Islamic Banking at Systemic Level: Issues and Approaches

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Most of the other lecture topics in this long-distance learning course were on issues like efficiency, corporate governance, risk management, financially engineered products, etc. These topics are important for better functioning of an individual Islamic bank. We now move from the micro to the macro issues:

1. How can the Islamic banking and financial system finance private and government financing needs, etc? Especially, when substantial funds commitments for longer period might be involved?
2. What transformation might be called for in practicing Islamic banking at the economy-wide level? More specifically, in the context of (i) financing foreign trade, (ii) regulation and control of banks and monetary policy and (iii) the legal system?
3. How might competition from conventional banks affect the Islamic banks?

This paper focuses on the above issues.

1. Financing Private Sector Needs

Whereas Islamic banks might penetrate into micro financing in the future, here we keep in mind potential areas where size of financing might be reasonable from an Islamic bank's point of view and the bank clients might be credit-worthy.

Some abbreviations used hereunder are as follows:

MF	=	Murabahah Financing
SF	=	Salam Financing
IJF	=	Ijarah Financing
ISF	=	Istisna' (إستصناع) Financing
MUF	=	Musharakah Financing
MOF	=	Modarabah Financing
DMF	=	Diminishing Musharakah Financing

i. Consumer Financing

MF (for small financing for a short period)
IJF (for sizeable financing for longer duration)

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A caution is warranted here: Blending of ijarah with sale needs to be avoided. However, the purpose of selling the asset to the client at the end of the lease may be achieved through other Shari'ah-compliant ways.

ii. Working Capital Financing

Our Reference: A sugar mill needing working capital for a sugarcane crushing season, namely a few months

MF — financing package for a single input (sugarcane):
SF — working capital for the season
MUF — (pure) Musharakah for the season
MUF + IJF — Musharakah blended with ijarah for the season

iii. Industry's Expansion Needs

MF, SF, IJF or DMF — for purchase of machinery and equipment
DMF <u>or</u> ISF+MF — for the new construction needs

iv. Resource Mobilization through Salam Certificates

A cement factory, for example, needs sizeable financing to meet its working capital and plant expansion needs.

Assumption: The factory produces a standardized product, and the demand for the output is perfectly elastic.

SF or ISF — financing to be provided against production and supply of prescribed output over a certain period of time

Salam Certificates — financing through tradable salam certificates, with each certificate representing delivery of a specified quantity of cement at a particular date (against the price to be fixed and paid at the time of issuance of the certificate) along with the condition that the holder of the certificate would have the original seller's permission to sell his rights to a third-party before the actual delivery date.— Of course, ultimately, the delivery is to be made to the holder of such a certificate at the appointed delivery date, and the transaction is not to be settled on margin.

v. Agricultural Financing

MF or IJF — for inputs needed by the farming sector
SF — financing with the settlement between a bank and its client to be in the form of output produced
MUF — for miscellaneous cases

vi. Real Estate Financing

MF, IJF or DMF — depending on the case at hand

2. Financing Public Sector Needs

Public sector financing needs are distinct from those of the private sector in two respects: (1) the funding requirements may be sizeable, and (2) the maturity period of financing may be longer. Thus, there would be need to work with divisible and tradable financial instruments.

To the extent that a similar situation may arise in addressing the private sector needs, the following instruments may also be adapted for those cases.

i. Murabahah with Divisible and Tradable Securities

In this case, payment obligations of the client can be represented by securities as follows:

Each security will have a fixed denomination that would represent the payment to be made in lieu of an installment or a part thereof, but the client to the financier. There also ought to be right of recourse for a holder of a security against his immediate seller. And, once the collection rights are transferred by a security-holder to another party through sale of the security, the former should not directly or indirectly reacquire the collection rights.

ii. Project Financing Through Ijarah

1. Sukuks can be developed against a BOT (Build-Operate-Transfer) arrangement, between the issuer of the Sukuk and the financiers, with Islamic banks playing the role of lead managers.
2. There may be a body to represent the Sukuk-holders (a legal person or a SPV) subject to the condition that it is independent of the of the issuer of the Sukuks, both in letter and spirit.[1]

iii. Istisna'-cum-Murabahah Financing

There may be an Istisna' arrangement between the financier(s) and some contractor(s) for building, say, a bridge. The same may be sold to the government on murabahah basis. The instrument can be designed around a staggered financing and sale arrangement.

iv. Redeemable Musharakah

A selected Musharakah arrangement can be developed along the notion of diminishing musharakah for financing public sector projects that also yield income flows.

v. Resource Mobilization through Selective Musharakah

Rather than privatizing public sector enterprises, the government can enter into a musharakah arrangement with private parties who might play a role on the management side.

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[1] This may be ensured through the terms and conditions of the SPV. For example, if it is pre-specified that the SPV will sell the sukuks at a predetermined price, that would mean a corroborative relationship between the SPV and the party seeking financing through this channel.

