institutions. As entrepreneurs and governments in third world countries obtain money capital from banks, the banks are in a position to influence the allocation of resources in the society. Thus the more vital interests of society - related to the level of economic activity, allocation of resources and the value of money - are liable to be handled either for the goods of the society or to its determinant by international banks. This is true even though local banking is controlled by indigenous banks. Therefore, because of the large surpluses of Islamic oil-producing countries, their economic future came to be viewed as dependent upon the way Western financial institutions performed their main functions as financial intermediaries and keepers of deposits. Historically, commercial banks have performed this function on the basis of fixed-interest payments; therefore, interest payments formed the basis upon which the banks dealt with depositors as well as the entrepreneurs to whom it advanced money capital. 16

Every society needs a mechanism through which savings and surpluses can be channelled to investors on the basis of some understanding regarding payments and returns. When society was relatively homogenous, the knowledge and communication between its members in respect to preference relating to risks, liquidity and repayment periods made barter or direct transactions satisfactory. As society became more complex and communication less efficient, the emergence of banks and insurance companies as financial intermediaries became both natural and logical. Accordingly, financial institutions continued to evolve until services such as safe deposits, checking facilities, easy transfers, overdraft, guarantees and agency functions in respect of purchase and sale, payment and receipt, and management and trust deposits became an integral part of modern banking. At the same time, as modern governments and private savers discovered that they need only a fraction of their assets at any one time, they opted to retain the balance with selected financial institutions. These institutions on the other hand found it desirable and profitable to retain a fraction of the deposits as a reserve, and advanced the remainder to other private and public borrowers who desired money capital for various periods of time. As borrowers used this money, new incomes were generated, bank deposit increased, and the same process started again. The results were the "creation of money" and an increase in money supply.
Some of the macro-economic benefits are visualised in the Islamic system. A large number of funds, which at present remain immobilised in Muslim countries would become available for productive investment. The ability of small and medium entrepreneurs to obtain financing would bring to the services of nation a large reservoir of entrepreneurial skill which would otherwise remain dormant for lack of resources. And the participation of banks in the losses of business financed will make them more careful in evaluating loan applications through the participation of banks in the success of business, greater information, skill and expertise should become available to business, thus making them more efficient and productive. 17

17 In an interview, a Muslim apologetic discusses the problems posed by the creation of a fully Islamised economy. He emphasises this points that in an Islamic economy there will have to be substantial changes in the life-style of Muslim countries and also in the nature and operations of commercial and central banks. He puts his argument: "We will have to change our life-styles, reduce our claims on resources and our dependence on borrowing. Moreover, we will have to introduce changes in monetary policy, we will also have to establish a number of auxiliary institutions to help the commercial banks and financials in their task of evaluating projects and auditing. "Banking Practice and Life Style", Arabia (London), November 1985, p.66.
A survey made about Islamic banks indicates that at present, the Islamic banks have a narrow and rather limited sphere of operations. Their portfolio structure is not well diversified. In the beginning of experiment with Islamic banking, it was necessary for the banks to choose "less risky and quick returns" type of investment projects for a variety of reasons. It would bring back the principal amount, generate profit and give access to resources for further expansion. It was also instrumental in bringing confidence among the managers and succeeded in showing to the general public the overall feasibility and viability of Islamic banking. Consequently, the Islamic banks concentrated investment in trade, real estate and construction etc. so-called "soft-areas" of credit. Although some of the Islamic banks have been undertaking equity participation in agriculture and industry, the number of such banks is very small. The problem is that the Islamic banks should come out of safe postures of "soft-investment" and invest in socially desirable long-term investment project. 18

According to questionnaire prepared by the writer, Islamic banks have made satisfactory progress in the last few years. All the banks singled out providing alternatives to interest-based

banking, efficiency and honesty as three most important reasons for their success; support of government and official agencies was mentioned by only three banks and only one bank referred to higher rate of return to investment.\(^{19}\)

\(^{19}\) Ausaf Ahmad, a defender of Islamic Banking writes that all except one bank which is in western Europe was ambitious to open branches in rural areas and agreed with the statement that Islamic bank in rural areas could serve a useful functions by mobilizing resources for economic development. Five banks felt that their investment portfolios was well-diversified while three banks accepted that their's was not. Six bank reported that they had a problem of excess liquidity, the other two said that they had no such problem. Amongst the six banks which have excess liquidity problem, one bank thought it to be very serious, two described the situation to be serious and for three banks it was not a source of serious concern. Excess of deposits, shortage of investment avenues, absence of long term investment opportunities, policy of central bank, and absence of very short term financial instrument etc, were pointed out as the factors responsible for the excess liquidity situation. For participation in productive ventures, Islamic banks were presented four alternatives: (1) involvement in management (ii) participation in supervision (iii) participation in equity (iv) provision of technical assistance. Only one Islamic bank i.e. Faisal Islamic bank of Egypt reported to use all the four methods; see Ausaf Ahmad, op. cit., p.69.
At present Islamic banks are mostly established either as a Joint Stock Company or a public limited company. Their financial structure reveals a complex and diversified pattern. The Islamic banks perform a number of banking functions. These functions range from opening of account for individuals and companies to undertaking direct investment and floating of subsidiary investment and trading companies. It is imperative for Islamic banks to conduct all their activities and perform all their functions in strict conformity with the Shari'ah. The business practice of Islamic banks includes: opening of current account, saving account, investment accounts and special investment account.

