CHAPTER-6

PROBLEMS OF ISLAMIC BANKING

Introduction

In its short history, persons involved in this field have studied the experiences of Islamic banks. In this chapter, the main focus would be on the problems and obstacles that Islamic banks are facing in various ways; the ideological, theoretical as well as the practical. These difficulties mainly stem from the circumstances created by their existence in places and regions where they operate in an economic, legal, administrative, cultural and social atmosphere of hostile or indifferent regimes. There are number of researches which show that Islamic banks are faced with problems such as environmental, conceptual, legal, institutional, and others depending upon country-to-country and place-to-place. Islamic banks are operating in various countries with different social, religious, and other heterogeneous conditions. Sometimes in the same country different governments can pose different set of challenges for Islamic banks.

Islamic banking is not only engaged in trade financing as presumed but in many of the Muslim countries they offer most of the services of a conventional bank like savings account, current account, special deposit account and money transfer through drafts, cheques, letters of credit and guarantee etc. apart from offering financial instruments ranging from interest free loans, venture capital, leasing and joint ventures to partnerships all under Shariah principle. However, it is stressed that it needs to develop a more professional organizational network and a wider client base. One of the earliest propounder of Islamic banking Dr. Ahmad Al-Najjar, some twenty years ago.

mentioned major problems confronting Islamic banking, many of them are still valid.\(^2\)

- Islamic banks perform their duties in economic administrative, legal, cultural and social situation where non-Islamic features prevail in one form or the other.
- Islamic banks follow a system, a philosophy and practice that do not meet with nor parallel to the system and practice of hundreds of other banks neighboring them and living with them in the same community.
- The legal problems, laws of countries where Islamic banks operate require that banking should not be subject to any risks. These laws stipulate certain restrictions which do not conform to \textit{Shariah}.
- There are some juridical issues where opinions diverge and unanimity is difficult to obtain, there is little coordination among Islamic banks in this respect.
- There is problem of seeking fast investment of liquid cash where available and the prompt arrangement when needed, as the work of Islamic bank is based on investment through partnership and requires a certain period of time for the study of the project to be financed.

Some significant problems, mentioned by various scholars are summarized by Fuad and Abdel Haq in their book \textit{Islamic Banking: Theory, Practice & Challenges}. To them these problems are basically arisen because of Islamic finance being a new discipline.\(^3\)

- It has certain boundaries and lacks the conceptual and analytical sophistication of conventional economics.


• Islamic economics has only recently come to be used as a rationale for determining policy objectives and implementation; consequently the data available for analysis are relatively limited.

• There is shortage of scholars sufficiently qualified in the relevant disciplines, Islamic jurisprudence and conventional finance.

• As a result of shortage of relevant data and qualified personnel there is a retardation of the theoretical development of the discipline.

• There has been a failure to establish modes of reasoning which will allow for a particular problem, the relevance of arguments from the fiqh or from conventional economics to be determined.

• The lack of criteria for determining whether a whole theory of all possible economic relations or transactions are needed, or if Islamic economics could or should confine itself to particular sectors of the economy or to particular sort of transaction.

A German economist Dr. Volker Nienhaus⁴ observes that Islamic banks are facing mainly three sets of problems.

1. Negative image of Islamic banking in Western Countries and by and large hostile or at least non-supporting role of the government.

2. Underdeveloped Islamic money market.

3. Islamic banks as practiced have reduced to just of legal alternative to the conventional Banks.

At present, in most of the Muslim countries there are some forms of Islamic banking or financial institutions which have been established since the second half of the 1970s. This development has basically taken two forms. The first has been an attempt to establish Islamic financial institutions side by side

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with traditional banking. In such attempts two types of institutions have evolved; Islamic financial institutions and commercial banks established mostly in Muslim countries, and Islamic investment and holding companies operating in some Muslim, as well as non-Muslim countries. These institutions compete with conventional banks to attract deposits from Muslims who wish to avoid interest and invest their funds on Islamic principles. The majority of later types of institutions are established through private initiatives. However, the earlier form has involved an attempt to restructure the entire financial system of the economy in accordance with the Islamic percepts.

For a comprehensive interaction of Islamic financial institutions in fully-fledged Islamic environment, it is stressed that even if the Islamic bank is functioning on the national level and in a completely Islamic environment, its transactions with non-Islamic economy cannot be a simple closed one. To achieve this idea of Islamization, the Islamic banks should go hand in hand with an overall Islamization process. This is the only guarantee for the efficiency and viability of Islamic banking models.

Vogel and Hayes, two Harvard University Professors, have classified the government stances on Islamic banking under the following categories:

1. Those that transformed their entire internal financial system to an Islamic form (Iran, Pakistan and Sudan).

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5 Throughout this study, the word traditional banking, conventional banking and the western banking will be used interchangeably and mean to express the form of banking other than those of Islamic banking. The commercial banks will also express the same meaning unless specifically mentioned Islamic commercial banks.

6 In both cases, by and large the banking operations of Islamic banks are subject to the specific regulations that apply to all banks. Few examples of the first category are Faisal Islamic banks in Egypt and Sudan, the Dubai Islamic Bank, and the Jordan Islamic Bank. Examples of the second that is investment holding companies having either a national or international character like the Dar-al Mual Al-Islami (Geneva), the Islamic Investment Company (Bangladesh), and the Bahrain Islamic Investment Company etc.


9 Attempt has been made by some countries to Islamize whole of their economy, however, the degree of successes of these attempts are yet to be observed.
2. Those that embrace Islamic banking as a national policy while supporting dual banking tracks (Bahrain, Brunei, Kuwait, Malaysia, Turkey, United Arab Emirates).

3. Those that neither support nor oppose Islamic banking within their jurisdiction (Egypt, Yemen, Singapore and possibly Indonesia).

4. Those that actively discourage a separate Islamic banking presence (Saudi Arabia & Oman).\(^\text{10}\)

Mahmood El-Gamal, a professor of economics at the Rice University, Houston, sums up the problems faced by Islamic banks in these words, “The recent history of Islamic economics is riddled with a number of paradoxes. First there is a great rift between the economic literature on Islamic finance, and the practical approaches taken by financial experts and practitioners in the area. Second, despite two or more decades of rhetoric regarding the development of uniform standards for Islamic finance, the market remains largely segmented. Third, despite the many juristic questions that are being raised by financial experts and practitioners, very few active jurists operate in the area. Fourth while those jurists have approved a number of new financial contracts that are extensively use in the Islamic finance industry, those same jurist have consistently criticized the overuse of those same contracts that they have declared to be Islamically permissible.”\(^\text{11}\)

Jassar al Jassar in *Islamic finance Success, Prospects and Neglected Areas*, identified that the key weaknesses to Islamic finance are lack of uniform regulatory and supervisory regime; absence of consensus on legal

\(^{10}\) The Kingdom of Saudi Arabia is only late entrant of the commercial form of Islamic banking. There is no sign of Saudi governments’ opposition to the Islamic banking as a concept. In fact the first Islamic bank i.e. Islamic Development Bank was established at the Saudi soil.

rulings; inadequate transparency; and failure to develop standardized contracts, short term liquidity and investment instruments.¹²

For Ibraim Warde, Islamic finance has not yet fulfilled its original objective of becoming an original and innovative system based on risk sharing that brings social and economic benefits to the Islamic world. Islamic moral hazard is also mentioned by the author, which suggest that very introduction of religion into finance can foster unscrupulous behavior.¹³

Divergence Between Theory and Practice

Various studies conducted on the practices of Islamic banks have found a big gap between theory and practices of the Islamic banks. Almost all theoretical models of Islamic banking are either based on Mudarabah or Musharakah or both but to date actual practices of Islamic banking is far from these models. Nearly all Islamic banks, investment companies and investments funds offer trade and projects fund on markup (Murabahah, and Bai-Muajjil), Istisna or leasing bases. Profit and loss (PLS) features marginally in the practice of the Islamic banking and finance.¹⁴ Two IMF fellows while studying the Islamic banking practices found varying degree of shift from the paradigm. They concluded that Islamic banking in actual practice diverges markedly from its paradigm (fiqhi) version and is carried out in a variety of ways that lie somewhere in between the benchmark (fiqhi) case and conventional (rihawi) banking. According to them the degree of divergence from the benchmark differs from country to country and at the end of the spectrum, Islamic banking

may coincide with conventional (ribawi) banking except for the terminology. Following table shows the crux of their findings.

