CHAPTER VIII

ISSUES, CHALLENGES, AND FUTURE PROSPECTS

AN OVERVIEW

Banking and finance as a social and financial institutions have an important role to play in modern socio-economic system. It has been a necessary outlet in the process of capital formation and hence economic growth and development of an economy. In an Islamic system, banking and finance is regarded as necessary as is done by other economic system. However, the difference lies in its principles and operations that have to be compliant with the injunction laid down in the Islamic Shari'ah. The main doctrine of Islamic banking, which is based primarily on Qur'ān and Sunnah, has been the prohibition of interest or ribā in all of its forms, purposes, mild or excessive rate, and substances. Islam stands for justice and equitable distribution of wealth and promotes the concept of universal brotherhood, whereas interest mechanism perpetuates exploitation, concentration of wealth in few hands and results in various social and economic problems such as economic instability, public debt and so on. The Islamic banking principle refers to the risk factor applicable to both capital and labour. Thus, the provider of capital must be willing to assume risk in order to gain a return on his capital provided to the working partner or entrepreneur. This, in turn, implies a concept of mudarabah, i.e., an agreement made between two parties: one which is known as rabb al mal provides 100 percent of capital for a project and another party known as mudanib or agent who manages the project using his entrepreneurial skills; profit arising form the project is distributed according to the predetermined ratio and any loss accruing is borne by the provider of capital. The working partner loses the fruits of his labour. Thus, an Islamic bank
as a financial intermediary can be set up and operated employing *mudarabah* principle called two-tier *mudarabah*. That is, on its liability side, depositor enters into a contract with an Islamic bank to share the profit accruing to the bank’s business on the basis of *mudarabah*. The bank, on its asset side using the same principle, enters into another contract with an agent-entrepreneur who is searching for investible funds and is agreeable to sharing the profit with the bank in accordance with a predetermined percentage stipulated in the contract.

Besides assuming risks and abolishing all of its operations from involving in interest transaction, an Islamic bank must steer clear from indulging in illegitimate business clearly declared in Islam such as gambling, alcohol etc. Like conventional banking, Islamic bank accepts deposits from the public on three main accounts, i.e., current, savings and investment accounts. Islamic bank pays no fixed return on deposits but rather the depositors in the investment account share return with the bank on the basis of profit and loss sharing. On financing side, unlike conventional bank which charges fixed interest income from bank’s lending, Islamic bank employs several Islamic modes of financing based on non-interest earning to the banks, i.e., profit and loss sharing, profit from trade- and lease-related financing and service charge. *Mudarabah* and *musharakah* or primary modes represent Islamic banking modes of financing based on profit and loss sharing. *Murabahah* (mark-up sale), *bai' mu'ajjal* (deferred sale), *bai' salam* (forward sale), and *istisna'* (manufacturing contract) refer to as sale-related modes. *Ijarah* (leasing), hire-purchase, and rent sharing constitute lease-related modes. Whereas loan with service charge, *qard hasan*, *al-rahn* represent loan related modes of financing. Besides these financing operation, Islamic bank also renders normal banking services for fee such as transfers, remittances, etc.

Like conventional banking system whose development has been synchronized with the emergence of Industrial Revolution in 16th century, the development of Islamic banking system has been a consequence of widespread Islamic resurgence in Muslim countries to transform their economy
along the Islamic line. Since interest in the banking system is repugnant in Islam, an interest-free banking as an alternative to interest-based system must be developed. The core of Islamic banking – *mudarabah* - was practised by the Prophet himself and by several of his followers, and Muslims in later period had developed such practices to better suit their financial transactions. Nevertheless, such practices and developments could not become institutionalized and specialized until the second half of the 20th century.

Development of Islamic banking in modern period has been both in the forms of theory and practice. First came out literature on Islamic economics, banking and finance and then setting up of various Islamic banks and financial institutions since 1960s. 1980s saw establishment of a few Islamic banking institutions in some non-Muslim countries. Until the end of 20th century, there were over 1,500 works on Islamic economics, banking and finance and approximately over 200 Islamic and financial institutions have been set up spanning the globe from Canada to Indonesia. With total assets of over US$ 160 billion, Islamic banking services rendered by worldwide conventional financial institutions, such as American Citibank, ANZ Grindlays and ABN AMRO, not only imply emphatic endorsement of the viability of the Islamic banking system and great advantage to the introduction of the system to the world banking and financial market, their cooperation with the full-fledged Islamic banks and financial institutions also helps in the area of Islamic banking and financial product development. The establishment of Islamic money and capital markets and the launches of Islamic funds and Islamic market indices pave the way for worldwide commitment in Islamic financial market and show that the interest in Islamic financial and monetary scheme has taken on a global dimension.

Regarding Islamic banking and financial movement in several part of the world, Middle East represents a hub of the practice. The movement has been also spread into Europe, North America, Africa, South Asia, Central Asia, and South-East Asia. Many times, international conferences on Islamic banking and
finance have been organized to discuss and draw up solution, future plan, and development on problems and issues related to the subject and practice of Islamic banking and finance. Like multinational conventional commercial banks, several Islamic banking and financial group such as Dallah Al-Baraka Group has been set up and expanded its operation in the forms of companies and subsidiaries in a number of countries. The Jeddah-based Islamic Development Bank has been established since 1975 to act as a world bank of Muslim countries and communities. Three countries namely Iran, Pakistan, and Sudan have transformed their economies and banking practices to be based on Islamic line. At certain point of time, new Islamic banking and financial products and services have been developed to cater for the needs of clients and investors in modern sophisticated world.

General focus of Islamic banking and financial development has been given in the region of South-East Asia. Despite Islam has been embraced by many inhabitants in the region describing as a mass conversion during 15th century, distribution of the number of Muslims in the region has been uneven. A large number of Muslims, significantly attributing themselves with Malayu culture, i.e., a combination of Malayness and Islam, concentrate in the region of Malay peninsula including Southern Thailand and Malaysia and the islands of archipelago including Indonesia, Brunei, East Malaysia and Southern Philippines. Muslims scatter in the rest of the region, as minorities. The region has thus been divided into two distinct categories namely Muslim-majority and Muslim-minority countries. As far as Islamic banking is concerned, Malaysia has played the leading role followed by Indonesia and Brunei. From among the Muslim-minority countries, the Philippines, Singapore, and Thailand have also set out to make experiment of Islamic banking and finance. Thus the development of Islamic banking and finance in South-East Asia has been discussed in three separate chapters. Malaysia the leader in one chapter followed by Indonesia and Brunei in another and the group of three countries having Muslim minority in the succeeding chapter.
In the rest of the countries, in spite of sizeable Muslim minorities, Islamic banking and finance has not been developed due to unstable political and economic conditions and political constraints. The Philippines is the pioneer to have institutionalized Islamic banking in secular environment that transforms through many years of transitional stage. Although Philippine Amanah Bank (PAB) was set up in 1973, the Moros of the Philippines, like Muslims in other part of the world, had transacted traditional Islamic banking practices such as partnership and barter trade, long before that. PAB was set up as a specialized bank under the Presidential Decree No. 264, with the feature of commercial, development and savings bank, originally designed to serve the special banking needs of the Muslim areas in the South and as part of the government's response to the Muslim separatists. For several years, most of the banking operation of PAB were based on conventional banking entailing interest transaction, whereas Islamic banking component has been limited to the Pilgrims Special Savings Deposits (PSSD), working similar to that of the Tabung Haji in Malaysia. Until 26th January 1990 under the Republic Act No. 6848, due to inefficient operation and poor performance, the PAB was then replaced by another image of full-fledged Islamic bank under the name of Al-Amanah Islamic Investment Bank of the Philippines. Under the new image, banking operations of the PAB are based on the principle of Shari'ah.