The structure of deposits has also undergone significant changes in Islamic banks. The relative significance of current account has declined and that of investment account has increased. The rate of growth of deposits showed that total deposits have increased at a faster rate in the initial period and at a slower rate in the later years. Similar trends could be observed about the growth of total assets. The structure of asset also exhibited changes over time. During the initial stages cash holding constituted a large portions of total assets. As bank matures, proportion of financial investment in total assets grows and that of cash holding declines.
One restriction is that the number of projects which can be financed by profit and loss sharing participation is limited; but supposing this number is large enough to employ all the funds of an Islamic bank, then other problems becomes obvious. One is that it would violate sound banking practices - and probably also the national banking laws and regulations - if short-term deposits were used for long-term financing. The higher the percentage of short-term deposits, the lower must be the amount which an Islamic bank can employ in long-term participation and investment financing.

Another limitation follows that if the bank has to employ the funds in such a way that an overall profit will result and which can be distributed to the capital owners and depositors every year, especially in the first year. Therefore, the bank cannot invest all long-term funds in newly established enterprises even if they promise high profits in the long-run; the short-term, new firms usually have not only no profits but close with losses in the first year. Thus the young Islamic banks have to channel some of their long-term deposits into investments which earn profits immediately, that is within the period during which the bank has to calculate and distribute profits.

20 See *Arabia*, (London) July 1984, p.47
Islamic banks perform all commercial, industrial, agricultural, transport, storage, mutual insurance activities, and so on. The capital in an Islamic bank is an essential guarantee to protect the deposits in the short-term and long-term. It is, therefore, necessary to impose strict conditions by stipulating a minimum of capital for Islamic banks, which is higher than the minimum for other banks. For the same reason, it is also necessary to be stricter in the ratio between capital and deposits in Islamic banks; for example; if the minimum for other banks is $ 20 m capital, it should be $ 30 m for an Islamic bank. If the ratio in other bank, between capital and deposit is 10 per cent, it should be 15 per cent in an Islamic bank. Most banking law required that the banks keep a part of the liquidity they are required to maintain in the form of deposits (with or without interest) treasury bonds or specified qualities, with the central banks. As Islamic banks are not operating on an interest basis it is necessary, while applying the restricted requirements of liquidity to allow the liquidity reserve required from them to be composed of elements in which Islamic banks are dealing, such as trade bills, shares and participating certificates of deposits, provided that it is negotiable according to special criteria.21

The basic ideas of banking laws for protections of deposits is the minimisation of risk. Islamic banks do not contest this principle although it is widely known that the basic principle of Islamic banks is the exposuer of risk. This is not precisely the case and therefore needs some detail and precision. The rule has been established by many religious texts.

1. The yield (return) is commensurate with the risk undertaken.

2. The profit is justified on the basis of a likely loss.

3. The yield (return) on capital not exposed to risk is not permissible.

It is evident that any income from an interest-based transaction, where capital and yield are totally secured, is prohibited because of the lack of risk element on the part of the owner of the capital.22

22 On the other hand, betting and gambling, whether they result in gain or losses, are prohibited operation because of the total risk involved. Between the two extremes of 100 per cent security and 100 per cent risk is located the area of allowed profit, carrying a portion of risk, *ibid.*, p.52
It is up to the investor to choose the degree of risk, he opts to expose himself to, and naturally, the higher the risk, the higher the profit and, on the contrary, the lower risk involved the lower the profit. Consequently, the banking formula known as "security, liquidity and profitability" is also known in Islamic banking, though in different practical forms. Conventional banks take the principle of 100 per cent security in their transaction which can not be adopted by Islamic banks.

According to an Egyptian economist:

"The formula adopted by conventional banks to follow the 100 per cent security did not prevent them from getting into difficulties, the least of which is bankruptcy of some banks which happens from time to time. The real lesson we should learn from the dilemma of third world debt is that depending on the creditor-debtor relationship not being the real expression of the 100 per cent security principles, it could even lead to the total loss of both capital and interest. The solution would lie in a formula where the security on the face is less than 100 per cent but where the creditor participates in the management of the funds and shares the result of his investment, carrying the real security for both capital and yield."