Table No. 6.1
Islamic Banking in Practice: Shift in the Focus of Banking Supervision

<table>
<thead>
<tr>
<th>Issue</th>
<th>Paradigm Version of Islamic Banking</th>
<th>Islamic Banking in Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Robustness to absorb external Shocks</td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>1 Liquidity Risk</td>
<td>Less Likely</td>
<td>More Likely</td>
</tr>
<tr>
<td>2 Insolvency Risks</td>
<td>Less Likely</td>
<td>More Likely</td>
</tr>
<tr>
<td>Assessment and Management of Operational Risks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 Reliance on appropriate procedure and adequate infrastructure,</td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>2 Reliance on human technical expertise</td>
<td>Higher</td>
<td>Lower</td>
</tr>
<tr>
<td>Prudential Standards</td>
<td>Relevant to be assessed on a bank by bank and country by country basis</td>
<td>Crucial</td>
</tr>
<tr>
<td>Information Disclosure requirements</td>
<td>Higher</td>
<td>Lower</td>
</tr>
</tbody>
</table>

 Luca and Fatahbaksh, Mitra. "Islamic Banking Issues in Prudential Regulations and Supervision" pp 210

It is often observed that Islamic banks do not write down the value of their deposits even when they are faced with crisis or have to write down their assets values. For example, when Kuwait Finance House (KFH) declared a net loss in early 1990s, it did not write down the value of deposits. When Qatar Islamic Bank had to write down loans that it had made to the Bank of Credit and Commerce International, it did not write down the value of deposits.

did the Dubai Islamic Bank, when in 1998 its assets were written down substantially.\footnote{16}

Samuel Hayes and Frank Vogel in their book *Islamic Law and Finance. Religion, Risk, and Return*, concludes that “regardless of the theory, Islamic banks have found that their competitive and regulatory context compels them to mimic conventional banks... pushing them into short term, low risk investments in an effort to offer their depositors returns similar in quantity and risk to those obtained by conventional depositors”.\footnote{17}

**Problems in Islamization of Economy**

At the macro level one of the important operational challenges of Islamic banking is its system wide implementation. Many Islamic countries, at present, suffer from financial disequilibria that frustrate attempt at wholesale adoption of Islamic banking. Financial imbalances in fiscal, monetary and external sectors of these economies cannot provide a fertile ground for the efficient operation of Islamic banking. In most of the Islamic countries fiscal deficits are financed through the banking system. To lower the costs of this financing, the financial system is repressed by artificially maintaining limits on bank rates. Thus financial repressing is a form of taxation that provides government with substantial revenues. Massive involvement of government in the economy makes it difficult for them to reduce their expenditure. Raising tax is considered a difficult option, thus, imposing controls on domestic financial markets become inevitable for raising revenues. These constraints make it very difficult for Islamic banks and other financial institutions to realize their full potentials. Zamir Iqbal, of the World Bank, concedes that the countries having higher fiscal deficits have faced daunting task in Islamizing their economy. In

\footnote{16} Cunningham, Andrew, ‘Culture or Accounting: What are Real Constraints for Islamic Finance in a Riba Based Global Economy?’, Fourth Harvard University Forum on Islamic Finance: *Islamic Finance The Task Ahead*. Harvard University, Cambridge, Massachusetts, October 2000, p 144. (Foot note 4).

his own words, "State-sponsored implementation of Islamic banking has been troublesome mainly because of significant fiscal deficits and balance of payment disequilibria which does not leave much option for the government whose citizen may wish to practice Islamic banking but the economic realities are not very favorable." \(^{18}\)

Three countries, Pakistan, Iran, and Sudan are reported to be in the process of Islamizing their economy.\(^{19}\) Governments in these countries have taken initiatives to transform the whole economy on Islamic economic principles. However, this has not been an easy task especially when these motives, in certain section of the people, are taken merely as political gimmick. Economic and social conditions of these countries are such that hoping any positive gain in the near future would be no less than a miracle. Political turmoil, economic dependency and moral degradation are rampant\(^{20}\) One can never be sure if any good can be done to Islamic banking by these countries In the present era of global finance repressive economic system with heavy dependence upon foreign aid cannot serve the purpose and interest of Islamic banking.

The researches suggest\(^{21}\) that after the official declaration of Islamization the banks in these countries are complacent regarding their customers as they think that customers have no other option to turn to, secondly, banks have not attempted to market their own Islamic identity. One of the reasons mentioned about banks’ unwillingness to not to market their Islamic identity is the possible fear of loss of profitability of these banks due to increasing base of

\(^{18}\) Iqbal, Zamu, ‘Islamic Banking at the Crossroads’ in *Islamic Economics Bulletin* Agra, India Vol 12 No 4 July-August 2002, p 4

\(^{19}\) For some detail discussion of Islamisation processes in these countries Please see Chapter M U The Future of Economics: An Islamic Perspective*, Leicester, U K, The Islamic Foundation, 2000, pp 279-95

\(^{20}\) Of them, one is among the topmost corrupt countries in the world with more than 22% of its total population earns less than Rs 650 per month and more than 70% of its total revenue goes for interest payment only. (See, Khan, Husain, ‘Budget-IMF Friendly, Poor Unfriendly’ *Impact International* Vol 32 No 9, September 2002, p 39), another one is among the most isolated from the rest of the world and the third is one among the poorest of the world

underprivileged customers. Third, banks try to externalize the cost of Islamization by not putting their own effort to educate the people concerning Islamic principles. Professor Wilson calls it an abnegation of responsibility by institutions supposedly have become Islamic. In the coming paragraphs the Islamization of Pakistan economy is taken for some detail description for the sake of proper understanding of Islamic banking problems.

Islamic Banking Problems in Pakistan

The process of Islamisation started since July 1979 when the operations of Investment Corporation of Pakistan, National Investment Trust and House Building Corporation were remodeled on Islamic lines. Profit and loss sharing on the accounts of commercial banks was introduced with effect from 1st January 1981. Since 1985, the commercial banks claimed to have switched over to PLS banking. However, the issue of Islamisation resurfaced in 1991 when the Federal Shariat Court (FSC) confirmed in its judgment that switchover to Islamic banking had not taken place. The Federal Shariat Court in 1992, declared all forms of interest-based banking un-Islamic. The Shariat Appellate Bench (SAB) of the Supreme Court on December 23, 1999, upheld the judgment and directed the government to eliminate all forms of interest based banking by June 30, 2001.

United Bank Ltd. (UBL), a state-owned bank, filed a review petition against this FSC-SAB ruling in the Supreme Court of Pakistan (SCP). The government of Pakistan supported the UBL review petition against the ban on interest-based banking. In its defense the government maintained that

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22 Ibid.
23 Pakistan occupies high rank among the top most corrupt countries in the world. A corruption index prepared by Lambsdorf having scores between zero for most corrupt to ten for most clean shows the real picture of many Muslim countries including Pakistan, which obtained 1.00 in the index. In the same index Iran's score was 1.89. For detail see; John, G. Lambsdorf, ‘Empirical Investigations of Bribery in International Trade’, The European Journal of Development Research, Vol. 10, No. 1, June 1998.
implementation of the FSC-SAB judgment will create enormous problems for the domestic, western-style banking and the economy, as well as Pakistan’s official and private business and financial dealings with the outside world. Taking notice, the Supreme Court of Pakistan, extended the deadline by one year to June 2002.

Yet in another turn the Supreme Court of Pakistan (SCP) has now revoked the proposed ban that was to become effective from June 30, 2002, and has now sent the case back to the FSC and directed review all matters of the present banking and financial system. In its present judgment, setting aside the 1991 and 1999 rulings, the SCP said the case has been made by UBL, the government and those appealing against these orders because “there are errors floating on the surface of record”.25

The bench headed by the Chief Justice of Pakistan further observed in its ruling, “We are of the considered view that the issues involved in the matter require to be determined after thorough and elaborate research and comparative study of the financial systems which are prevalent in the contemporary Muslim countries of the world”.26

The Supreme Court also said that Justice Dr. Tanzilur Rehman, the then chief justice of FSC that gave the 1991 ruling had “delivered the judgment with a pre-determined mind, and had relied on views he himself had expressed in his own books and writings on interest-based banking and economy. Justice Rehman had also ignored opinions of globally known Islamic scholars and jurists including Sheikh Mohammad Abduhu, Sheikh Rashid Rida, Abdul Razzak Sanhuri, Sheikh Mahmood Shaltut the former rector of Al-Azhar University at Cairo, and the present rector of the university Dr. Muhammad Sayyid Tantawi”.27

25 The Supreme Court’s recent rulings received through e-mail: abdui@noord.bar.nl
26 Ibid.
27 Altab, Muhammad, ‘Landmark ruling lo impact the banking sector’ Arab News June 2002. Ruling received at the discussion forum of ibfinder@yahooogroups.com
The government of Pakistan removed Justice Taqi Usmani, who had been sitting on the Shariat Appellate Bench for the last two decades and had been instrumental in the process of Islamisation in the country.28

In their review petition the UBL and others put following challenging and pertinent questions that are albeit necessary to make one ponder upon;

1. Is there any single bank in the Islamic or Non-Islamic world, which is truly run on an interest-free basis?

2. Can a Central Bank conduct its monetary policy without a norm of interest?

3. Are not the practices of Islamic banks a queer blend of interest-based modes of finance carrying a façade of Islamic names?