In Singapore, although Islamic banking development seems to be insignificant in proportion to the country's financial development and capacity of the Muslims to have access to Islamic banking operations, Singaporean Muslims have achieved great success in mobilizing resources through Mosque Building Fund (MBF). As most of the mosques have been demolished for urban renewal and development, the second-generation of newly built mosques need a unique method of funding. MBF, whose significance is worth mentioning although not directly related to Islamic banking operation, represents a systematized collections of funds for the construction and maintenance of mosques, successfully managed by Singapore, probably the only country in the world to implement such scheme. As far as Islamic banking
is concerned, there is no restriction on the part of the Singapore’s government for the implementation of Islamic banking and financial services by private units. But for the country to become a truly Asia’s premier business and financial centre, its consideration to broaden its banking and financial industry to compose of Islamic alternative must be emphasized to diversify the financial structure of its economy.

In Thailand, the struggle towards government implementation of Islamic banking and finance is highly becoming politicized. Islamic banking practice in Thailand has been through several years of transitional stages from the self-managed informal arrangement to government-regulated Islamic cooperative and Islamic window. Due to differences in stands towards the implementation of Islamic banking, a government policy to approve and implement Islamic banking in certain government-led party was not supported and accomplished by another succeeding government. This has created frustration among the Muslim community and led to an idea of establishing an easy adopted government-supported Islamic savings cooperative. Despite being small social and financial units, Islamic savings cooperatives have proved great advantage in creating proper public understanding and popularity of Islamic banking paving the way to future aspiration of having an Islamic bank established. Islamic banking windows rendered by conventional commercial banks draw up public debate. Many Muslims are doubtful in such arrangement while many others are of the opinion that such implementation would be ideal in primary stage of Islamic banking development in the country, due to lack of infrastructural and human resources to establish a full-fledged Islamic bank.

Thus Islamic banking and financial institutions exist, with variant degrees, in many Muslim-minority countries in South-East Asia. But in spite of their well performances, magnitudes and developments, they may not be able to compare with that of the Muslim-majority countries. The existence of Islamic banking and financial institutions in Muslim-minority countries shows that the size of Muslim population is not a barrier to have such a banking system.
Under the category of Muslim-majority countries in South-East Asia, in terms of high percentage of Muslim population, Indonesia ranks first followed by Brunei and Malaysia. In fact, Indonesian Muslims represents the largest number of Muslim in the world. But in terms of Islamic banking and financial development, large number of Muslim population is regarded here as insignificant. Indonesia has more or less two big Islamic banking players, i.e., Bank Muamalat Indonesia established in 1991 and Bank Mandiri Syariah founded in 1999. This is obviously due to the fact that Indonesia, being a secular state, is set to have been influenced by the ideology of Pancasila in which democracy and capitalism constitute significant elements. The establishment of Islamic bank is rooted by a genuine need of Muslims that later gained government support. This is reflected by the tremendous response from the public demonstrated by the overwhelming stock buying as an instant commitment on the date of signing the Act of Establishment of Bank Muamalat Indonesia on 1st November 1991.

As far as the tiny sultanate of Brunei is concerned, the first Islamic bank, Islamic Bank of Brunei Berhad, started operation in 1993 as a royal-patronized financial institution paving the way for Islamic banking and financial movement in the country. With its aim to diversify its economy from oil-rich nation into a regional financial hub providing employment opportunities as well as attracting new skills and technology to compete with its neighbouring countries i.e., Malaysia and Singapore, Brunei has decided to build an international offshore financial centre to capitalize on the niche market of Islamic banking.

Among the Muslim-majority countries of South-East Asia, the main emphasis has been focused to the development of Islamic banking and finance in Malaysia. With most advanced and highly developed Islamic banking and financial movement than any other countries in the region, Malaysia's Islamic banking and financial development deserves to be regarded as the model of the future, not only for other countries in the region but rather for the world at large. In Malaysia, Bank Islam Malaysia Berhad (BIMB) was established in July 1983
with a paid-up capital of RM 80 million, as its first full-fledged Islamic bank licensed under the Islamic Banking Act 1983 (IBA) which was enacted for Islamic banking to exist side-by-side with conventional banking. The bank was listed on the Main Board of Kuala Lumpur Stock Exchange on 17th January 1992. In 1997, BIMB implemented a restructuring arrangement to increase its paid-up capital to RM 500 Million and assumed the title of BIMB Holdings Berhad. The restructuring implementation was arranged to accommodate the growth of its asset and to better position itself in meeting future expansion and growth. As at end-June 1999, the assets of BIMB stood at RM 7.1 billion while deposits and financing outstanding amounted to RM 5.7 billion and RM 3.8 billion respectively. It has 80 branches throughout the country and 1,670 staff manning the bank. After more than 15 years in existence, BIMB has proved that Islamic banking is viable and had demonstrated its ability and capacity to operate in parallel with conventional banks within the banking system.13

Although Malaysia has already established an Islamic bank since 1983, the bank was not able to serve the entire needs of the population, especially since the operations of the Islamic bank were constrained by the limited number of branches and resources. Furthermore, a single Islamic bank does not constitute a banking system. An Islamic banking system requires a large number of dynamic and pro-active players, a wide range of products and innovative instruments, and a vibrant Islamic money market. This has led the Central Bank of Malaysia, Bank Negara Malaysia (BNM), to introduce various measures to provide the necessary infrastructural and institutional framework to an Islamic banking system in the country. These measures, for instance, include the introduction of Skim Perbankan Tanpa Faedah (SPTF) or Interest-free Banking Scheme (IBF) in March 1993, which allows conventional banking institutions to offer Islamic banking products and services using their existing infrastructure, including staff and branches subject to specific guidelines issued by BNM. As at end-June 1999, the number of participating banking institutions amounted to 54, comprising 24 commercial banks, 18 finance companies, 5 merchant banks and 7 discount houses.14 Another major development in
Islamic banking in Malaysia was the introduction of the Islamic money market on 3rd January 1994, for the smooth functioning of the system. It plays an important role, firstly, in providing Islamic financial institution with facilities for adjusting portfolios over the short-term, a major problem of Islamic banking system, and secondly, in serving as a channel for the transmission of momentary policy. Hence, Islamic banking sector gains greater significance in mobilizing resources for financing economic activities. The Islamic money market comprises three aspects, i.e., trading of Islamic financial instruments, *mudarabah* inter-bank investments (MII), and the Islamic cheque clearing system (ICCS).\(^{15}\)

Besides banking intermediaries, BNM has also encouraged non-bank Islamic financial intermediaries to improve their participation in the Islamic banking sector. These ancillary institutions, which have created their own niche markets, include the *takaful* (Islamic insurance) companies, savings institutions such as Tabung Haji, development finance institutions, and other financial intermediaries which offer Islamic banking services such as the housing credit institution. On 1st October 1999, the second Islamic bank of Malaysia, Bank Muamalat Malaysia Berhad (BMMB), commenced operation as part of the strategy to promote greater competition and innovation among the players in the Islamic banking system.\(^{16}\) Apart from Islamic money market, Islamic capital market, which comprises the securities [facilitated under the Government Investment Act 1983(GIA)] and the Islamic corporate securities (Islamic debt securities and Islamic equity) are offered to the public and institution; and the secondary market, in which existing Islamic government papers and Islamic corporate securities are traded, provides another important Islamic resource mobilization for financing economic activities. All these hub of measures help Malaysia to create a comprehensive Islamic financial landscape in the country encompassing the Islamic banking system, the non-bank Islamic financial intermediaries, and the Islamic financial market. Total assets of the Islamic banking alone as at end-June 1999 stood at RM 34.1 billion while deposits and financing amounted to RM 26.1 billion and RM 11.7 billion respectively.\(^{17}\)
The target of 5 per cent commitment and performance in terms of Islamic banking deposits and financing had been set by BNM and successfully accomplished by individual banks by the end of the year 2000. However, as part of a challenge over the next 5 to 10 years for Islamic banking system to become a significant player in the Malaysia's banking system, market penetration of more than 30 per cent would make the existence of Islamic banking more meaningful.\(^\text{18}\)

In Malaysia, another focus has been dedicated to the unique financial institution, which is truly regarded as a pioneer to institutionalize Islamic financial system paving the way for Islamic financial development in the country. The Pilgrims Management and Fund Board or popularly known as Tabung Haji (TH) is arguably the world's largest Islamic savings institution\(^\text{19}\) having been set up to fulfill the desire of Malaysian Muslims that money spent on pilgrimage must be clean and unmixed with \(\text{ribā}\).