Since the depositors in an Islamic banks share in its profit and loss, while the relationship of depositors to the conventional banks is one of debtor and creditor, it is
recommended, while elaborating suitable system for the activities of Islamic banks, to give depositors a kind of supervision, over the activities of Islamic banks, which could take the form of a depositor's, 'General Assembly', entitled to participate in the discussions of investment accounts and to elect the auditors. Attending such a depositor's General Assembly could be limited to those depositors who have a minimum of $1,00,000, for instance and whose period of deposit is one year minimum. 23

Deposit Mobilization:

The Islamic banks so far have done an intensive research in devising non-usurious procedures to utilize their funds. Very little research has been done in devising the tools to attract deposits. This may be so because they have not yet faced the shortage of deposits. But if they do not pay attention to devise the non-usurious tools to compete with the interest-bearing tools of raising deposits, then these banks are likely to face problems in their growth particularly when they are working side by side with the modern banks. So far Islamic banks have the following types of deposits which differ from the deposits in other banks.

23 Ibid., p.52.
On saving accounts they are not obliged to offer any reward because the amount of the savings is guaranteed and the holders of these accounts are not liable for any losses that the bank incurs. This account, therefore, can attract only those customers who have money to save but do not want to take a risk and also are not keen to earn profits on their savings. Though, the investment accounts have the attraction of getting a higher rate of return than the current rate of interest this account will attract only those people who have the money to save, want to earn money and are willing to take a risk. For these two types of people, the Islamic banks have to compete with two institutions: (1) interest based banks (2) stock market. The third category of people, those who have money and want to earn profit on their savings without taking any risk, are not available to Islamic banks.

It is a general feeling that, as far as the tools to attract the depositors are concerned, very little research has been done in this area. This may be so because they have not yet faced the shortage of deposits. But as one writer points out that, 'if these banks do not pay attention to devise the non-usurious tools to compete with the interest-bearing tools of raising deposits, then these banks are likely to face problems in their growth. There has been a lot of theoretical discussion on the literature on Islamic banking as to how to save the
depositors of investment accounts from the risk of the losses that the bank might incur. Islamic writers, in search of a viable alternative to interest-based banking, have suggested a number of schemes such as building reserves by the bank out of their good time earnings to compensate losses in bad time or launch deposits insurance with the backing of the Central bank and the cooperations of all commercial banks and their depositors. 24

The slow growth in the deposits may not necessarily be reflecting the failure of Islamic banks to attract deposits but the fact remains that in a society where interest based banks are also allowed to exist, Islamic banks stand at a disadvantage. How they are going to successfully compete the interest-based bank is not clear from their current programme.

24 M. Fahim Khan, "Islamic Banking as practised Now in the world", in Ziauddin Anmadled) Money and Banking in Islam. Op. cit., p. 269; Fahim Khan points out that 'none of these scheme are so far operating and the depositors in the investment accounts stand liable to loss. None of the bank so far have undergone such a possibility. According to him 'an effort on a large scale is needed to devise non-usurious tools (going beyond conventional device) of banking that can raise the deposits for Islamic banks. The existing Islamic banks will have to do this research only in their own interest but also in the greater interest of the Islamic countries who are Islamising their societies.
It has been pointed out that Islamic banks in Muslim countries face certain special situation which is not shared by their counterparts in the capital-rich countries. The Islamic banks in poor countries will have to make an extra effort for resource mobilisation. Hence, it shall be necessary for them to undertake regional diversification so that Islamic banking does not remain concentrated only in urban centres. Large masses of population are concentrated in the rural areas in poor Muslim countries. In the event of regional diversification of Islamic banking, it might become possible to utilise the hidden and potential savings in the rural sector of these economies. Once the potential savings of the rural sectors are realized through Islamic banks, they could be invested in the project which would be socially productive. The choice of these bankable projects will have to be carefully made. It should be based upon the principle that local resources must be used for local development. Hence, priority must be given to small and medium size projects, covering agriculture, irrigation, handicrafts, small scale industry and agro-based industries in which local resources both financial and real, physical as well as human, could be utilized for potential use.25

25 Ausaf Ahmad, op. cit., p.
Delays in Payment:

One problem which the Islamic bank faces is how to deal with cases of delay in payment. In the interest-based bank it is easier to handle this problem as interest gets accumulating and sometimes the rates are increased if the debt is not paid promptly. Payments for financing techniques that are used by Islamic banks also become due at a specified time. Since Islamic banks do not charge interest, delay in due payments may cause a number of problems for them. One way to solve this problem is to sell the "collateral" against which finance is provided by the Islamic bank. However, it may not solve the problem completely. Hence, Islamic banks have been exploring the ways and means to impose a fine for delay in payment. The main problem is that it should be done in such a way that it should not resemble interest payment charged by traditional commercial banks in similar circumstances. Hence, it is suggested that Islamic bank may impose some penalty on defaulters for delay in payment in accordance with the stipulation of agreement in anyone of the following ways:

i. Claiming part of the profit which customers might have made during the period of default.

ii. Claiming the profit which the banks could have made if the held up funds were returned promptly i.e., opportunity cost of these funds.
Exchange of Deposits:

With the expansion of its network in different countries, the Islamic banks face another problem of exchange of deposit which need to be solved in conformity with the Shari'ah. The problem may be stated as follows: The Islamic bank A may have a surplus of US dollars and be in need of pound sterling. While Islamic Bank B in a different country may have a surplus of pound sterling but might be in need of US dollars. The following solution to this problem has been proposed:

1. "Agreement should be reached on the kind of two currencies for which exchange of deposits is to be made among the Islamic banks and value of each deposit is to be calculated at the prevailing exchange rate.

ii. Each party shall deposit with the other party the agreed amount as deposit which may be used and had to be returned on an agreed time.

iii. The same date shall be fixed for returning both amount so that each party shall return to the other what he would have taken in the form of an exchange of deposit.
iv. Agreement may be reached that each party enters the deposit from the other party in his investment account, it may also be agreed that both deposits be considered as a non-profit current account.

v. If both parties agree that each purchases from the others the currencies deposited with him by other party, that may be possible on the date of return at the rate of exchange prevailing on that date.

vi. No agreement may be reached that any party gain more benefit from the other except the right of use which is a mutual right for both parties.

There is a need to investigate the Islamic juridical, economic and operational aspects of this proposal. This problem is still being studied from different angles and no special solution has been adopted so far.26

"The structure of deposits has also undergone significant changes in Islamic banks. The relative significance of current

26 These proposals have been quoted from Ausaf Ahmad's Development and Problems of Islamic Bank, op. cit., p.56."
accounts has declined and that of investment accounts has increased. The rate of growth of deposits showed that total deposits have increased at a faster rate in the initial period and at a slower rate in the later years. Similar trends could be observed about the growth of total assets. The structure of assets also exhibited changes over time. During the initial stages cash holding constituted a large portion of total assets. As the bank matures, proportion of financial investment in total assets grows and that of cash holdings declines.  

In Islamic banks, neither the principal deposit, nor a predetermined yield on it, are guaranteed, in theory, by the banks. In this way Islamic banks do not stand as an original party in the relationship between both depositors and users of funds, but performs, instead, the role of a proxy of depositors vis-a-vis the users of funds. This proxy has two kinds, first, a proxy including delegation from depositors to invest their deposits in any project, called "General Deposits, where Islamic banks invest with numerous users of funds and consider all these general deposits as one pool. Profits of investments are placed in this pool and then redistributed among depositors on the basis of a points product system (each amount multiplied by number of days) after deduction of management fees.

27 Ibid., p.75.
Second, the proxy where the delegation from depositors is specified to investment of deposits in particular project after approval and acceptance of the risks involved. The profits of these projects are distributed among depositors after deduction of management fees of the bank. This is called in Islamic banking terminology 'specified deposits'. It is clear that in these two kinds of deposits and specially the second, the banks perform the functions known in the banking terminology as the "fiduciary function". It is also assumed that in both cases the depositor is aware of the risks to which this deposit is exposed. This principal of capital risk is an incentive for him to deposit his funds in this kinds of account and avoid depositing them in the pre-determined interest system. The principle of autonomous free-will of the parties where it is not contradictory to public order and public morale - is the suitable legal basis for allowing this kind of deposit.

The legal basis of the depositors' share in the bank's profit is the agreement of the banks share-holders (who are the only ones entitled to the bank's profit) to surrender a part of their profit to depositors. This legal analysis leads us to the problem of subjecting the yield, distributed among depositors, to taxes. It is known that the interest on deposits, paid by the conventional banks, is an expense, and is therefore,
deducted from income before arriving at the net profit, which is subject to taxes. The net, after taxes, and reserves are to be distributed as divided to the shareholders.

In the case of Islamic banks, the accounting follows the same trend. The yield distributed to depositors (as opposed to dividends distributed to share-holder) is considered an expense on the profits of the bank, to be deducted before arriving at the net profits of the bank, subject to taxes. The treatment of the yield on deposits of Islamic banks on the same basis as the treatment of interest on deposits in conventional banks is normal as both are returns on money.28

Co-operation Among Islamic Banks:

There can be close cooperation between various Islamic banks because they share the same ideology. Islamic banking in different countries and communities are trying to organize the banking business, which is backbone of modern economic and industrial system in consonance with the principle of Islamic Shari'ah, so these banks are operating at the same ideological plane and share a common value system.

At the operational level, the ideological operation of Islamic banks may take several forums. For example, it may take the form of exchange information and ideas, several Islamic banks hold seminars, symposia conferences from time to time and publish information bulletin, magazines and books several Islamic banks have a Shari'ah board and economic research section attached to them. It is imperative for Islamic banks to pool their intellectual resources to find Islamically acceptable solution of the problems confronting Muslim Ummah in its social and economic transformation.

One expression of the cooperation of Islamic banks at the ideological level is international Association of Islamic Banks set up in 1977. According to its statute the Association aims at "tightening the relations among Islamic banks, paving the way for cooperation among them coordinating their activities and ensuring their Islamic identity to achieve the Joint interest.

The association undertakes a number of activities and has participated in the establishment of Faisal Islamic Bank in Sudan, Egypt, Jordan, and Bahrain. It has undertaken various steps in the field of technical consultation among the Islamic banks. The purpose of this institute was to prepare necessary technical and professional manpower required for the growth of Islamic Banks.
Unfortunately, the Institute closed down after a couple of years of operation.