4. What are exactly the Islamic compliant instruments of finance? Can these instruments meet the myriad and diverse needs of modern trade, finance and banking?

5. When and where have these instruments been applied and with what degree of success?

6. Does the Islamic Development Bank as the model Islamic bank operate on interest-free basis? If that is the case why did it offer to extend a loan to the government of Pakistan after nuclear detonation at an interest rate of 5% above LIBOR?

7. By what mechanism can Islamic banks undertake financial intermediation, which is the primary function of all commercial banks throughout the world?

Above-mentioned questions are very important and serious not only in the context of Pakistan but to the Islamic banking industry as a whole? Because of certain obvious reasons people are forced to think Islamic banking merely a window dressing of interest based conventional banking.

Chapra, one of the senior Islamic economists acknowledges that Pakistan has done much less in terms of providing the necessary legal and institutional underpinnings needed to make the system work honestly and efficiently than what has been done in a number of industrial and developing countries where the conventional financial system prevails. Chapra also admits that Pakistan does not serve a worthy example of Islamization. It seems to be gradually moving away from the socio economic goals of Islam in spite of the great deal of lip service being paid to it by the government.

A case study of Iran and Pakistan banking system conducted by two IMF staff mention three major issues behind the problems faced by Islamic banking in these countries, which are firstly, legal framework; these countries lack the well defined legal system, specifying the domain and limitations of property rights and contracts that fully correspond to the established banking system and the Islamic law.

Secondly, fiscal policy objectives and Instruments; the government of these countries have been unable to formulate non-interest based instruments for financing budget deficits, ‘thus the government, which is the major exponent of the implementation of the Islamic system, is forced to raise funds through borrowing on the basis of a fixed rate of return’.

Thirdly, inadequate financial infrastructure; this has two dimensions one the general and the other specific. The earlier one relates to the lack of familiarity with the requisites of Islamic business ethics emanated from lack of knowledge regarding Islamic ethical rules. The latter relates to the long-standing problem of inadequate education and training on the part of staff and personnel within the banking system.

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29 Ibid., p. 283.
33 Ibid. p. 27.
Another study by a senior economist of Pakistan specified three main reasons for the failure of Islamic banking institutions to effectively abolish interest from the operations of financial institutions that are:

a) Lack of political will.

b) Absence of awareness about the potentials of Islamic banking.

c) Inexperience of the banking sector. 14

Another Pakistani economist in his essay *Islamic banking as practiced now in the world* has given some detail account of the failures of Islamic banking in Pakistan. 15 He observes that very little has been done to attract deposits from the public.

Criticizing the Islamic banking movement in Pakistan, Muhammad Anwar Asi in his article 16 *Towards Islamic banking system, by fits and starts* says, “The movement for Islamisation gets a big boost when staunch religious elements are in ascendancy. This happened during partition of the country when the urge to adopt Islamic way of life was still strong. General Zia-ul-Haq got involved with the process in view of the strength of 1977 Nizam-e-Mustafa movement. In the recent years, the matter came to prominence due to rising fundamentalism in the country. On the other hand, only lip service is considered sufficient and the issue is put on the back burner when religious elements slow their efforts to press the point and push their agenda”.

Siddiqi, in this regard, opines that the problems of Islamic finance has only compounded when politicians of the country, riding high on the emotions of the public, have used this issue as the springboard for their power. The moment they succeeded the issue reached at the backburner. This has resulted in highly polluting the environment of the Islamic banking, commitment of the

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16 Published in, www.brecorder.com, nd. 2002
problems, frustration of the public and enthusiasm of the Islamic economists. Professor Siddiqi voicing his concern of the politicization of Islamization remarks that “Nation states tend to use everything, including religion in general and Islamic finance in particular, as instruments of national policy for promoting their strategic interests and hidden agendas. In case of authoritarian regimes, Islamic Finance has often been used as a tool for consolidation of authority and for ensuring political legitimacy. Priorities dictated by economics have been forsaken in favor of those dictated by political expediency.”

Macro Level Problems of Islamic Banks

Macro levels problems are those that are related with Islamic banking as an industry. The major problems confronting Islamic banking as a whole includes problems of Islamization of economy, which has not been encouraging yet. It may be pointed out that almost 20 years has passed since the beginning of Islamization of economy in few noted countries. Unfortunately these efforts have been sacrificed at the altar of politics. (See the above section of the Islamization of economy).

Another major macro level problem faced by Islamic banking is the agency problems i.e. moral hazard and adverse selection. Though this is a universal problem not specifically linked to Islamic banking but it becomes more pertinent for Islamic banking when it is characterized that Islamic economic system is more value oriented. Several of the problems faced by Islamic banks are originates from this agency problem. Especially heavy reliance of Islamic banks in short-term assets structure and resorting to financing techniques that are more close to conventional financing. A visible

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shift of Islamic banks from paradigm version is also the result of economic and social environment that is not conducive as far the Islamic values are concern.

Some of the ideological, theological and theoretical issues still haunt Islamic banking. in this regard current researches have specially focussed on Shariah standardization, financial engineering and secondary markets. These problems are further aggravated by the relative deficiency of Muslim countries in education, growth and development. Most of the Islamic countries lacked democratic system of governance and are marked with very high corruption in their public life. This has resulted in politicization of the Islamization.

Another major problem confronted by Islamic banks is the small size of their operation. Most of the Islamic banks are under capitalized and cannot enjoy the economies of scale. This problem stems from the fact that most of the Islamic banks are the product of individual initiatives (especially wealthy individuals of Middle East). Islamic banking in spite of generating all the euphoria is yet to become a mass movement. As yet Islamic banking has succeeded in select pockets only unless it reaches to the masses it will remain undersized, undercapitalized.

Islamic banking as a whole must be ready to face some of the harsh realities of the time. In fact Islamic banking is already faced with some of those difficulties. Islamic banking willy-nilly is compared with other Islamic movement of the time and is very often projected as manifestation of the so-called ‘Pan Islamizm’. Islamic banking as an industry cannot do much about it except to face the reality as boldly as possible.

Entry of western multinational financial institutions into Islamic banking arena has not helped the cause. It has hastened the competition forcing Islamic banks to follow a quick-buck psychosis. It is a well-known fact that conventional institutions are more keen to follow letter than spirit. In these situations Islamic banks are left with very narrow set of choices. If the Islamic

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banks are to compete in the market they must follow the conventional institutions who naturally are far more efficient in their operations as compared to their Islamic counterparts.

In this regard Islamic economists must think of establishing an organization like that of Bank for International Settlements (BIS) which can look into the over all affairs of the Islamic banking. This organization shall be assigned to harmonize the Islamic banking practices, will ensure the healthy competition, will issue Shariah guidelines and will also be authorized to issue and revoke licenses of the financial institutions claiming to follow the Islamic principles. The Islamic economists, bankers and the Shariah experts can discuss modalities since the issue is important enough to warrant immediate attention. If the bank for international Settlement (BIS) can issue and impose regulations to bring harmony into world commercial banking system why not an Islamic agency. Some major problems faced by Islamic banks are described below.

**Islamic Banking as Industry**

**Extra Management:** Islamic banking as industry faces various challenges. These problems are basically the result of the functions adopted by Islamic banks. One of such problems faced by Islamic banks is the extra management burden with regard to monitor and evaluation of the project financed by these banks. This in fact, puts Islamic banks at disadvantageous position vis-a-vis to conventional banks. The problem is further compounded by mal accounting practices adopted by entrepreneurs. Every cost incurred, raises the cost of the banks and lowers the profit of the depositors.