TH, a semi-government body, was established in 1963 to serve two functions - as a financial institution and as a pilgrims' management body. Even though its activities after two decades seem to have reoriented more along commercial lines. Nevertheless, its original goal of enabling its members to perform the \(\text{hajj}\) and safeguarding their welfare during the pilgrimage continues to be served. It has been mentioned that “the functions of the Board as a savings institution is secondary to its main function as a pilgrims' management institution”\(^\text{20}\). This is precisely along the motive behind the establishment of TH that has been initiated by Royal Professor Ungku Abdul Aziz of the University of Malaya who, after and extensive study of the rural economy in the 1950s, presented a memorandum to the government suggesting the need for a corporation which will assist Muslims to perform \(\text{hajj}\) without impoverishing them or imposing financial hardships after the pilgrimage.\(^\text{21}\)

Tabung Haji's management as we have seen details in Chapter 6 is divided into five departments mainly financial, depositors, \(\text{hajj}\), human
resources, and investment department, all of which co-operate under the board of directors supervised and advised by various councils and committees such as Haji Advisory Council, Investment Advisory Council, Shari'ah Council and Audit Committee. TH's implementation of various operational schemes enables Muslims to save for the purpose of hajj. Although, TH is not a bank, it operates as a bank. That is to say, it accepts deposits, carries withdrawal and makes investment to get a return for the board and its members. TH has a wide variety of investment activities including investment in shares, subsidiary companies, land and buildings, money market and other permissible short and long-term investments. With few branch offices in its early year of incorporation, their number increased to 89 branches in 1998, with total assets of RM 7.3 billion, total depositors of 3,461,270, total deposits of RM 2.9 billion and accumulated savings of RM 6.7 billion.

Economic crisis of 1997 had slightly affected the number of depositors to the TH due to sudden public panic and less confidence against all kind of financial institutions including the TH. Nevertheless, such panic and less confidence against the TH were very quick to subside in the following year of the crisis. Thus, the 1997 economic crisis had less impact on the operation of the TH. For many years, TH has been able, at an increasing rate, to distribute profits at the rate of bonus of 9.5 percent to all savers and zakat funds for the general welfare of the people of Malaysia. Its impressive contribution to the development of Islamic banking and finance in Malaysia that can be replicated elsewhere, coupled with its significant successful operation and performance in primarily fulfilling the long life desire of many individuals for the performance of hajj rituals enabled it to win the award of the IDB prize winner in Islamic banking in 1989. It is the model of the future financial institution, which transformed from a non-commercial Islamic voluntary organization to a highly organized and specialized Islamic financial institutions that join the objective of fulfillment of Islamic religious ritual and commercial banking together. TH is a good example of how a specialized saving-oriented financial institution can work successfully in accordance with the Islamic principles.
The final focus in our study has been on the role of Islamic banking and finance in the economic development of Malaysia. As is generally known, the banks and financial institutions play a crucial role in the process of capital formation bridging the gap of saving and investment leading to economic growth and development. Islamic banking and financial institutions also do the same. However, they serve special function that can never be served by conventional institution in the process of economic development. In countries where there exits sizeable Muslim population such as in the region of South-East Asia, there are pious Muslims, who, for religious reason, stay away from financial transaction with interest-based banks and financial institutions. It is in this connection that Islamic banking and financial institutions can convince them and bring them into the mainstream economic process of capital formation and development through permissible means of saving and investment or, in short, permissible mean of banking.

Islamic bank is not just a bank that does not operate under the interest mechanism. Rather it is a bank based on certain economic and philosophical principles derived mainly from the Holy Qur'ān and Sunnah. It is an institution dedicated to serve special need and economic welfare of the people and is given to the development of human resource based on Islamic values. The elimination of interest from Islamic banking makes direct investment and equity financing or venture capital a must. Equity participation through mudarabah (profit and loss sharing) and musharakah (partnership) not only brings about greater justice and efficiency in the allocation of resources, but also reduces concentration of wealth, inequality in distribution of income, and poverty and ensure better human resource mobilization and greater employment generation. "Islamic financial system", according to Professor Abdul Hamid El-Ghazali, former Director of Islamic Research and Training Institute/ Islamic Development Bank, Jeddah, "has a more powerful built-in mechanism of human resource mobilization than the existing models development under conventional economics."
Islamic banking and financial institutions have played a meaningful role in fostering economic development and social progress of Malaysia. Overall, Islamic banking and finance constitute at least 5 per cent in the process of capital formation in Malaysia by which the rate is on and on increasing. Islamic banking institution such as BIMB has achieved its financing facilities for the implementation of various infrastructural and development projects. In 1996 and 1997, for the expansion and modernization of Kuala Lumpur International Airport, which required total funding of RM 8.8 billion, for instance, was partially funded by BIMB’s syndicated financing structure along a deferred payment structure. Also in 1996, BIMB along with other co-arrangers organized a RM 1 billion istisna’/ijarah project financing facilities for the Kuala Lumpur Light Rail Transit project. Economic development programme introduced by Yayasan Pembagunan Ekonomi Islam Malaysia (YPEIM) or Malaysia Islamic Economic Development Foundation established in 1976 greatly helps many poor Muslim out of the vicious circle of poverty. Accumulated zakat provision of various individual Islamic banking and financial institutions as part of religious obligatory social welfare function helps improving social and economic status of the community especially the poor and needy.

Islamic banking institution is also active in promoting priority sectors of the economy. Funds for the priority sectors such as Fund for Small and Medium Industries (FSMI) and New Entrepreneur Fund set up by BNM have been allocated to the targeted group of people through BIMB as an active participating financial institution appointed by the government. The setting up of Islamic banking and financial educational and training institutes either by various academic institutions such as the Islamic management centre of the International Islamic University, Malaysia or by Islamic bank itself such as BIMB Institute of Research and Training Sendirian Berhad by BIMB, no doubt, contributes to the development of knowledge and expertise in Islamic banking and finance. This in turn leads to social an economic progress of the people of Malaysia and has an impact on the neighbouring countries of the region.
PROBLEMS AND CRITICISMS FACED BY ISLAMIC BANK

The establishment of Islamic banking and financial institutions is a new development in the contemporary world financial system. This is noticeable not only in Muslim countries, but also in non-Muslim countries. These institutions provide Islamic services on the basis of equitable and just Shari'ah principles. However, such a novel working system must naturally be accompanied by a number of methodological and operational problems and criticisms. These problems and critiques are discussed below.

Excess Liquidity

The majority of Islamic banks, with the exception of a few such as that of Malaysia, suffer from excessive surplus liquidity, which can not be allowed by prudent management policies to be used in areas which are not liquid. There are mainly two reasons for this.

1. The risk and uncertain factors associated with investment account on the basis of profit and loss sharing (PLS) do not guarantee full return of such deposits. This causes depositors with Islamic banks tending to hold deposits in current and savings accounts that guarantee full return.

2. Lack of organized and developed Islamic financial market that can play a supplementary role as a tool through which the optimum use of available financial resources with Islamic banks can be achieved whilst realizing the required balance between liquidity and profitability. In Malaysia, such problem is negligible because of the government implementation and the setting up of Islamic money and capital markets since 1994 to ensure smooth functioning of Islamic banking system.29

Efforts have also been exercised in Bahrain in the development of short-term money market instrument to fill the gap of short-term excess liquidity of Islamic banks such as Faysal Investment Participation Share (FIPS), a liquidity
management scheme which aims to provide diversified short-term to medium-term investment in the pool of good quality leasing and *murabahah* transactions, launched by Faysal Islamic Bank of Bahrain.\(^{30}\) Prior to this, a pioneering arrangement was made by Arab Banking Corporation (ABC) founded in 1980 who successfully devised an overnight inter-bank market based on equity which has reportedly excited the attention of many bankers of providing an outlet for Islamic banks’ excess liquidity.\(^{31}\)

As far as the excess liquidity with Islamic banks is concerned, a major problem to this is the lack of organized and developed Islamic money market, which will allow the developments of short-term instrument and transactions of short-term financial investment between Islamic banks. Apart from few countries such as Bahrain and Malaysia, Islamic money market is hard to be well established due to small number of Islamic banks available in the country. The only possible arrangement is to place such excess fund with the central bank in which for the most case earns no return. This is obviously a demerit to the development of Islamic banking.