Islamic banks are in a position to undertake project financing, not only in the countries where they are located but in other Muslim countries as well. Since experience has shown that some Islamic commercial banks are reluctant to finance projects in countries where they are neither located nor represented, it would be in the best interest of Muslim countries themselves to have at least one Islamic bank in their country. This would not only pave the way for cooperation between Islamic banks and lead to growth of Islamic banks but could also be starting point for resource transfer from resource-rich countries to resource-poor countries. The mechanism of cooperation between Islamic banks can be Mudarabah and Musharakah and lending etc., depending upon the nature of project. Some of the Islamic banks are also holding equity capital in other Islamic banks also keep deposits with each other. Such practices would increase with the increase in the number of banks.

There are also people who hold the view that Islamic bank should have a full support from the Islamic Development Bank which is based in Jeddah. In this regard various efforts
have been made. For example, IDB proposed that there should be the involvement of Islamic banks in foreign trade operation of Islamic Development bank on the basis of risk - sharing. Also the involvement of Islamic banks in leasing operation of IDB where IDB bears all risk or shares it with Islamic banks. The other proposal includes:

1. extending line of learning facilities to Islamic banks which are at present extended to national development banks by the IDB;
2. co-financing of equity with Islamic banks;
3. IDB's participation in equity of Islamic banks.

However, to what extent these co-operation proposals are realized will depend not only on the IDB but also on the response of Islamic banks. However, it must be kept in mind that Islamic

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29 At the time of the annual conferences of the Islamic Development Bank, Board of Governors, representatives of various Islamic banks are invited as observers and a separate meeting of IDB and Islamic bank is held to discuss ways and means of mutual co-operation. The IDB also convenes joint meetings at other levels to exchange project information with the Islamic banks. Some of Islamic banks are involved in the investment deposit scheme of IDB, which keeps some deposits with some of Islamic banks. The attempt to identify further areas of cooperation between Islamic banks and IDB is a continuous process. See Development and Problems of Islamic Banks, op.cit.
Development Bank is an international financial institution having special concern for economic and social development of member countries while Islamic banks are commercial banking institutions. Therefore, regional co-operation between these two types of institution is constrained by their different nature. The objective of Islamic Development Bank is to foster economic development and social progress of member countries and Muslim communities as well as jointly in accordance with the principle of the Shari'ah. In this regard, both Islamic banks and IDB carry the same ideology. The project and activities preferred by the IDB may not be the same as those preferred by any Islamic bank. So, it has to be seen, in term of day-to-day working, that to what extent the Islamic banks can come forward to finance long-term projects. Thus, Islamic banks can play a useful role in social and economic transformation of Muslim society.30

The most common form of Islamic finance transaction is trade finance, where there has to be some element of risk. The Islamic institutions buy those materials from a seller and pay the seller and then sell those materials to the persons who really need.

30 These views were expressed by Ausaf Ahmad, Ibid., p.72.
Another factor that puts the Islamic banks at a disadvantageous position in composition with interest-based banks is that the Islamic banks have to supervise and in some cases manage the operation of the projects that they are financing. This problem is serious in developing countries where the business enterprises, generally, do not maintain proper accounts or keep different sets of accounts for different purposes.

The extra management burden of the Islamic Banks also put it at a disadvantageous position vis-a-vis the interest-based bank. Islamic banks have to supervise and in some cases manage

31 "Flexible, Liquid and benevolent; but confused", Arabia, (London) December 1984, p.44; Trrance Calson, an American Lawyer, deals primarily with Islamic financing and more generally with international business transactions such as acquisitions, mergers, joint ventures and licencing arrangements. Talking about the weakness and strength of Islamic banks he says: that the strength are first flexibility, second, great liquidity none of the Islamic Institutions I know of have difficulty in attracting deposits. It is not very likely that there is going to be a shortage of cash on that part of an Islamic institution. The third strength is that I think they do tend to look for projects that have a beneficial purpose and often will take more risk or perhaps take a lower rate of return if the project has a good purpose — if it is going to help people. Building hospital is one example.
the operation of the project that they are financing. It is considered that this problem is serious in developing countries where the business enterprises, generally, do not maintain proper account or keep different sets of accounts for different purposes. Fahim Khan, after surveying a number of banks writes that the presence of such mal-practices will raise the cost of Islamic banking. According to him unless such fool-proof devices are developed that do not entail these extra-cost of Islamic bankers, the growth of Islamic banking activities are likely to be constrained considerably. The Islamic banks have devised certain strict rules and regulation so that they select only sound parties but these procedures not only discriminate them infavourably against banks but also do not guarantee that their customers will be obliged to declare actual profit of their enterprise. None of the banks so far seems to have faced the problem perhaps, because either the Islamic banks have not expanded their business to the extent where they could feel this problem or because so far these banks have been dealing only in the real-estate and trade business where such management problem may not be significant\textsuperscript{32}.