**Consumption Loans:** A big amount of loans are demanded for consumption or for non-productive purposes. How to finance these are big question before Islamic banks. Since profit cannot be charged on these loans,
Islamic banks have little incentives to finance these kinds of demand, which further pushes people away from Islamic banks. Some camouflaged practices under the name of *Murabaha* might be the outcome of these compulsions.

**Research and Training:** Teaching, training and researches are the wherewithal for the development of any discipline. Since Islamic banking is still in its nascent stage it becomes even more indispensable for Islamic banking. There are several aspects to this point; one of that is Islamic banking requires *Shariah* experts who are well versed in the financial aspects as well. Apart from this basic requirements Islamic banks also have to have financial engineers who could develop new products for the Islamic banks to keep them in competition with the conventional banks. Islamic banks need to train their staff who mostly have come from the conventional background. To acquaint them with the Islamic percept of banking there is need for training centers that could supply fresh graduates to this highly growing industry. In countries where whole economy is under transformation, a quality research becomes even more pivotal. Some long pending theoretical issues like determination of service charges, the maximum permissible margin of profit, the rent of physical capital etc, needs immediate attention of the researchers; earlier they are solved the better it is for the industry. In this regard, various Islamic economists have raised concern to ask whether service charges can be levied on pure loans. *If* yes, then how it is to be calculated? How to envisage the costs in future without involving the element of interest? How to decide a margin of profit? And how should the rent of physical capital be calculated, so that it does not include interest element?

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Small Size of Islamic Banks: Size is another important issue, which determines efficiency and the profit. Larger the size higher the economy of scale enjoyed by the industry higher the profit and so higher returns to public. Islamic banks are expected to perform all the services of the conventional banks at lower cost and also expected to provide higher returns to the public as compare to the conventional banks. However, this is not possible as long as Islamic banks do not enjoy considerable economy of scale. Following table shows average assets size of the seventy-eight Islamic banks during the period of 1996. Researches have shown that Islamic banks hardly arrive at the minimum required size to benefit from their size. One such study by Fuad and Iqbal⁴⁶ has found that minimum required size for full efficiency is US$ 500 million in assets. However, the available data indicates that Islamic banks are significantly below optimal size. It can be pointed out that by 1996 only ten Islamic Banks were of the optimal size and the rests were far behind the required size to enjoy the economy of scale.

Table No. 6.2
Islamic Financial Institutions by Size of Assets (1996)

<table>
<thead>
<tr>
<th>Assets (US$ Millions)</th>
<th>Frequency Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-50</td>
<td>39</td>
</tr>
<tr>
<td>51-100</td>
<td>13</td>
</tr>
<tr>
<td>101-200</td>
<td>4</td>
</tr>
<tr>
<td>201-300</td>
<td>3</td>
</tr>
<tr>
<td>301-400</td>
<td>8</td>
</tr>
<tr>
<td>401-500</td>
<td>1</td>
</tr>
<tr>
<td>&gt;500</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>78</strong></td>
</tr>
</tbody>
</table>

(Source: *Directory of Islamic Banks and Financial Institutions*, 1996, as quoted by Fuad and Iqbal.)

⁴⁶ Abdullah, Fuad and Iqbal, Munawar. op. cit. p.245.3
The Financial Engineering: The challenges are to introduce new Shariah compatible products to enhance liquidity in the market and to offer tools to manage risk and diversify portfolios. The contemporary Muslim economists, in various conferences and seminars have now discussed that financial engineering in Islamic finance will have to focus on new financial innovations\footnote{For the detail discussion on the issue, see Ausaf Ahmad, *Towards an Islamic Financial Market*. Jeddah IRTI/IDB, 1997. 81pp. And also in Askari, Hossein and Zamir Iqbal. “Opportunities in Emerging Islamic Financial Markets.” *Banca Nazionale Del Lavoro* Quarterly Review, 194, September, 1995, pp. 255-282.} that are able to satisfy the needs of the market on two ends of the maturity structure i.e. extremely short term money market and long term. Money markets that our Shariah compatible do not exist at present and there is no equivalent of an Islamic inter-bank market where bank could play over night funds or where they borrow to satisfy temporary liquidity needs. Infact as yet Islamic banks have so far mostly served as intermediaries between Muslim financial resources and major commercial banks in the west. Efforts should be made to reverse this one-way relationship. There is an urgent need to develop marketable Shariah based instruments by which asset portfolios generated in Muslim countries can be marketed in the west.

Operational Challenges: This can be looked upon at micro as well as the macro level. Micro level; means setting up the financial institution on a profit loss sharing principles. Macro level; means economy wide implementation of an Islamic financial system.

In presence of asymmetric information due to market inefficiency Islamic banks have found it difficult to develop a strong asset portfolio on the basis of (PLS). It has resulted in costly monitoring and preference for short-term trade related transactions. Moreover, lack of legal and institutional framework that may help in facilitating appropriate contracts has increased the problems of Islamic banks. Islamic banks are faced with the non-availability of equity-based benchmark a reference rate that reflects the rate of return on real sector. In such situation the common practice to evaluate the portfolio
performance or comparing various investment alternatives for Islamic banks has been the London Interbank Offer Rate (LIBOR) as the proxy.  

**Shariah Standardization:** Since Islamic banks have to accept the Shariah compatible investment portfolios; they have to clear their projects by the Shariah board. In the light of this the standardization of introducing new product has been another operational problem faced by Islamic banks. At present each bank keeps its own Shariah board for examining and evaluating each new product without coordinating the efforts among other banks. In many cases each religious board has its own preference or adherence to a particular school of thought. This process should be streamlined and standardized to minimize time, effort and confusion.

**Shariah and Investments Concerns:** Because of the religious dimensions of the Islamic banks new products and instruments cannot be introduced unless ratified by the supervisory Shariah board. Almost all the major Islamic banks have got their own Shariah Board whose members are though trained in the Shariah aspects but they lack even a formal training in modern finance. This seriously constrains the Shariah scholars’ ability to issue well-informed rulings on financial products and activities.

Similar problems relating to legal framework and religious jurisprudence arise due the divergence of views and opinions, resulting in difficulty or even impossibility of achieving a consensus. In this respect, co-ordination of Islamic banks meets with several problems. Some Shariah related

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44 Abdullah, Fuad and Iqbal, Munawar, ‘Some Strategic Suggestions for Islamic Banking in the 21st Century’, *Review of Islamic Economics*, Islamic Foundation, U K., No. 9, 2000, p 51
issues are required to be elaborated again to make it easy in understanding and in implementation. There are still various issues that are cumbersome, confusing and inconsistent while applying, primarily not because of inconsistency in its principles but in its interpretations. This also sends wrong signal to the practitioners. The judgment of Shariah scholar is neither absolute nor uniform. Various schools of Islamic jurisprudence apply Islamic teachings to business and finance in different ways. Disagreement on specific issues frequently occurs between and among them. Many times Shariah scholar changes their minds reversing earlier decisions.45

**Liquidity Concerns:** In some of the studies by western scholars, liquidity concerns has been projected as a big problem for Islamic banks, one such study mentions that “...among the most obvious impediments to the future growth of Islamic banking and finance are lack of liquidity, a limited set of approved instruments, cumbersome transactional arrangements, and no ready provisions for risk management.”46 Two of the problems i.e. ‘liquidity’ and limited sets of ‘approved instruments’ are refuted by Islamic economists. One such study by Iqbal has categorically disproved this charge.47 As far the limited sets of so-called ‘approved instruments’, are concerned the current researches has shown that Islamic finance has sufficient number of required financial instruments.

Some times either due to shortage of readily available projects or due to delay in assessing the viability of particular projects Islamic banks are found with surplus liquid funds which has been a cause of concerns for Islamic

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economists who now are discussing how to channel these surplus funds to deficient Islamic banks in most profitable and mutually beneficent ways. Furthermore, how could such banks facing excess liquidity initiate contacts with potential investors and provide them with necessary finance. There are also suggestions that Islamic bank should develop new financial instrument 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 Muslim countries.