**Inability to Get Away from the Trappings of Conventional Banks**

The concentration of most Islamic banks in short-term financing or their lending operations that have been confined primarily to secondary modes for financing, short-term trade and lease operations of large and well-established firms and corporations pose another problem and critique for them. They do not seem to play any significant role in financing small and medium-scale businesses, farmers, industrialists, and craftsmen or provide venture capital on PLS basis.\(^{32}\) Whereas assets of Islamic bank are concerned, they have had to rely heavily on *murabahah* and some other secondary modes of financing, all of which share a common characteristics, viz, the return on capital is predetermined as similar to interest-based mode. Moreover, the rates of return they charge seem to be closely related to the London Interbank Offer Rate (LIBOR). Therefore, there seems to be a feeling that in egalitarian terms their
overall performance is not only not better than that of commercial banks but may in some respect be even worse.  

Islamic banks offer their services basically to customers who already had business relations with conventional banks. Their support for new entrepreneur and self-employed people is very limited. They do not yet provide risk capital especially to small and medium-sized new enterprises. In addition, while relying on the secondary modes of financing they do not seem to be fulfilling faithfully the conditions laid down by the Shari’ah for the permissibility of these modes. This criticism may or may not be right. However, what provides credibility to it is the secretiveness and lack of adequate transparency on the part of these banks about their operations. It is difficult for outsiders to know what is actually going on. The annual reports of most of these banks do not disclose adequate information about the modes, terms (short medium, or long), or nature (trade, investment, or venture capital) of their lendings. However, such weakness does not exist in Malaysia where Islamic banks are required by Law to submit their annual reports which consist of all banking operations undertaken by them during each financial year, subject to auditing and investigation, to the Central Bank. Such informations with the Central Bank and with individual Islamic banks are open for the public to investigate.

From a banker’s point of view, a lot of good reasons can by given for the preference for short-term financing and for the neglect of long-term PLS financing. For example:

1. In most Muslim countries, governments have set up or support specialized banks for the financing of agriculture and industry. Commercial banks have traditionally not been involved in medium and long-term financing of agricultural and industrial ventures. Their domain was and is trade financing. Islamic banks follow the established ‘division of labour’ and concentrate on trade financing where mark-up techniques are very appropriate.
2. A low percentage of PLS financing can be due to a weak demand of the entrepreneurs. Entrepreneurs with good profit expectations may prefer a financing of their projects on the basis of fixed cost of funds (interest, mark-up, leasing rate, etc.) so that they do not have to share the expected profits with someone else. Entrepreneurs with weaker projects who are not sure about the profitability of their ventures would prefer PLS as it would, at the least, relieve them of the obligation of paying a fixed return on the fund obtained. If this is the case, then Islamic banks are not willing to fund such ventures.

3. PLS techniques cause much higher transaction costs than techniques with predetermined returns for the bank, especially in medium-or long-term project financing. The bank has to study and evaluate entrepreneurial proposals and plans. This requires highly qualified and costly personnel. Further, the bank must find adequate protective measures against manipulations of the partner’s profit, e.g. by elaborating sophisticated contracts which are not standardized but consider all particular aspects of the specific project, or by utilizing manpower from the bank’s staff to supervise regularly the management of the financed partner. Whatever method is taken, it will add to the cost of the project.

4. Most of the money paid into investment account is of a short-term nature. It would be very risky to finance medium-and long-term projects with short-term funds. This mismatching of maturities is a problem also for conventional banks, but it is more serious for the Islamic banks. Islamic banks have not yet developed adequate instruments for the (very) short-term placement of surplus funds and for the raising of funds in cases of liquidity shortage, and they have no access to the interest-based lending facilities of the central banks. The problem is exacerbated by the fact that Muslim countries, as in the case in much of the developing world, suffer from a lack of deep and efficient capital and
money markets that can provide the needed liquidity and safety for existing assets. The absence of suitable long-term instrument to support capital formation is mirrored in the lack of very short-term financial instruments to provide liquidity. Unless equity-based modes become more popular or other negotiable instruments are developed, the Islamic financial markets will remain undeveloped. Some attempts are being made to develop negotiable instruments based on *ijarah* and *salam*. However, these have not been used to any significant extent so far. The major hope for developing Islamic secondary markets lies in a wider application of equity-based financial instruments and securitization of some of the existing modes.\(^{39}\)

5. Banks are responsible for the security of deposits. In Islamic banks, PLS financing expose PLS deposits to the risks of fluctuating remunerations. If the average depositor is risk averse, he may prefer an employment of his deposits in transactions with secure and predetermined returns.

   It is worthwhile to mention that Islamic banks which set out *musharakah* and *mudarabah* financing in their balance sheets have applied the PLS techniques not to medium-and long-term venture, but mainly to short-term trade financing with no significant uncertainty about the resulting profit. Islamic banks can dispense with PLS partnerships is due to the fact that they can employ their funds also under other admissible forms of secondary modes of financing with predetermined earnings.\(^{40}\)

6. Inability of Islamic banks to punish defaulters by charging a penalty, shortcoming in business ethics and moral hazard make it difficult to establish closer bank-client relationship - a precondition for successful Islamic banking. For example, clients either do not keep adequate records or keep fraudulent records of their operations in order to evade tax payment or any other reasons, making it even more difficult for Islamic banks to participate in modes of financing other than short-term
trade financing. Until such time that business ethics and moral values improve and the banks develop sufficient capability to monitor and audit enterprises, such that they are assured of the accuracy of the reports on business activities, they will be reluctant to take equity positions in enterprises.\textsuperscript{41}

7. As happened in the case of Iran and Pakistan, the lack of clear and legislatively sanctioned definition of rights and limitations of private property has induced reluctance on the part of both the entrepreneurs and the banking system to engage in long-term and Islamic-based profit and loss sharing project activities. This lack of well-defined law has strengthened the environment of uncertainty, limited long-term investment and hence forced the banking system to concentrate its asset portfolio in short-term transactions.\textsuperscript{42}

The concentration of Islamic banks in short-term financing has, thus, drawn up many critiques from the public. However, it is not possible to establish the validity of such critiques unless following considerations have been taken into account.

Firstly, it is often realized that the Shari'ah has itself been realistic and allowed the secondary modes, which are in the nature of sales transactions. Their primary purpose is to facilitate sales and purchases on credit and, thereby, fulfill a social need for which the primary modes are not necessarily suitable.\textsuperscript{43} The Shari'ah has, however, laid down certain conditions for their permissibility to safeguard the interests of all parties to the transaction, particularly the debtors. The use of secondary modes is not, therefore, undesirable if the conditions are honestly fulfilled.\textsuperscript{44} Overdue emphasis on mudarabah and musharakah in the earlier writings on Islamic finance was perhaps misplaced. What the Shari'ah has prohibited is a predetermined positive rate of return on a pure lending transaction. When the financing becomes associated with sales of goods and services, as it does in secondary
modes, the return becomes a part of the price and is indistinguishable from profit, which is permitted.

Secondly, it is not realistic to expect the banks to have made faster progress towards the use of more risky primary modes. The banks are not adequately equipped in their present stage of evolution to manage the risks involved in a more rapid move towards the use of these modes. They do not have any kind of expertise needed to process, monitor, supervise and audit the various risk-sharing projects. Their generally small size has made them overly cautious because of the risk of failure in the event of a severe shock to the domestic or the international economy. They have, therefore, tried to ensure that the risks they take are not greater than the manpower and financial resources they have at their disposal for managing them.