\textit{Apart from internal and local problems of Islamic banks, the participation of these institutions in international market

\textsuperscript{32} M. Fahim Khan, \textit{op. cit.}, p. 273.}
have raised many problems still to be resolved. Rodenry Wilson points out two major problems: First problem concerns the banking regulations in most western countries which stipulates detailed reserved requirements for all licensed banks and deposit takers. The view that the sole liquid asset must be cash or interest bearing treasury bills, does not confers with the Islamic principle; Islamic banks often hold commodities such as precious metals or even certificates of ownership of commodities as part of their liquid assets. The assets which the bank acquire for resale under the murabaha (profit-sharing) scheme are usually counted as part of their reserves, but western banking regulations do not recognise this. 33

Another problem in the relationship between Islamic banks and conventional banks both in term of participation in clearing arrangements and dealings in the inter-bank markets. If an Islamic bank arranges currency exchange with Western banks, or even arranges acceptance of cheques drawn on other banks, it becomes involved with institutions which profits from interest transactions, and it may even end-up holding interest bearing assets itself.

The experiment of Islamic bank, in so far as their results are concerned, have brought out something like this. At present, the Islamic banks have a narrow and rather limited sphere of operations. Their portfolios structure are not well diversified. In the beginning of experiment with Islamic banking, it was necessary for the banks to choose "less risky and quick return" type of investment projects for a variety of reasons. It would bring back the principal amount, generate profits and give access to resources for further expansion. It was instrumental in bringing confidence among the managers and succeeded in showing to the general public the over-all feasibility and viability of Islamic banking; consequently, Islamic banks concentrated investment in trade, real estate and constructions etc. - Although some of the Islamic banks have been undertaking equity participations in agriculture and industry, the number of such banks is very small. Now the initial viability being established, Islamic banks need to come out of safe pastures of "soft-investment" and invest in socially desirable long term investment projects.

The financing of long term projects by Islamic banks have certain pre-requisites not required by interest-based banks: The Islamic banks will have to identify projects, carry-out technical feasibility studies, estimate expected stream of profits and only then they shall be able to invest in a project. Moreover,
they will have to develop a long term investment strategy. The interest-based banks usually are not concerned with macro-economic effects of their financing operations. The Islamic banks are expected to show more social responsibility in this regard by ensuring socially productive use of their resources.³⁴

Muslim proponents believe that Islamic banks as compared to other interest based banks are operating at a relatively small scale. It is argued that the expansion of Islamic banks has to take place on two lines: first, Islamic banks need to be established in those muslim countries where there are no Islamic banks. The number of such muslim countries are 28. It is necessary to take actions for establishment of Islamic banks in these countries so that movement of Islamic banking does not remain localised one but becomes universal in Islamic world. Secondly, more and more Islamic banks need to be established in the countries

³⁴ A recent conference on Islamic banking held in London in April 1988 at London University's School of Oriental and African Studies (SOAS) focused on these problems. Professor William Ballantyne a barister specialising in Middle East law said: "perhaps what is required in today's climate is not just a restructuring of the Shari'ah to fit western economic concepts but some restructuring of those concepts in order to meet the Shari'ah. See "Banking Philosophies eye one another". The Middle East (London), p.30.
where they are already functioning. The establishment of new Islamic banks would strengthen the already existing banks. In that event, there would be more scope for inter-bank dealings among the Islamic banks. Slowly, one could expect the emergence of an Islamic banking system within each national economy which would complete with the interest-based commercial banking system and may really effect the direction in which investible resources are used. There is another dimension of expansion of Islamic banks. They must diversify their location regionally. At present, most of the Islamic banks are located in major urban centres. They should be ready to take Islamic banking to rural areas by opening more and more branches in the villages. The regional diversification of Islamic banks might help to develop saving and banking habits among the rural segment of population and promote resources mobilization for economic development.

Islamic Bank vis-a-vis Central Bank:

In some countries, central banks prohibit the involvement of commercial banks in trading and investment activities. This is normally done to prevent industrial houses from setting up, commercial banks and then to use them to their advantages in other

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35 Development and Problems of Islamic Banks, op. cit., p.64.
industries. This is a big hindrance in the development of Islamic banks as these banks cannot function without indulging in trade and investment directly. Hence the central bank will have to grant Islamic banks some special concession in this regard.

The relationship between Islamic banks and central bank was, and still is, rather tense. Islamic banks started in 1970s in Muslim countries which were dominated by conventional banking systems and governed by Western-style banking laws. Commercial banks in these countries, as well as central banks could not accept the idea of banking system not based on interest. Islamic banks were refused authorisation to operate. Responding to the pressure of public opinions however, the only way was to promulgate special laws exempting Islamic banks from the existing banking rules and even from the control of the central bank. Some Islamic banks were set-up under the patronage of governmental authorities, which were, by nature, far from the ordinary banking system.