Environmental Problems for Islamic Banks

In most countries of the world the system of banking prevalent is designed by the western and so the laws regulating it. In fact the present banking system is introduced by the colonial rulers to their subjects. Most of the banking laws were also designed by the western and after the independence most of the countries followed the same pattern of banking with minor changes in the banking regulations. Some of the problems faced by the Islamic banks emanate from these banking regulations. This is not to say that Western banking is by default against Islamic banking but it grew and prospered in such a way and its legal system evolved as such that it does not conforms to the spirit and objectives of Islamic banking. For example, legal reserve requirements were introduced for deposits safety and to curtail the credit creating capacity of the bank but at present it has become one of the biggest hurdle since Islamic banks are by nature investment banking and if a good amount of their deposits are held up in legal requirements then it will naturally reduce the profitability of Islamic banks. Another example is the divorce of commercial banking with actual business involvement; this again was done keeping in view the

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49 There are certain western banks in Germany and France that do not distinguish between commercial and investment banking. But these are exceptions, by and large there is clear-cut distinction between the banking activities and the investment activities where banking activities denotes financial intermediation only.
depositors interest as well as to avoid concentrating power into the hands of few. Those controlling the industry should not control banks and those running the banks should not engage in business activities, so that depositors are not risked and power is not concentrated into the hands of few. Wherever Western banking principles are followed, whether in the Western countries itself or in the Far East, Islamic banks are faced with certain basic problems that are direct consequence of inherent contradiction with Islamic banking principles. Two major such problems as pointed out by a prominent Western Islamic economist are:

- Banking regulations in western countries stipulate detail reserve requirement for all licensed banks and deposit takers. The ruling that the sole liquid asset must be cash or interest bearing treasury bills, does not confirm with the Islamic principles.

- The second problem is the relationship between Islamic banks and conventional western banks both in terms of participation in clearing arrangements and dealing in the inter bank market. If an Islamic bank arranges currency swaps with western banks, or even arranges acceptance of cheques drawn on other banks, it becomes involved with institution which profits from interest transaction and it may even end up holding interest-bearing assets itself.

A point, in this regard is raised by the Governor of the Bank of England is that, “It is important not to risk misleading and confusing the general public by allowing two essentially different banking systems to operate in parallel. A central feature of the banking system of the United Kingdom (and most of its previous colonies) as enshrined in the legal framework is capital certainty for depositors. It is the most important feature which distinguishes the banking sector from the other segments of the financial systems. Islamic banking is perfectly acceptable mode of financing but it does not fall within the definition

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of what constitute banking in the U.K. The Bank of England is not legally able to authorize under the Banking Act, an institution which does not take deposits as defined under that Act".50

The Director of International Islamic Bank of Denmark mentions another point that originates from the accounting procedure, "The tax laws are against the Islamic philosophy and pose the greatest difficulty. In most OECD countries Mudarabah is constrained by fiscal acts which define profit as an after tax item for the profit creator and a fully taxable item for the profit receiver".51

Some of the problems of Islamic banks emerge from the fact that Islamic financing techniques are difficult to define and explain under western terms. Wilson makes a point, "There is failure to explain the methods of Islamic finance in western terms and this tend to alienate the client. Second, for the client with minimal financial knowledge and little or no experience of banks, the literature is unnecessarily complicated and legalistic".52 Some other concerning issues raised by professor Wilson are, the lack of documentation on actual practices of Islamic banks and the lack of Islamic accounting standard. He says, "there is no practical guide to Islamic financial instruments, and no universally acknowledged standard reference manual for Islamic bankers to follow".53 About accounting practices Wilson writes, "most Islamic banks are subject to conventional audits", and these audits are usually checked by the Shariah supervisors who "have legal rather than accountancy qualifications, and may not be able to fully understand the accounting procedures. Further more they are paid a fee for their services, and have an interest in being

51 Kirsten, Ingo, 'Islam and financial intermediation', IMF Staff papers, 1982, p.120.
retained”. In these conditions a question of impartiality of the Shariah supervisors are natural to arise.\footnote{Ibid., p.13}

In some secular countries where socialist idea of banking is followed Islamic banks are forced in ‘credit rationing’.\footnote{In this case, a certain proportion of the total deposits are directed by the legal authorities to some specified sectors, defined as ‘priority sector lending’ for lending at low rate of interest.} While in other countries like India where mixed economy pattern is followed Islamic kind of banking is not possible under the current legal setup where apart from the stipulatory ‘reserve requirements’, ‘credit rationing’ is also required. A former officer at the Indian Central Bank ( Reserve Bank of India) and the Managing Director of India’s reputed Islamic financial institution Bait-un-Nasr mentions following, including other, factors obstructing the growth of Islamic banking in a country like India.

- Lack of availability of investment avenues, which can truly be considered to conform to the principles of investment of Shariah and also ensure safety, liquidity and reasonable returns.
- Institutional borrowing facilities in case of need (dearth of availability of liquid funds in case of emergency).
- The prevailing atmosphere of crises of confidence created by failures of organizations which had a tag of conducting their business on Islamic lines.
- Flashing of red signals by a couple of commercial banks.
- Absence of means for transferring surplus funds to the areas of needs.\footnote{Dalvi, M. Abdul Wahab, “Random Thoughts on Some Economic and Legal Challenges to Islamic Banking System”, Paper presented at the National conference on Islamic Economic Issues and Challenges, Organized by the Indian Association For Islamic Economics (IAFIE), New Delhi, October, 2-3, 1999. p.1-2.}

While mentioning some legal difficulties, Dalvi has also touched one important aspect from Shariah point of view. He says, “Islamic banks are not
allowed to build up their own reserves out of the cost to be recovered on the basis of loan" moreover, in India all such reserves of whatever size are not allowed to be invested by the law of the country in any manner other than the prescribed one i.e. in interest bearing instruments.58

Islamic Finance: Western Misgivings

It is more than three decades since Islamic banking and finance has been in practice. Yet Islamic finance is still in its infancy as compared to western conventional finance. It has been, however, developing with remarkable pace even during the current recessionary period. It was a general view at the beginning that Islamic finance is byproduct of the so called “oil boom”. Few of the writers often try to impress that fundamentally there is no difference between Islamic and conventional finance and whatever remains is largely due to fundamentalist (backward looking) approach of a few Muslim zealots who always want to go back and stick to the fourteen centuries old principles.

One of the misgivings, spread by some western scholars, is that Islamic banking is a product of the oil boom. Though some Muslim scholars have tried to dispel this proposition, detailed statistical data are still needed to establish the truth. It would be pertinent to pose the following counter questions before the western writers.

➤ Presently the Islamic finance industry, even with a fair amount of exaggeration, is not worth more than US $ 300 billion. Is not this amount too meager to be worth comparison with the oil boom, which runs into tens of thousands of billion dollars? What about the report published in the Financial Times April 11, 1996 that states that western banks and financial institutions have $ 670 billions Muslims money in

58 Ibid., p.4.
their coffers? A study conducted by Merrill Lynch in 1996 estimated that Middle East private investors are worth US$ 800 billion, of which about half is Saudi individuals. Where this money gone: Into Islamic banking?

- Saudi Arabia, one of the largest beneficiaries of the oil boom has still got the fewest Islamic banks in comparison to many other Muslim countries. And what about the above mentioned study, which puts Saudi high net worth individuals US$ 400 billion. Where this money is invested? Vogel and Hayes of Harvard have actually put Saudi Arabia in the group of countries that discourages Islamic Banking.

- A 1995 study/survey of global private wealth produced by Oliver, Wyman & Company placed the number of high net worth individuals at 2,550,000, with 3% coming from the Middle East. The worldwide assets of these individuals were estimated to be $11,500bn, with 4% coming from the Middle East. (The figures comes to $ 460 billion)

- Personal Finance magazine states that more than US$5 trillion is estimated to be looking for global wealth management and further refers to a study performed by Gemini Consultants and Merrill Lynch that estimates wealth held by high net worth individuals in the Middle East at US$1 trillion.

- How many countries playing pioneering roles in the endeavors to Islamize their whole economy are beneficiaries of the ‘oil boom’?

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61 As quoted by Gainor, Thomas, ‘Islamic Private Banking – Now and in the Future’. Paper presented at AIC Worldwide Limited Conference, Islamic Investment '99 17th September 1999. Author can be contacted at, Tom@gainorlaw.com

Do those writers wish to claim that Islamic revolution in Iran was a product of the oil boom?

Were the experiences of Mit Ghamr and Nasir Social Bank in 1963 & 1971 an outcome of the oil revenues?

Before establishment of the Dubai Islamic Bank and Islamic Development Bank in 1974 & 1975 respectively, hundreds of endeavors can be found in establishing interest free institutions in several countries like India, Pakistan, and Malaysia, etc. How many of these countries were beneficiaries of oil?

Muslim economists had been writing about Islamic banking since 40 years prior the establishment of the first Islamic bank. Were they writing in the hope of oil revenue?