Finally, an equity-based Islamic economy does not exist, and a representative rate of profit is not available to serve as a benchmark for determining the rate of return in secondary modes. The banks have, therefore, no other alternative but to use the LIBOR for this purpose. This makes the secondary modes appear similar to interest-based operations. However, even if a representative rate were available, market forces may not necessarily allow the banks to move away significantly from LIBOR. This because if they charge a rate significantly higher than LIBOR for their lendings, they might lose at least some of the users of their funds to conventional banks. If they charge a rate significantly lower than LIBOR, they might be able to give a lower dividend to their depositors and shareholders thus driving some of them to the conventional banks. Therefore, as long as the conventional financial system dominates the world financial markets, Muslims may have to bear with the Islamic banks in their use of LIBOR as an approximate benchmark at least in the initial phase of Islamic banking development or Islamization.
Islamic Bank & Legal and Institutional Framework and Bodies

Legal framework and regulation and the attitude of government and central bank in some countries are not conducive to the well implementation of Islamic banking. These, for example, can be demonstrated below.

1. Further expansion of Islamic banking is curtailed due to hostile attitude of the government. Oman, for example, is known to be hostile to the proliferation of Islamic banking. On the contrary, the commitment of the government of Malaysia plays a great patronizing role in assisting development of Islamic financial system in the country.

2. Problems arise from the banking procedures applied by the central bank to all banks including Islamic banks with regard to monetary reserves and liquidity requirements. Although Islamic banks do not object to the principle of the central banks control, they believe that because their operations are of a different nature, they should be exempted from liquidity control procedures. The argument is that these procedures are meant to protect depositors by preventing banks from over-using depositors' funds to the level of exposing depositors to the risk of not being able to withdraw their deposits because of the bank's poor liquidity. In Islamic banks, while this might apply to current and savings deposits, it does not apply to investment deposit accounts. Moreover, Islamic banks do not accept interest, and hence they are in disadvantageous position vis-à-vis commercial banks, which earn interest from these deposits with the central bank. It is true that central banks in some Muslim countries do not pay interest on the compulsory reserves, but these reserves themselves represent a restraint on Islamic banks and results in the decrease of funds which could have, otherwise, been used in viable ventures.

Islamic banking development depends greatly upon the attitudes of monetary authorities in both Muslim and non-Muslim countries. Their attitudes
range from passive hostility to active support. Those that are hostile would like the system to fail so that they can get rid of it. Others, though not hostile, have adopted a passive attitudes and have not taken the initiative to bring about the kind of legal and institutional changes needed to solve the systematic problems or to pursue a comprehensive programme to educate central and commercial bank employers, depositors, users of funds, and the general public about the mechanisms and implications of the new system. This serves as a great drawback, which the banks cannot overcome by reliance on their own resources. Some, like Malaysia and Bahrain, have done whatever they can to support the system and to provide a proper legal framework, to create the shared institutions, standardize financial statement, provide guidelines for prudent management, enforce adequate checks and controls, establish an Islamic financial market, and act as lender of last resort.

3. The working of Islamic banking and financial institutions is also affected by the tax structure of the country. In Pakistan, for instance, not only did the imposition of 12.5 per cent income tax erode the profit of Mudaraba companies, but it also made their survival difficult. According to Vice Chairman of the Mudaraba Association of Pakistan (MAP), S.M. Aminullah, "tax exemption was given to the Mutual Funds and Unit Trust but the same was denied to the Mudarahas despite the fact they are also based on the concept of mutuality. Mutual Funds of all kinds are universally exempted from tax so long they distribute 90 per cent of their annual profits. By denying the universal benefit to Mudarabas, the important Islamic mode of finance has been jeopardized".

4. Another problem is that a network of shared auxiliary institutions needed for the creation of a full-fledged Islamic banking system has not yet been established. Banks need shared institutions to provide data about the business standing and credit rating of borrowers, help evaluate proposals for financing, audit the accounts of businesses whose profit and loss statement are suspect, and train borrowers to
maintain proper accounts and to prepare feasibility reports on investment proposals in an acceptable manner.\textsuperscript{56} One of the reasons for the absence of such institutions is that the number of players in the market and the range of products available so far is not large enough to create the depth that is necessary to make these institutions viable. Without the establishment of these institutions and an Islamic inter-bank market, it is not possible for Islamic banks to efficiently perform all their tasks, including the satisfactory management of their liquidity and risks.\textsuperscript{57} This factor is said to be negligible in the case of Malaysia, where there exists large number of players with wide variety of Islamic banking and financial institutions as well as well-organized Islamic financial markets.

**Islamic Bank and Competition**

So far, Islamic banks had a fairly large degree of monopoly over the financial resources of Islamically motivated clients. This situation is changing fast. Islamic banks are now facing ever-increasing competition from the new entry of some conventional banks in the market. Although, it is difficult to know with certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short list may contain some of the giants of international banking business such as Chase Manhattan, Citibank, and ANZ Grindlays. In addition to these, in many Muslim countries, several commercial banks are offering Islamic banking services. In Malaysia, commercial banks have been permitted to open Islamic banking windows.

While this development is recognition of the viability of Islamic banking, does it augur well for the future of Islamic banking? The answer may not be very simple. In general, competition is supposed to be good for the growth of any industry. It forces inefficient firms to either shape up or ship out. It reduces the cost and improves services to consumers. It promotes innovation and brings improvements in product quality. Participating Western banks may bring
their efficiency, market research and innovative capabilities, sophisticated banking and result oriented approach to Islamic banking, which may lead to the development of new products and provision of better services to consumers. But, however, such competition generates concern for Islamic banking as an infant-industry in which small firms in their infancy deserves some kind of protection from harsh and ruthless competition until they can stand on their feet and be able to face competition from their bigger counterparts. One may argue that Islamic banks may well deserve that treatment due to several factors, for example:

1. In comparison with conventional banks, Islamic banks are still regarded as minorities. All the Islamic banks are very small as compared with the mega banks of modern times, each one of which has assets far in excess of those of all the Islamic financial institutions put together. This smallness of their size introduces a built-in weakness into their operations because, in the event of a domestic or external crisis, smaller banks are more likely to fail than banks of optimum size. In addition to their inability to reap economies of scale, they are unable to adequately diversify their portfolios and to muster sufficient resources for training, market research, product development, and technological improvement.\(^{58}\)

2. Conventional banks, particularly Western banks, have a large advantage over Islamic banks in terms of their experience and long standing in the market. Their systems, procedures, techniques of product innovation, marketing strategies, diversification in portfolio, are much superior to those of Islamic banks. This exposes Islamic banks to an unequal competition.

3. At the need to compete with conventional banks offering better quality services on better terms, there is a real danger of Islamic banks
emulating the conventional ones even at the risk of losing sight of the socio-economic goals set by the Islamic paradigm.\textsuperscript{59}

The risk of Islam being made use of for commercial gains even by parties or institutions, which do not really believe in it, is also very high. For conventional banks, the Islamic counters represent innovations and add much variety and luster to the range of services provided by them. However, the interest of Islam itself may have been marginalized, if not sacrificed, in the process to the extent these Islamic counters share a common 'kitchen' in which funds mobilized and invested can get mixed up.\textsuperscript{60} This erodes public confidence and generates criticism against Islamic banking system. Even if there are separate ‘halal kitchens’ which are completely isolated from the main (conventional) ones, a disservice is done to Islam to the extent that these counters provide an unfair advantage as they allow the conventional banks to do what Islamic banks can, while Islamic banks cannot do what the conventional banks actually do. In other words, conventional banks, as in the case of Malaysia, are competing with Islamic banks not on a 'level playing field', with rules of the game being skewed in favour of the former. This does not augur well for an orderly development of Islamic banking in the country.

All this should not be construed as an argument in favour of protection for Islamic banks. Far from it, undeniably, protection can do more harm than good. Without a doubt, it is competition, not protection that will bring the best out of an Islamic bank. While protection can breed complacency, competition can force them to be innovative and efficient. But, competition must be fair and even. This observation calls for more Islamic banks, not more Islamic counters in conventional banks. The fact that Bank Islam Malaysia Berhad has been too conservative in its approach thus far, behaving in a risk-averting manner - concentrating on mudarabah and musharakah modes - may well be attributed to the fact that it has enjoyed a monopoly status in Islamic banking far too long without being challenged by rival Islamic banks in the market place.\textsuperscript{61} Moreover, with the well-establishment of its own various subsidiaries that are
active in various field of economic and financial activities such as Islamic insurance, Islamic unit trust, offshore banking unit, property, capital market as well as in the field of research and development, BIMB as a full-fledged Islamic bank in Malaysia, has enjoyed competitive atmosphere in line with the ambition of Bank Negara Malaysia to create competitive environment for more significance of Islamic banking industry in the country.