36 "How the central banks can accommodate Islamic banking" Arabia (London) November 1984, p.48. Examples are the Ministry of Social Affairs for the Nasser Social Bank in Egypt (Religious Endowment) for the Faisal Islamic Bank of Egypt and Bahrain Islamic Bank. The Islamic banks prepared, as an alternative that the International Association of Islamic Banks such as the Islamic Development Bank of Jeddah. These proposals were not practical. The offer of, such an institution could be coordinations and cooperations and it would not cover any of the functions of central banks. Central banks pursued the subject, discussing it twice during the meeting of the central banks of Islamic countries, held under the auspices of the organisation of the Islamic conference. The direction of the discussion was steered towards promulgation of such laws, organising Islamic banking or at least, a change in banking laws to include a special section on Islamic banking activities — in both cases under the control of Central banks.
With the success of Islamic banks some rose within a few years to watch the rank of well-established conventional banks. Consequently, the central banks were forced to ask the legislative authorities to put this "unwelcome quest" under their control.

The central banks play a key role in supervising the commercial banking sectors. Therefore, a close central bank/Islamic bank relationship is vital for the promotion of the Islamic banking and financial system. In most Islamic countries, the banking, licensing and regulatory laws are modelled on western systems designed to regulate *riba* banks. Their laws and regulations have been formulated to supervise and control the traditional banks whose objectives and functions are basically different from the Islamic banks. The principal differences arise from the fact that the Islamic banks are based upon participation principles while the conventional bank's deposits are protected through the mechanism of central bank under its existing regulations. The contractual relationship between an Islamic bank and its clients, and the types of asset held by it, makes it practically impossible to totally abide by the central bank's legal requirements. Therefore, exemption or amendments to the existing central banking regulations are called for which would enable the Islamic banks to fulfil the statutory requirements. Since the Islamic banks need extra help and assistance from the
central banks in areas such as mobilisation of deposits, financial assistance and liquidity support, it is necessary for the central bank to make any financial provisions for rendering assistance to the Islamic banks.

The idea of central bank's control over the Islamic banks has been emphasised in order to protect their depositors as well as for the regulations of all their activities. The control will be in the form of internal regulations, control, mechanism, cooperation between Islamic bank in this respect and an exchange of experience among them - especially between the newly established ones and the older ones. Moreover, there should be neither total exemption of Islamic banks from control, nor their complete submission to the same rules governing other banks. Instead there should be different regulations suitable to the nature of Islamic banking, implemented by the central banks. 33

If there are more than one Islamic banks in each country, it would be possible to persuade the central banks to adopt different policies towards Islamic banks. Central banks must be persuaded that they accept a lower proportion of total deposits in case of Islamic banks; and the Islamic banks may be allowed to borrow from the central banks against their deposits on an

37 "How the Central banks can accommodate Islamic banking", Arabia (London), November 1984, p.48.
interest-free basis. Similarly, till the banking system in a Muslim country is Islamised completely, the Islamic banks and interest-based banks would continue to exist simultaneously. So long as the Islamic banking sector constitutes a rather small part of the total banking sector, the central bank's credit control tools are expected to be the same what they are at present. However, if the Islamic Banking sector grows and becomes a significant portion of banking sector in the national economy, central banks shall be compelled to take Islamic banks into account and develop new techniques of credit control to deal with them. Muslim economists also think that the central banks must make legal and financial provisions for Islamic banks, including the fostering of interest-free financial instruments, to enable them to function successfully with the existing international banking system. The role and functions of the central banks vis-a-vis the Islamic banks would have to be substantially different in areas of banking promotion, lender of last resort and credit control and regulations.

The central banks also need to accord at least equal treatment of Islamic banks so far as the fulfilment of the requirements, voting rights, licensing and establishment of new branches of Islamic banks. One of the major difficulties to the promotion of Islamic banks is the lack of interest-free financial instruments to enable them to meet the statutory liquidity requirement of the
central banks, as well as to place excess liquidity in profitable ventures.\(^{38}\)

The promotional aspect of the central bank's role in the Islamic banking development is extremely important and it will be an additional responsibility of the central banks in an Islamic society not to facilitate and assist the growth of new banks. Mutual sharing of experiences and know-how of central banking and Islamic banking operations, setting up of specialized departments in central banks would help Islamic banks.

The progress of the Islamic banking system will depend on the help and support that government and their central banking authorities are prepared to provide. In order to develop a market for interest free financial instruments, the central banks may explore various possibilities. These may include:

- allowing the Islamic banks to invest funds in instruments which may be issued by government corporations and agencies Islamically, on a divided basis, and to treat such investments for statutory reserve requirements.

- Opening Islamic investment accounts in the books of the central banks and paying profits to the Islamic banks for investment made by them in these accounts.
- issuing participation term certificates which would be yet another avenue for Islamic banks to invest on Shari'ah principles.

- purchasing from the Islamic bank some obligations such as *murabah* of customers of the Islamic bank and the profits accrued through such purchase can go to the central bank.

- participating in profit/loss sharing accounts of Islamic bank through investment in these accounts.