These are a few questions that must be addressed by opponents of Islamic banking before they can claim authentically of their point. They should also answer convincingly the questions raised by Muslim economists regarding some inherent fundamental weaknesses of the present day banking systems. A few of them are as follows,

Why are such banking crises there frequently? What purpose does it serve the United States Government to pay billions of its dollars out of taxpayers’ money to keep Mexico pay interest? (Mostly due to the US banks)

Why are most industrialized countries always willing to lend to the poorest ones, even when they are aware of the paying capacity of the recipient countries? Are these debts out of love and human concern? One should not

At present, in India alone there are more than 200 such financial institutions like Muslim Funds

Bankul Meals, Cooperative Credit Societies and other unregistered philanthropic organizations which were primarily established keeping in view Muslims inhibition against interest. Many more such organizations has come to grief due to various reasons; however, the fact remains that Muslims always felt discomfort dealing with interest based organizations. This can also be construed from the fact that Muslims proportion in banking services is lowest in compare to other government jobs.
forget that the third world countries have paid more than three times their debt to the donor countries as interest only.\(^4\)

Muslim economists have argued years ago that the present banking system is inherently biased in favor of the rich against the poor. What is the reply to this charge? Would the rich countries oblige by giving the details of ‘petrodollars’ invested in their own countries? Was not the collapse of many financial institutions in the US during the 1970s due to the fear of massive capital flight caused by the establishment of the Islamic banks?\(^5\)

One of the pioneers of Islamic banking, in his recent address, at the Fifth Harvard University Forum on Islamic Finance Information Programme (HIFIP), has charged against the current financial system in these words, “There is a widely shared perception that there is much more inequality in the distribution of income and wealth today than at any other time in the entire past of mankind. This applies to the distribution within nations as well as between nations. Worse still, inequality is growing and there is nothing on the horizon to indicate a reversal in this trend. It is rightfully regarded as a potential threat to peace and a phenomenon unbecoming of human fraternity.”\(^6\) It is not as if only Islamic economists are in search of some value-based system of economy. A good number of western economists too are not satisfied with the current affairs of the world economy.

Why do many western writers give the example of Bank of Credit Commerce International (BCCI) as a failure of Islamic banking? Do they need to be informed that Islamic banks are those which do not deal with interest at least on paper? Was BCCI qualified on that merit?

\(^4\) A 1990 data shows that out of the $ 1200 billion owed by the Third World countries to the First one, only $ 400 billion constituted the original borrowing. The rest constituted the accrued interest and capital liabilities. See Ahmad Khushid, Islamic Finance and Banking: The Challenges and Prospects, Review of Islamic Economics, Islamic Foundation U K, No 9 2000 p 71


The number of failures of Islamic banks is miniscule compared to the number of failures of western banks. Bank failures, in U.S., in one year alone are more in numbers than failures of Islamic banks in the last thirty years together. In the US during 1990s only around 900 thrifts collapsed costing the insurer US $ 300 billion and the taxpayer US $150 billion\textsuperscript{67}. Bank failures, which averaged six (mostly small banks) per year from 1946 to 1980, have also risen exponentially, averaging 104 per year during the 1980s\textsuperscript{68}. As against this, how many Islamic banks have collapsed since the first Islamic bank the Mit Ghamr? Every body knows that this bank was closed, after successful operation of four years, due to political exigencies of the socialist government. Even if we include Mit Ghamr as a failure the only other bank, which can be declared as a failure, is the cooperative Islamic bank in Pakistan during late 1950s. How many other Islamic banks have failed? Or the government was forced to close after a run on it, which has become a common feature of the present day conventional banking. Even in a country where depositors are explicitly insured of the safety of their deposit by the government, bank run is not very uncommon. If certain Islamic finance companies in India, Egypt and some other countries can be construed as a failure of Islamic finance, then the picture is grimmer of the conventional finance. In India alone more than 30,000 finance companies had run away during the last couple of years\textsuperscript{69}. More so if the failure of some company can be declared as the failure of a particular system, then the US financial system is more worthy of being called a failure than any other. What could be the best example than the very recent (Enron, WorldCom, Xerox, US Airlines and many others) accounting frauds and corporate failures in the U.S?


\textsuperscript{69} Reserve Bank of India, Report on Trend and Progress of Banking in India. Mumbai 2000
Why do Western economists, when faced with a crisis, talk of low interest? Are they not shy of calling for zero interest? (Is not it because this would mean indirect support to Islamic banking).

Here, one need not intend to condone the failures of Islamic banks, which of course are a challenge to Islamic economists who need to work very hard to meet the expectations of the people.

Depositors in the Islamic banking system are in a more vulnerable position compared to the depositors of the conventional banking. By agreeing to share the risks they have reposed faith in the system at the cost of their own insured return. On the other hand the Islamic banks, which should have been happy due to their risk being shared with the depositors, have failed in delivering on the expectations. Islamic financial industry as a whole has woefully failed to develop an equity culture in its operations. One of the pioneers of Islamic banking, Professor Siddiqi is not very content with the current state of the Islamic banking, though, he is quite hopeful with the potentials of Islamic banking, according to him, “Not all Muslims are fully satisfied by the character and performance of the existing Islamic financial institutions. Barring the small minority who sees no need for them, most express dissatisfaction either on the ground that they are not Islamic enough or because they are inefficient as compared to their conventional counterparts. But all agree that these deficiencies could be remedied overtime and there is nothing to justify aborting the experiment. There must be some reason for this resilience”.

The onus now lies on Islamic financial institutions to capitalize on this resilience to develop and evolve Islamic way of business. Some of the apprehensions of Islamic financial institutions are genuine that the present accounting procedures along with moral hazards conditions make it difficult for

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them to offer Islamic financial instruments. But therein lies the actual challenge for the Islamic financial institutions.

**Islamic Banking Problems with Central Bank**

Since the central bank plays a key role in supervising and overseeing the commercial banking sector, therefore, a close relationship is considered to be vital for the promotion of the Islamic financial system. Although Islamic banks are in the operation for more than three and half decades they are not yet directly related to the concerned central bank in matter of policy framework. In most of Muslim countries the banking, licensing and regulatory laws are modeled on western system designed to regulate interest-based banks. These laws and regulation have been formulated to supervise and control the traditional banks whose objectives and functions are basically different from the Islamic banks. Thus, the contractual relationship between an Islamic bank and its clients, and the types of assets held by it makes it practically impossible to totally abide by the central bank’s legal requirements. Therefore, exemption as amendments to the existing central banking regulations are called for which would enable the Islamic banks to fulfill the statutory requirements. Since the Islamic banks based on *Shariah* principles need extra help and assistance from the central banks in areas such as mobilization of deposits, financial assistance and liquidity support it is necessary for the central bank to make legal and financial provisions for rendering assistance to Islamic banks.

There has been put more emphasis on the role of central bank for the control of Islamic banks in order to protect the depositories as well as for the regulating all its activities. There have also been suggestion to establish a kind of self-control in the form of internal regulations, control mechanism, and cooperation between Islamic bank in this respect and an exchange of experience among them especially between the newly established ones and the
older ones, so that this control system may develop in a way suitable to the nature of Islamic banking and the environment in which it is implemented.

Moreover, it is argued that Islamic banks must be allowed to borrow from the central banks against their deposit on an interest-free basis; till the banking system in Muslim country is Islamized 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 bank into account and develop new techniques of credit control to deal with them. However, 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. However, the role and functions of the central banks vis-à-vis the Islamic bank would have to be substantially different in areas of banking promotion, lender of last-resort, credit control and regulations. The central banks needs to accord at least equal treatment of Islamic banks so far as the fulfillment of the requirements, voting rights, licensing and establishment of new branches of Islamic banks, to enable them to meet the statutory liquidity requirement of the central banks, as well as to place excess liquidity in profitable avenues. Such rules are stressed because the promotional aspect of the central banks role in the Islamic banking development is extremely important in mutual sharing of experiences and know-how of central banking and Islamic banking operations, and setting up of specialized departments in central banks. These steps are considered necessary because 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 these facilities. Moreover, 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 dividend 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 Shariah principles, purchasing from the Islamic bank some obligation such as Murabaha of customers of the Islamic bank and the profits accrued through such purchase can go to the central bank, participating in profit/lose sharing accounts of Islamic bank through investment in these accounts.\textsuperscript{72}

Islamic economists also suggest that the central banks may promote development of money markets to the needs of the Islamic banks where these banks can place their surplus funds. Particularly, in the areas of cash reserves and liquidity ratios, the regulatory measures by the central bank vis-à-vis Islamic banks need special treatment. But in the cases where the central bank pays interest on cash reserves, the ratios for Islamic banks need to suitably reduce to compensate them. Thus, a 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 in Egypt has already stepped into establishing and coordinating contacts with the central banks to enable the establishment and functioning of Islamic banks. Given the circumstances under which Islamic bank works, we find them at a considerable disadvantage compared with conventional banks. The Islamic financial system needs to be supported initially by well developed and sophisticated Islamic substitutes for the classical monetary regulations set by central banks.