Lack of Uniformity in the Accounting and Auditing Practices

Lack of uniformity in the accounting and auditing practices of Islamic banks poses another problem for Islamic banking. It is, therefore, difficult for even an educated person to make a meaningful comparison of their balance sheets. However, in order to introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks under the guidance of IDB, have established an organization called Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI). The organization, now functional and based in Bahrain, is composed of a supervisory committee and a Financial Accounting Standard Board responsible for preparing, issuing and amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board.62

Since 1993, AAOIFI has issued 16 accounting standards, four on auditing and three on governance, including one on capital adequacy, and has started issuing Shari’ah standard. For the most part, the Islamic regulations are adaptations of International Accounting Standards (IAS) concentrating on added disclosure. However, according to Rifaat Abdul Karim, AAOIFI’s secretary-general, “none of the contracts that are used by Islamic banks is catered for by International Accounting Standards. Faysal Islamic Bank used to put all of its investment accounts (deposits) off-balance sheet. Arab Banking Corporation (ABC) Islamic, Bahrain Islamic Bank, and Al-Baraka put them no-balance sheet. Each of them could find a justification in IAS”.63
One example is *murabahah* transactions. According to him, in Jordan, the Islamic banks booked the profit from *murabahah* contracts upfront; in Bahrain profit was allocated over the period of the contract; in Malaysia earnings were booked on a cash basis when the installment was received; and in Sudan the profit was only taken when all the installments had been received. The situation is still not regularized mainly because of the sensitiveness of each local central bank. To date only Sudan, where all the banks are Islamic, and Bahrain have adopted the standards. The largest private sector Islamic institution in the world, Saudi Arabia's Al-Rajhi, issues standard accounts because the Saudi Arabian Monetary Agencies will not allow otherwise. It will be sometime before any perceptive change in the uniformity in accounting practices of Islamic banks is observed. The major reason for this is that AAOIFI is a voluntary organization and has no binding power to implement its standards. Although Malaysia may not adopt accounting and auditing standard of the AAOIFI, the form and content of the balance sheet and profit and loss account shall, together with the report of the directors and auditing procedure, be as approved by the Central Bank.

**Islamic Bank and Supervisory Framework**

One of the most important crippling problems of Islamic banking and finance is that its products have not yet become standardized. The primary reason for this may be that a number of *fiqh* (Islamic jurisprudence) issues related to Islamic finance still remain unresolved. In the absence of standardized products each bank is under constraint to have a Shari'ah board. Moreover, a number of conventional banks have also begun dealing in Islamic products, most of them without clearance from any Shari'ah board or without bothering about the conditions laid down by the Shari'ah for their permissibility. This has led to some confusion and to a misuse of some modes of Islamic finance.
It is, therefore, not realistic to expect anything better in the absence of a centralized institution to promote a dialogue between the various Shari’ah boards and, itself, evaluate these products critically with the objective of standardizing them and ensuring faithful compliance with the Shari’ah. For the lack of consensus among Shari’ah councils will be a difficulty for Islamic banks since it creates unnecessary confusion and so restricts the concept of Islamic banking from wider acceptance and recognition. As pointed out by Norton Rose and Neil Miller, Bahrain-based international lawyers “lack of consistency in interpreting the Shari’ah was slowing down the growth of Islamic banking.”

In Malaysia, before May 1997, the difference in the opinion among Shari’ah consultants on similar issues which may impede the creation of a sound and healthy Islamic banking system was noted by Bank Negara Malaysia (BNM). However, such problem is carried away when BNM has established the National Syariah Advisory Council for Islamic Banking and Takaful (NSAC) in May 1997 as the highest Shari’ah authority on Islamic banking and takaful.

**Shortage of Trained and Qualified Personnel**

Due to the recent emergence of Islamic banking and the lack of academic and professional training, Islamic banks suffer from a shortage of qualified managers in different areas of their operations. There is also a serious shortage of scholars who possess even a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly many staffs of Islamic banks are not very well trained in the use of Islamic modes of finance. Unfortunately, very little effort has been made to meet these requirements, since the level of success of Islamic banks will depend, at the micro level, on the quality of management and the level of staff training.

In Malaysia this problem may not be felt so much due to existence of many institutes and departments in many universities and colleges, providing education, training, and undertaking research and development on Islamic banking and finance. Islamic bank (and many Islamic financial institutions
including the Securities Commission) also conduct various seminars and educational and training programmes to educate and train people and staffs for better understanding the working of Islamic banking system in Malaysia.\textsuperscript{73}

**CHALLENGES AND RESPONSES**

A number of challenges and responses concerning with Islamic banks are noted below.

**Social Role and duty**

Statistics and eyewitnesses show that most Muslim people, communities and minorities live below the benchmark of poverty.\textsuperscript{74} It is a regrettable situation that relief and charitable organizations as well as traditional subsistence programmes have not been able to change or alleviate. It has rather grown worse until humiliation has become widespread, the communities have become spoiled and corrupted and Muslims have become a symbol of misery, disease and famine. This has become a great challenge which calls upon Islamic banks to urgently meet their commitments in terms of an effective social economic role, a role which should transcend writings in books and lectures to become something tangible which the poor Muslims may feel in the fields, valleys, factories and workshops.\textsuperscript{75}

**Islamic Bank and the West**

The main challenge facing Islamic banking is to become more sophisticated and competitive and to forge greater linkages with the conventional banking system. This does not mean that Islamic banks must be familiar with conventional banks, but rather their cooperation for better result in terms of product innovation and so on must be emphasized. Moreover, Islamic banks must develop means and ways to attract funds from Western financial resources for Muslim countries. As a matter of fact, Islamic banks have mostly served as intermediaries between the financial resources of Muslims and major commercial banks in the West. In this context, there has been a one-
way relationship so far. There is still no major Islamic bank that has been able to develop ways and means of intermediating between Western financial resource and the demand for them in Muslim countries.76

Islamic Bank and Supplementary Institutions

The major challenge in the 21st century is the need to integrate the role of Islamic socio-economic institutions and organizations in supplementary to the Islamic financial institutions into the mainstream of development planning of Muslim and non-Muslim countries. In this context, the role of hajj, waqf, and zakat as powerful social and economic institutions of the Ummah (Islamic people), apart from their historical roles as pure religious institutions, need to be recognized and implemented.77

Islamic Bank and Challenging Competition

Competition in the local and world market imposes a serious challenge for Islamic banking and financial institutions. Despite they have succeeded in mobilizing large amount of funds, it will require much more stern efforts to maintain a reasonable rate of growth in future. There are several reasons for that. Firstly, it must be realized that much of the deposits now with Islamic banks are not due to the attraction of higher returns or better services but because of religious commitment of the clients. This source of deposit has been almost dried up. Secondly, Islamic banks are now facing ever-increasing competition due to the entry of some conventional banks including some major multinational Western banks in that markets. Finally, competition is expected to increase further due to globalization. Therefore, the survival of Islamic banks depends upon their abilities to remain in the market, i.e., to increase efficiency and performance. To make a competition of Islamic bank with its counterpart more fruitful, following points of challenge must be fulfilled.
Increase the Size of Islamic Bank

Size is an important variable to determine the efficiency of a bank. It determines the scale and scope of efficiencies. Economists have shown that larger banks are in a better position to reach the optimum mix and scale of output. As a result, they are more efficient than smaller ones. The available data shows that Islamic banks and financial institutions are much below the optimum size. In addition to efficiency, larger size also bring about a number of advantages such as more influence in positive credit rating, easy portfolio diversification to minimize risk and so on. Thus, in order to increase the level of efficiency and be more competitive in the banking industry, it is desirable that the size of operations of Islamic banks be substantially increased. In this regard, serious consideration should be given to mergers. This is what actually exercised by banking industry in Malaysia during the year 1999.