The central banks also need of the Islamic banks. Studies may be initiated for the creation of such markets where Islamic banks can place their surplus funds. In the areas of cash reserves and liquidity ratios, the regulatory measures by the

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39 The organisation of the Islamic Conference took official awareness of this important issue and set-up, under the aegis of Governors of Central Banks and Monetary Authorities of the Islamic countries, a high local committee to examine the whole range of relationships between the central banks and the Islamic banks. The committee met in Riyadh in March 1981 under the chairmanship of the Governor of the Saudi Monetary Agency (SAMA) and prepared an exhaustive report on the "promotion, Regulation and supervision of Islamic Banks", The report reaffirmed that the establishment of Islamic banks would reflect the sincere desire of the people of the Islamic world to apply the Islamic Shari'ah in different fields of life. See *Arabia*, London, Feb. 1986, p.62.
central bank vis-a-vis Islamic banks need special treatment. In the cases where the central bank pays interest on cash reserves, the ratios for Islamic banks need to be suitably reduced to compensate them.

The dialogue between the central banks and Islamic banks is an ongoing process. On behalf of the Islamic banking system, the International Association of Islamic Banks has already stepped into establish and coordinate contacts with the central banks and also to undertake further studies and research in Islamic banking fields with the help of eminent experts. Some countries have already amended their banking and other related laws and introduced new legislations where necessary, to enable the establishment and functioning of Islamic banks. Given the circumstances under which Islamic bank works, they are at a considerable disadvantage compared with conventional banks. The Islamic financial system needs to be supported nationally by well developed and sophisticated Islamic monetary regulations set by central banks.

Central banks, being the guardian of the banking communities in their respective countries, have a responsibility to exert efforts to promote Islamic banks. They have to set-up adequate guidelines for the regulations, supervisions and promotion of Islamic banks. Some of the areas where central banks can provide support may be summarised as follows:
Islamic banks cannot have access to money markets whether nationally or internationally, whereas conventional banks can easily resort to the central bank or other banks in case of a liquidity crisis. Therefore, the central bank is will have to make provisions, in its regulations to extend assistance to Islamic banks on basis of conforming to Islamic laws.

Since Islamic banks cannot deal with conventional financial instruments which are usually interest-bearing, central banks will have to look into ways and means of developing financial instruments which are interest-free. This will enable Islamic banks to make profitable use of funds they place with central bank to meet statutory liquidity requirements.

Solution to these problems requires a thorough understanding of the workings, technique and philosophy of Islamic banks by the monetary authorities. A special organ in the central bank has to be created to look after Islamic banks. This could provide a forum for exchange of views and experiences which could better place Islamic banks in their societies to play their role in full.

At the end we may conclude that the severe international economic recessions of the early 1980s posed a big test to the viability of the Islamic banks which had grown under the favourable economic conditions of the early decade. With the economic recessio
the Islamic banks came under pressure from two sides. Firstly recession at home led to a squeeze on their source of finance. This was partially the case for the large multinational banks whose main source of finance, both share capital and the deposits, came from the surplus oil economies of the Middle East. The second source of pressure was the squeeze on the profit resulting from the surplus in the world trade and the decline in the return on real investment which comprised the main sphere of activity of Islamic banks. Despite such pressures the Islamic banks appear to have successfully passed through this difficult phase.

To pass through the recessions of the early 1980s many of the Islamic banks had to undertake major restructuring measures. If the 1970s was the decade of youthful growth and multiplication, the 1980s was one of maturity and consolidation for the Islamic banking movements.

On both front the Islamic banking movements have made major strides. Serious pitfalls have been overcome and valuable experiences accumulated. Though these past achievements are reassuring the future path of development of Islamic banking is by no means an easy one. An important factor which can help ease the future progress of Islamic banking is to build upon the accumulated experiences of the past.
At a time when the growth of the world economy is being shifted by the apparent inequalities of its financial system, the experiences of Islamic banking movement may even have valuable lesson for the debt-ridden third world economies.\textsuperscript{40}

An international seminar on Islamic banking (held in Dacca March 1985) discussed the liquidity problems of existing Islamic banks and to facilitate the establishment of Islamic monetary and capital market. The issues discussed were that Islamic banks possessing convertible surplus funds could channel their money to other Islamic banks with foreign exchange deficit for profitable and mutually beneficial investments. Furthermore, banks facing excess liquidity could initiate contacts with potential investors and provide them with necessary finance, rather than waiting to be opposed.\textsuperscript{41}

\textsuperscript{40} The latest results of Islamic financial institution confirm that in the era of economic difficulties due to falling oil revenues, especially in the Arab Gulf states, most of Islamic banks have shown remarkable resilience because it has ability to absorb the shocks of economic recession than Western banks. For a full report see; "Islamic banks-recessionproof", \textit{The Times of India} (New Delhi) 15 January 1988, p.12.

There is a general feeling that Islamic banks should develop new financial instruments, to help mobilize medium and long-term savings to bring them into line with medium and long-term investment. The bank could also promote small and medium sized projects to encourage mass involvement and to share in the economic development of Islamic countries. Banks should try to develop incentives and facilitates to attract business from clients. All these issues mentioned in this chapter, however, reflect that Islamic banks are not in total failures. But despite the obstacles in their operations and lack of proper instruments, they may perhaps, overcome some of the problems through experiments.