Since Islamic banks cannot have access to money markets whether nationally or internationally, whereas conventional bank can easily resort to the central bank or other banks in case of a liquidity crisis, therefore, the central bank is needed to make provision, in its regulations to extend assistance to Islamic banks on basis of Shariah. This will enable Islamic banks to make profitable use of funds they place with the Central Bank to meet statutory liquidity requirements. Solutions to these problems require a thorough understanding of the workings, technique and philosophy of Islamic banks by the monetary authorities. It has been suggested that a special organ in the central bank should 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.

In fact the severe international economic recession of the early 1980s passed a big test to the viability of the Islamic banks, which had grown under the favorable economic conditions of the early decade. With the economic recession 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. To pass through the recession 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. An important factor, which can help the future progress of Islamic banking is to build upon the accumulated experience of the past.
Problems with Financing Techniques and Market

When Islamic economics was introduced it was claimed that it is an alternate to interest based economy. It was contended that Islamic economics is contrary to the fixed pay off system of interest-ridden economy and drives its strength from profit and loss sharing (PLS). Therefore, all the banking models derived under Islamic framework were based on PLS principles. More than two and half decades of Islamic banking have proved that Islamic banking is far from those enshrined objectives and methods. Most of the Islamic banking practices still revolve around fixed pay system that too keeping in view interest as the benchmark. Even the Islamic Development Bank has failed to follow PLS principles in its business transactions.\(^{73}\) Where is the mistake? Islamic economists at various forums and seminars frequently raise the point. Is the mistake in model itself, or in the practices adopted by the Islamic bankers or with the public which is not ready to accept this system?

Two financing techniques, which have drawn a lot of controversy and criticism in this regard, are Murabahah and Bay Muajjal.

**Murabahah**: Keeping in view the contemporary practices, it is often pointed out whether Islamic banks are finding it practical to eliminate interest. The issue becomes even more debatable when Islamic finance practitioners try to legitimize variety of practices in Islamic banking that amount to interest in disguise. One of such controversial instruments widely practiced is Murabahah. It has often been observed that in many cases of Murabahah transactions Islamic banks do not actually buy or sell but they simply provide

\(^{73}\) See Wadood Abdul, *Basic Deficiency and Defects in Islamic Banks and the Remedy*, a commentary on IDB-IERTI occasional paper no. 4 ‘Islamic Banking: Answers to some frequently asked questions’ authored by Munawar Iqbal, Mabid Ali Al-Jarhi and M. Umer Chapra. This hand out is distributed through electronic mail. A survey of Islamic Development Bank financing shows that more than 70% of the IDB financing to its forty-eight member countries was under non-PLS mode, see Errico, Luca and Farahbaksh, Mitra, *Islamic Banking: Issues in Prudential Regulations and Supervision*, Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st Century, Harvard University, Cambridge, Massachusetts. October 1998, p. 209.
finance to buyers in a round about manner through proxy buying and selling and use this mode only to legitimize fixed-return on capital.

Aliero Ibrahim puts the blame on Islamic economists, he says, “The Islamic economists, in their urgent need for a financial system that conforms to Shariah and in the absence of an Islamic blueprint, try to replicate the western banking system by mechanically substituting the interest system chiefly with Murabahah.”

In fact a major portion of the Islamic banks assets are in markup (Murabahah) form, which ensures the bank a predetermined profit.

Arshad and Asad put this in another way, “Thus in principle interest-based transactions have been replaced by those based on Murabaha, leasing and some Musharkah, all of which are permissible under Shariah. Appearances are deceiving, however, and only the form of the transactions have changed with no change in the underlying transactions”.

Bay Muajjal: It is a variant of Murabahah and one of the most controversial financing techniques adopted by Islamic banks. Bay muajjal is defined as differed payment with markup which is intended for short-term loans to individuals, industrialists, farmers and traders. Very often this markup for differed payment is linked with time value. One of the pioneers of Islamic banking in this respect observes; “... with respect to bay muajjal a variant of Murabahah, I would prefer that bay muajjal is removed from the list of permissible methods altogether. Even if we concede its permissibility in the legal form we have the over riding legal maxim ‘any thing leading to something prohibited stands prohibited’. It is advisable to apply this maxim to bay muajjal in order to save interest free banking from being sabotaged from within”.

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Another very senior Islamic economist Professor Khurshid Ahmad says; “Murabahah (cost plus financing) and bay muajjal (sale with differed payment) are permitted in the Shariah under certain conditions. Technically it is not a form of financial mediation but a kind of business participation. The Shariah assumes that the financier actually buys the goods and then sells them to the client. Unfortunately, the current practice of “buy back on markup” is not in keeping with the conditions on which Murabahah or bay muajjal are permitted. What is being done is the fictitious deal, which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of the Shariah injunctions”.

Hasanuz Zaman, a senior Islamic economist, objects to the practices of Islamic banks in these words, “... many techniques that the interest free banks are practicing are not either in full conformity with the spirit of the Shariah or practicable in the case of large banks or the entire banking system. Moreover, they (Islamic banks) have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate.”

Zaman becomes more scathing and observes, “It seems that in large number of cases the ghost of interest is haunting them to calculate a fixed rate percent per annum even in Musharakah, Mudarabah, Ijarah (leasing), hire purchase, rent sharing, Murabahah, bay muajjal, Participation Term Certificate (PTC), Term Finance Certificate (TFC) etc. the spirit behind all these contracts seems to make a sure earning comparable with the prevalent rate of interest and, as far as possible, avoid losses which otherwise could occur”.

There are certain obvious and genuine reasons behind the failure of Islamic banks to follow an ideal system of an ideal society. Those include moral hazard, high expectations in terms of returns and services, high

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79 Ibid. p. 203.
monitoring and transaction cost involved in PLS financing, adequate legal backing in case of litigation, fraud, biased accounting practices and policies, adverse monetary and fiscal policies and the most importantly inability of the financial intermediaries to deal with actual businesses.

Many a times it has been observed that entrepreneurs with good profit expectations prefer a financing of their projects on the basis of fixed cost of funds (Interest, Markup, Leasing etc.), so that they do not have to share the profit with some one else. Another issue that compels Islamic banks to adopt quick and fixed return practices is high transaction costs involved in PLS modes which require highly qualified and costly personnel. In addition, supervision of long-term project also adds to the cost, thereby reducing the profit margin or increasing the risk. One more problem for Islamic banks is the short-term nature of their fund which is very risky to invest in long-term projects. Since most of the executive and managers of the Islamic banks come from conventional financial institutions they are not fully committed and sincere in following Islamic banking principles and those little serious are not well versed in Islamic banking principles.

Some of the problems faced by Islamic banks stem from the lack of a well defined legal system, specifying the domain and limitation of property rights and of contracts, that fully corresponds to the established banking environment of uncertainty, limited long term investment have forced the banking system to concentrate its asset portfolios in short term transactions.

Lack of Secondary Market: Secondary markets in Islamic financial markets are shallow, under developed, and inefficient. Lack of efficient

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60 It has also been observed that entrepreneurs with high-expected profit, if not able to get finance through Islamic fixed return modes, resort to conventional finance. On the contrary those entrepreneurs with low expected profit or high risk prefer Islamic banks leaving Islamic banks either with high risk or low profit portfolio.

secondary markets and liquidity in the Islamic financial markets has indirectly limited the range of maturity structure available to the investor. Due to absence of liquidity, Islamic bankers cannot easily expand portfolio across capital markets and are restricted to limited opportunities for portfolio diversification. Available data of three years portfolio structure shows that over a period of time from 1988 to 1990 the structure of Islamic bank in short-term portfolio has increased from 68 percent to 75 percent. While medium and long term investments structure reduced from 9 percent to 6 percent during the same period. Portfolio structures of Islamic banks during the period 1988-1990 are as follows.