Building Proper Institutional Framework

Building a proper institutional set up is perhaps the most serious challenge for Islamic finance. Since every system has its institutional requirements. Islamic banks alone cannot cater for all of their institutional requirements, which is supposed to provide alternative ways and means for meeting the needs of venture capital, consumer finance, short-term capital, long-term capital, etc. A number of mutually supporting institutions or arrangements are needed to perform various functions. These include security markets, investment banks and equity institutions such as mutual funds, pension plans, unit trusts, etc. Even within the Islamic commercial banking arena, a number of supporting institutional arrangements, such as lender of the last resort, insurance and re-insurance facilities, inter-bank market, etc, are needed to be established.
Financial Engineering

Financial markets are becoming more and more sophisticated and competitive. In order to exploit the fast changing market environment and face increasing competition, Islamic financial market must be established and developed. This, in turn, implies the need for Islamic financial engineering and innovation. Until now, the Islamic financial tools have essentially been limited to classical instruments developed centuries ago. In the light of the principles of *ijtehad* (Islamic original thinking), a need towards financial engineering is desirable, of course within the known principles of Islamic finance. Engineers in modern finance have designed several new instruments such as mortgage, options, derivatives, hedging, insurance, pension plans, credit cards, etc., to meet the needs of customers for various financial services. Efforts must be given either to adopt them to meet the requirements of Shari'ah or to invent Islamic alternative to them.\(^8^1\)

In addition, according to Syed Jaifar Aznan, Vice-President of IDB “some scholars have argued that one of the distinguishing features of Islamic banking is risk-sharing. A major challenge (in this context) for Islamic banking and Islamic bankers is to develop financing modes based on profit and loss sharing, which do not expose the Islamic bank to unnecessary risks."\(^8^2\)

Another Islamically permissible method is needed to be found for penalizing a defaulter and compensating the aggrieved party in the case of delayed settlement of a financial obligation, which may not necessarily be the result of a loan but rather of some contractual financial obligation. Late settlement of a financial obligation arising out of the purchase of goods and services under *murabahah* by a person, who is capable of making the payment on time, is one of the major problems faced by Islamic banks. Can the financier or the bank be compensated for the damage as well as the loss of income caused by such default? If the late payment does not lead to any penalty, there may be an incentive to default. This may set in motion a chain
reaction and, if the amount involved is large, may even lead to a breakdown of the payments system.\(^5\)

**Greater Cooperation among Islamic Banks**

All Islamic banks must cooperate and consolidate to compete with mega-conventional banks. Islamic banks must focus on cooperation as a way to survive. According to M.N. Siddiqi, "greater cooperation among Islamic banks and pooling of resources to meet liquidity needs, etc., are pre-conditions to their successful practice of profit-sharing on the asset side."\(^6\)

One forum which was established to enhance cooperation is the International Association of Islamic Bank (IAIB), working under the umbrella of the IDB, founded in 1977 to promote and foster the Islamic banking movement. However, it was not able to achieve its objectives due to lack of consensus and inefficient management. The recent reshuffle of the executive committee, coupled with the appointment of a dynamic secretary-general, should give a necessary boost and creditability to the association.\(^7\)

**Centralized Shari'ah Verdict**

As pointed out earlier that central Shari'ah supervisory body of all Islamic banks should be established to ensure standardized Islamic financial products and to remove inconsistency in the verdict of Shari'ah bodies of various Islamic banks. One possible recommendation to this question may be to have the autonomous Shari'ah board operating under the supervision of some international organization like the Islamic Development Bank. This may be acceptable provided that the Islamic Development Bank finds it practical to successfully manage a Shari'ah board that has the responsibility of examining hundreds of banks around the world and of issuing certificates of Islamic credential to them.\(^8\)
Teaching, Training, Research and Development

Teaching, training, and research are the where-with-all for the development of any activity. As mentioned above, there is a serious shortage of scholars who possess a working knowledge of both Islamic *fiqh* and modern economics and finance. Similarly, most of the managers, staffs or even the clients of Islamic banks are not very well trained and informed. Therefore, it is extremely important to have the people with the right kind of skills, knowledge, and commitment to run and manage Islamic banks. To promote teaching, training, and research in Islamic banking and finance and to produce and disseminate authentic information on their activities with a view to develop new Islamic financial products, it is recommended that Islamic banks strengthen their cooperation with the assistance of the Islamic Research and Training Institute based in Jeddah, Saudi Arabia.

Appropriate Legal Framework, Policies, and Procedures

The commercial, banking and company laws and tax structure in most of the Muslim countries or in non-Muslim countries wherein Islamic banking is operated are fashioned on the Western pattern. Those laws provide a rather narrow scope for Islamic banking activities. While parties can structure their agreements according to an Islamic contract, the enforcement of those agreements can be costly. Those conditions, among others, necessitate that special laws for the introduction and practice of Islamic banking be put in place. It is necessary to enact some laws to facilitate the operation of a mixed system. In this respect, one important policy issue is the treatment of dividends for the purposes of determining tax liability. Under the conventional system, interest paid by corporations is treated as a tax-deductible expense. Similar treatment must be given to the dividends paid out by Islamic financial institutions.\(^7\)
Improve Service and Technology

Better quality services and the ongoing developments and changes in the information technology industry are responding to market changes and needs. In the present day of globalization. High quality service, tremendous development in communications, technological inventions and the trend towards a liberalization of banking transaction, impose new challenging situation by paving the way for Islamic banks to take advantage of the revolution in communications and new equipment of services. Extending computerized banking system to provide direct screen and keyboard access to business client with appropriate modem links may well become more of an issue for Islamic banks in the future. There can be little doubt that the telecommunication revolution will have profound implication for the logistic of providing Islamic banking services, just as it has for conventional banks. The low cost telecommunication services, the internet, the evolving business intelligence and enterprise, resource-planning technologies are opening the way for institution to provide high quality service making a profit and remain competitive in a global market place. Failing to cope with the technological change and development and provide better services force many firms to leave the industry.

Addressing the 1999 World Islamic Banking Conference held on 4th-6th December 1999 in Bahrain, Atif A. Abdulmalik, the chief executive officer of the First Islamic Investment Bank (FIIB), outlined six points on which the industry should concentrate implying a challenge for the next century. There are:88

1. moving away from the murabahah syndrome,
2. making a clear distinction between business and social objectives,
3. greater focusing on human resource development to create a 'participatory corporate culture',
4. greater cooperation between Islamic and conventional banks
5. greater responsibility to management, and

6. a full-blown embracing of information and banking technology.

It is, thus, appropriate to conclude here that most of the requirement for the proper function of Islamic banking system may be fulfilled only over time through an evolutionary process with the combined efforts and resources of the government and the central bank and Islamic banks.

FUTURE PROSPECT OF ISLAMIC BANKING - SOUTH-EAST ASIAN PERSPECTIVE

Despite the fact that Islamic banking and financial institutions confront a number of problems and challenges, nevertheless, Islamic banking has grown and is no longer a negligible phenomenon. It seems destined to grow further because of the following reasons. The first and foremost of growth possibilities stems from religious beliefs or ‘patriotic sentiments’. There is an increasing demand for it by Muslims both in Muslim and non-Muslim countries. Secondly many Muslim nations are significantly underbanked and this structural fact points the way to substantial systematic growth. Not all deposits will be captured by Islamic banks, but it is reasonable to expect that a large number of deposits will be attracted by the combination of religious acceptability and the strong returns available with Islamic banking products. But the more important is that the major players in Islamic finance are already established in many of these markets and ready to take advantage of the developing financial system.