<table>
<thead>
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<th>Types of Investment / Year</th>
<th>1988 (%)</th>
<th>1989 (%)</th>
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<td>Short term</td>
<td>68.4</td>
<td>75.4</td>
<td>75.6</td>
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<tr>
<td>Real Estate</td>
<td>20.9</td>
<td>15.4</td>
<td>15.5</td>
</tr>
<tr>
<td>Social lending</td>
<td>0.9</td>
<td>0.3</td>
<td>0.3</td>
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<td>Medium and long term</td>
<td>9.8</td>
<td>07.4</td>
<td>06.7</td>
</tr>
</tbody>
</table>

Source: International Association of Islamic Banks

Researchers have given several explanations for the failure of Islamic banking in adhering to the principles of profit and loss. Few of them are as follows:

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84 Dar Humayon, Harvey, I. David and Presley, R. John, 'Size, Profitability, and Agency in Profit and Loss-Sharing in Islamic Banking and Finance'. 'Second Harvard University Forum on Islamic
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• Capitalists’ unwillingness to bear risk and entrepreneurs’ tendency to exclude others from sharing profits.
• Islamic banks in the wake of severe competition from conventional banks are forced to offer relatively less risky modes of investments.
• Non-participatory role of investors in the management makes it less attractive.
• Equity financing is not feasible in short-term projects due to ensuing high degree of risk.
• Unfair treatment of equity in taxation also makes it less lucrative.
• Non-existent secondary market for Islamic financial tools.

Inter-Bank Co-Operation among Islamic Banks

After the experience of Islamic banks at the national and international levels, there has arisen much concern on the cooperation among them in various ways, i.e. financing, deposit changing, investing strategies, and innovating modes of financial instruments to suit the contemporary needs.

One positive aspect in this regard is that the conventional banks are becoming increasingly interested in relationship with Islamic institutions and a number of them have set up units which specializes in providing investment and correspondent banking services, Islamic bankers have yet to show that they can develop from this success at the gross-roots level into breaking the mould of traditional banking on an international scale. A positive step often suggested is the creation of an international Islamic banking society to enable Islamic financial institution to exchange information and get over their suspicions of one another.

In fact, the cooperation with the central banks in Islamic countries and other countries is still non-existent. Almost all the Islamic banks are working
under special decrees and are thus obliged to operate under these rules and regulation. The dialogue between Islamic banks and central banks has not developed at mature level. Islamic banking is also seen as an international banks, which means it will cooperate with the local Islamic banks by offering international banking services which of course include interest-free loans international investment, technology transfer, trade, commodity and currency trade, besides this development funding – all based on Shariah principle. But how to utilize its collective investment talents and professional expertise to strive for goals. Up till now, Islamic banks have been viewed skeptically in western banking circles. But as the movement gains momentous and respectability cooperation between Islamic and conventional bank is expected to induce the latter to develop special tools to help the Islamic banks at the time of their liquidity need that will further enhance the Islamicity of Islamic banks.

Cooperation between Islamic and conventional and among Islamic banks is also needed for inter bank transaction. There are many who feel that the case of Islamic banking cannot be advanced unless a strong system of inter-bank transactions based on Islamic principles is developed. The lack of such a system forces the Islamic banks to turn to the conventional banks for their short-term needs of liquidity which the conventional banks do not provide without either an open or camouflaged interest.65 Now, most of the Islamic bankers have found in their experiences that competition with conventional bank will be healthy attitude, but cooperation between Islamic banks should also be strengthened. This might help banks deal with the problems of liquidity shortages and surplus, for which adequate instruments have not yet been developed. This can be manifested specially in the direct trade relations between Islamic countries.

In various conferences among the bankers and financial analysts, it has been proposed that investment and merchant banks could act as financial

advisers, defining projects, analyzing costs and benefit and advising on economic life of projects. In return they would receive funding and management fees. One of the important ways in which western and Islamic institutions could work together is in devising new banking instruments that conform to Islamic principles.

Conclusion

Islamic banks have been facing a number of problems which can be evaluated on various grounds. Some of the problems faced by Islamic banks stem from the nature of their businesses. Another kinds of problems can be evaluated from the point of the view of the treatment Islamic banks receive from various governments, Muslims as well as non-Muslims. A set of problems is specifically associated with the institutions concerned. Several problems faced by the Islamic banks have been overcome by their past experience while new problems are still hindering the performance of Islamic banks at various stages. Some of them are related to their internal structure, which has grown unplanned and instantaneous to the demand of the community. Some of the inherent theoretical contradictions still haunt the business of Islamic banks. Early models of Islamic banks, which were supposed for financial intermediations only, has taken precedence by the Islamic banks engaging themselves in the actual business about which Professor Siddiqi has rightly mentioned, “All this (Islamic banking trading practices) keeps Islamic banks focused on doing what they are not equipped to do-real industrial or agricultural production, trade, commerce, etc. It also keeps them away from what they would be able to do as financial institutions”.86

Since Islamic banks have largely concentrated on actual business they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. Because of the same they are facing problem

in financing consumer loans and government deficits. Second, the risk involved in profit sharing seems to be so high that almost all of the Islamic banks have resorted to those techniques of financing which bring them a fixed assured return. As a result, there is a lot of genuine criticism that these banks have not abolished interest but they have, in fact, only changed the nomenclature of their transactions. Third, the Islamic banks do not have the legal support of the Central Banks, which seldom have the necessary expertise and trained manpower to appraise, monitor, evaluate and audit the projects that are required to finance. Various issues are yet to be resolved before Islamic banks could really expand their arms outside their small religious clientele. To penetrate the masses Islamic banks need to be more professional and service oriented besides maintaining their religious identity, which at present is diluted because of their certain dubious practices under the guise of Shariah. Islamic banks also need to devise Shariah compatible instruments, which would help them, finance consumption and the government that has not been possible in the past without indulging in wary practices.

Islamic banks in different countries are working under different formats in some countries they are registered as investment companies while in other they are working as non-banks, still in some other countries they are working as cooperatives, merchant banks, special purpose banks etc. This has rendered the supervisor confused about the actual nature of Islamic banks. This is not a healthy sign for Islamic banks; in whatever country they operate it is the responsibility of Islamic banks to convey their supervisor (Central Bank or any other supervisory authority) about the actual nature of their business practices. This will enhance the trust of the supervisor, bring transparency in their operations and thus lead to increase the acceptance and confidence of Islamic banks among the general public.

While summing up, the problems faced by Islamic banks, it would be worth to quote one of the senior most Islamic economists who stressed to express that "the climates under which Islamic banks are operating (domestic
and external) is anything but congenial. The moral fabric of the society is weak. The legal framework is antagonistic. The tax system is partial towards the interest system and almost inimical to a profit sharing system. The state of competition between the Islamic and traditional banking system is such that most of the odds are against the Islamic system.87

To help the cause of Islamic banking a country should have a developed financial market where innovations can be taken off without much susceptibility to the system. The country must not be corrupt which is the basic qualification of becoming Islamic and people of the country must be educated enough along with commitment towards the cause. If one analyzes the above prerequisite for developing a case for Islamic banking unfortunately none of the Muslim country would qualify. In some countries people are highly committed but they lack the requisite expertise and their leaders are highly corrupt. In many of the Middle Eastern countries people are educated, not as corrupt but they lack commitment, moreover, they have not been successful in developing their own financial market beyond a certain level as they mostly have carried their financial businesses in the Western countries.

One should not ignore that expectations from Islamic banking were very high in the beginning which could not be materialized fully, nevertheless, if one compares the first thirty years of Islamic banking experiences which are not as discouraging as the 19th hundred years of conventional banking when banking failures was a not an uncommon feature. Even today the number of bank failures in United States alone in a single year is more than the total failures of Islamic banking combined together for many years.88


88 Following the Great Depression and stock market crash of 1929, over 9,000 banks failed in the United States. At the end of 1990, there were approximately 900 out of 41,000 thrifts which collapsed costing the insurer US $ 300 billion and the taxpayer US $150 billion [Benston and Kaufman (1997)]. Bank failures which averaged six (mostly small banks) per year from 1946 to 1980, also exponentially, averaging 104 per year during 1980s [Gorton and Rosen (1995)]. All quoted by D. Ajit, ‘A Case for Risk Based Deposit Insurance System in India’. http://rbi.org.in, September 30, 1998. The cost of Savings and Loan crisis alone in United States in the 1980s and early 1990s are estimated to the tune of the size of the Islamic banking industry as a whole i.e. around US $150 billion.