Apart from Islamic injunction, which prohibits Muslim from interest transaction, there are large number of non-Muslims who refrain from investments in business enterprises and companies on various religious and ethical grounds. Respect of all religions and coexistence is greatest human characteristic. Pious life and value based society is the goal of every religion besides Islam. Vices like gambling, intoxication, prostitution, fraud and cheating, deception in weight and measures, etc., are disapproved by all other
religions - Christianity, Hinduism, Buddhism, etc. There is no doubt that religious and ethical factors also play a very important role in consumption behaviour, economic decision making and choice of investment in project.91 One such scheme which have already been initiated in England and in some other Western countries is the Ethical Unit Trust (EUT) – a mutual fund that follows certain religio-ethical rules while it decides its investment portfolio. It specializes in seeking profits for investors while conforming to certain ethical criteria. When clients invest in it, they can be sure that none of the money will be invested in companies which engaged in the arms trade, gambling, interests, manufacture or/ and distribution of either alcohol or tobacco.92 This successful combination of ethical and equity investments is implied in itself the concept an principle of Islamic banking and finance. With the present world of moral decay, there is a great intensive step towards the direction of promoting ethical values in people's socio-economic lives. This factor combines with the principle of Islamic banking which is characterized by built-in stability and is theoretically more rewarding that fulfils the requirement of justice and allocative efficiency, will create a hope regarding its acceptability and popularity in non-Muslim countries as well.

It is interesting to note that Islamic banking has witnessed a noticeable growth over the last quarter of the 20th century, with an increasing demand for Islamic banking services, an improved legislative and administrative framework, the introduction of new Shari'ah compliant investment vehicles, and a wider international acceptance and awareness of this specialized and highly ethical banking activities. Despite this growth, the supply of Islamic banking facilities is still below the demand in terms of services and international presence. Many countries with minority or even majority Muslim communities are still lacking Islamic banking and financial products. As pointed out by Syed Tariq Hussain, Director and Head of Finance of ANZ Investment Bank, London, and Professor Rodney Wilson of the Department of Economics, University of Durham, that approximately US$ 650 billion of leasing and project finance will be required by the Arab world up to the year
2010, mainly in power, telecommunication, oil and gas, and private sector infrastructure. Islamic financial institutions are, therefore, poised for unprecedented growth rising on par with conventional project financing in future. In addition, there is not enough provision of dedicated Islamic financial products in countries, such as the United States of America, and Britain, each of which has a sizeable, sophisticated, and wealthy minority Muslim population. Duncan Smith, Head of Islamic Investment Banking Unit of the London-based United Bank of Kuwait pointed out that the US and Britain represent a potential markets for Islamic products and services of more than 10 million people. Moreover, there are considerable opportunities for proliferation of Islamic banking and financial services once the regulatory complexity and restriction facing the operations of Islamic institutions in many conventional societies has been simplified and codified. In many Muslim countries such as Libya, Tunisia, Algeria, Morocco, Oman, Indonesia, etc. and in markets where there are large number of Muslim minorities such as in North Africa, Europe, South Africa, Russia, India and so on, there are hardly any Islamic investment funds available, particularly those that aim at the retail market.

Thirdly, in the Islamic banking industry at the wholesale markets, it is highly super-competitive and no international financial institution is going to make it easy for the (full-fledged) Islamic banks to erode their existing market shares. This circumstance provides a big push to both full-fledged and dual financial institutions to draw up marketing strategies, which would be a growth-led potentiality. The more they are able to show that their system is both equitable and profitable to the participants, the more users and providers will be attracted to it. The industry certainly has the potential to be a major force in the financial world.

Last but not least, at the present world of its sensitivity to economic and financial crisis under the interest-based financial system, interest-free financial system is seen and considered as an alternative towards financial and
economic growth with stability. There is no harm at introducing such a system either at micro or macro level. Such introduction is proved viable in many countries such as Malaysia and Sudan. Thus, there is a great deal of introducing Islamic financial system in crisis-driven countries in the future.

With respect to the region of South-East Asia, in general, the future of Islamic banking is bright. There is no doubt that those factors which have been pointed out earlier will hold true for the prospect of Islamic banking and finance in the region. As a matter of fact, in most countries in the region, there are sizeable Muslim population and that their demands for Islamic financial product is on-increasing, since there is certainly lack of such products in the region. The recent financial and economic crisis will only add more credit to such arguments. The crisis-driven mass would try to find out alternative system in place of interest-based system. In addition, two major growth and development projects namely Indonesia, Malaysia, Thailand-Growth Triangle Development Project (IMT-GT) and Brunei, Indonesia, Malaysia, Philippines - East ASEAN Growth Area (BIMP-EAGA) will provide a tremendous opportunity for the prospect of Islamic banking and finance in the region of South-East Asia. As most of the targeted people involved are Muslims, their demands will be for the Islamic financial products as their means of economic activities as part of their commitments.

In the case of Malaysia where Islamic financial industry is highly developed and organized and with the establishment of Labuan as an International Offshore Financial Centre (IOFC), the opportunity of Islamic financial system as a provision of a wide range of product to existing conventional one will only lead the country to fulfill its ambition of becoming a regional financial centre in competition with Singapore. Moreover, Brunei is another new competitor in the field of Islamic banking to have drawn up its ambition to turn itself from an oil-rich nation into an international offshore financial centre. This competitive atmosphere will obviously lead to a glorious prospect of Islamic banking and finance in the region as a whole.
NOTES & REFERENCES


10. RISEAP, op. cit., p. 82.


17. Ibid, p. 252.


38. Ibid, p. 344.


44. While the total elimination of secondary modes may not be neither feasible nor desirable, there is a general consensus that honest fulfillment of the conditions laid down by the Shari'ah for the permissibility of these modes is necessary to inspire confidence in the Islamic credentials of these banks. Simultaneously, there is also emphasis on a more rapid progress towards the use of primary modes so that the proportion of equity in the total financing of enterprises become substantially higher and their reliance on credit, particularly short-term, declines [Khan, Tariqullah, "Demand for and Supply of Markup and PLS Funds in Islamic Banking: Some Alternative Explanations" *Islamic Economic Studies*, December 1995, p. 39]. And according to data given by the International Association of Islamic Banks, the share of *murabahah* in their aggregate financing declined to 40.3 per cent in 1996 and that of *mudarabah*, *musharakah* and *ijarah* rose to 7.2 per cent, 12.7 per cent, and 11.5 per cent respectively. Other unspecified modes had a share of 28.3 per cent. There is, thus, a gradual response to the criticism to which Islamic banks have been exposed. [International Association of Islamic Banks, *Directory of Islamic Banks and Financial Institutions* 1996, Jeddah, International Association of Islamic Banks, 1997, p. 18.


55. Ibid.


58. Ibid, pp. 269-270.

There are some other genuine concerns about the entry of large multinational banks into Islamic banking market. Naturally, their motives are purely commercial. They view it as a lucrative business opportunity. This is fair enough. However, serious doubts have been expressed as to whether they are following the rules of the game. It is apprehended that conventional banks may not follow correctly and faithfully the percepts of Islamic banking. In all major Islamic banks, there is a Shari'ah board, which regularly reviews the operations and contracts of the banks to determined their compliance with the requirements of the Shari'ah. Similar arrangements do not exist at the conventional western banks in most cases. It is also suspected that conventional banks may not be able to keep fully separate accounts for their Islamic banking operations. In the event they do mix 'Islamic money' with their general pool of investible resources or they do not keep separate accounts for Islamic activities, there is a strong possibility that permissible (halal) returns may be contaminated by ribā. [Iqbal, Munawar, et al., Challenges Facing Islamic Banking, op.cit., p. 57].


Iqbal, Munawar, et al., Challenges Facing Islamic Banking, op.cit., p.40.


Ibid.

Ibid.

Iqbal, Munawar, et al., Challenges Facing Islamic Banking, op.cit.,


69. Ibid, pp. 268-269.


75. Ibid, p. 18.


83. A number of opinions have been expressed on this subject, but so far there is no consensus. For a range of opinions expressed on the subject, see Zarqa, M.A. and El-Gari, M.A., "Al-Ta'wid ‘an Darar al-Mumātalah fi al-Dayn bayn al-Fiqh wa al-Iqtisād", *Journal of King Abdulaziz University: Islamic Economics*, 1991, pp. 25-57 as well as the comments by M. Zaki 'Abd al-Barr and Habib al-Kāf on pp. 61-4, as quoted in Chapra, M. Umer, *The Future of Economics*...., op.cit., p. 302.


90. Ibid.

92. Ibid.


94. Ibid.