3. Special Issues in Foreign Trade Financing

The banks primarily intermediate in the transfer of ownership of merchandize from the exporters to the importers <u>and</u> payment from the importers to the exporting parties. Thus, they play an economic role function. The same can continue with the Islamic banks seeking compensation for their role function.

The issue of riba arises when the banks also have to commit their own funds to help an importer or an exporter. Furthermore, treatment of the fund committed by importers toward their Letter of Credit might need care.

1. The funds tied toward L/C requirements may be treated as loans to the banks during the pendancy of the transaction.
2. Banks may enter the financing commitments by coming into the picture either as “traders” (providing murabahah financing to the importers or salam financing to the exporters) or “partners” (providing either modarabah or musharakah financing to their clients). Some fresh considerations in the performance of L/C role function might arise in these instances.

4. Regulation and Control of Islamic Banks

There is need for inter-bank Islamic money market, with divisible and tradable financial instruments.

The central bank can play traditional control and regulatory roles but with some changes. For example:

1. The central bank may prescribe prudential regulations for good governance by Islamic banks, of course, within the limits allowed by the Shari’ah.
2. The central bank may prescribe liquidity and other reserve requirements for deposits that are generated by way of loans or those that offer flexible withdrawal facilities. But the same purpose might be served through limiting the capacity of the banks to deposit mobilization through musharakah, rather than modarabah.
3. The central bank might provide liquidity to Islamic banks through discounting their Islamic commercial paper. Provision of liquidity on short-term modarabah basis is conceivable but subject to the condition that neutrality of the central bank is not compromised.
4. Control/regulation might be need in order to ensure that role of the Islamic banks does not exceed that of filling the financial gaps in the transactions taking place in the economy.
5. There will need for weeding out misuse of Islamic banking.
6. The central bank might carry out Shari’ah audit, over and above the internal audit by the Islamic banks.

5. Monetary Policy

Due to integration of real and financial sectors in an Islamic financial setup, both the need and the scope of monetary policy will change.

6. Transformations in the Legal Domain

The legal setup would need a thorough review. For example, creditors might need to be given first claim on all assets of the debtors (beyond some objectively defined minimum), irrespective of whether there is collateral or no collateral. And, the existing distinction between "legal" liability and "personal" liability might need review, along with changes in bankruptcy laws.

All laws affecting Islamic banks' role as economic agents—traders, lessors and partners—need review. For example, taxation rules standing in the way of murabahah, transfer levies in leasing matters, etc., would need to be rationalized such that the Islamic banks' role as financial institutions is strengthened.

7. Islamic Banks versus Conventional Banks

The Shari'ah essentially means a way of doing things. This ought to reflect in the working of Islamic banks at all levels: from doing transactions to record-keeping and the skill-profile of the manpower. The conventional banks may not move into the turf of the Islamic banks if there are fundamental differences between the requirements of interest-based banking and Islamic banking. Otherwise, chances are that interest-based banks may give Islamic banks a run for their money through "Islamic windows".

Postscript

There is need to reflect on the following Ayat, and construct/reconstruct the Islamic banking paradigm, rather than "Islamizing banking".

وَلَقَدْ ضَرَبْنَا لِلنَّاسِ فِي هَذَا الْقُرْآنِ مِنْ كُلِّ مَثَلٍ لَعَلَّهُمْ يَتَذَكَّرُونَ (27) [الزمر: 27]

We have put forth for men, in this Qur'an every kind of Parable*, in order that they may receive admonition.* [***Az-Zumur* 39: 27**; emphasis added]

وَلَقَدْ صَرَّفْنَا فِي هَذَا الْقُرْآنِ لِلنَّاسِ مِنْ كُلِّ مَثَلٍ وَكَانَ الْإِنسَانُ أَكْثَرَ شَيْءٍ جَدَلًا (54) [الكهف: 54]

We have explained in detail in this Qur'an, for the benefit of mankind, every kind of similitude: but man is, in most things, contentious. [***Al-Kahf* 18: 54**; emphasis added]

وَلَقَدْ صَرَّفْنَا لِلنَّاسِ فِي هَذَا الْقُرْآنِ مِنْ كُلِّ مَثَلٍ فَأَبَى أَكْثَرُ النَّاسِ إِلَّا كُفُورًا (89) [الاسراء: 89]

Of course, our belief in the Tawhid and the internal consistency in the Qur'an and in the Sunnah can also be our guide.

Additional Readings:

1. *IIIE's Blueprint of Islamic Financial System* (Islamabad: International Institute of Islamic Economics, 1999)
2. Sayyid Tahir, "The Islamic Financial Paradigm" Paper read in connection with the award of the IDB Prize in Islamic Banking for the Year 2000 awarded to the International

Institute of Islamic Economics, delivered at the Islamic Development Bank in September 2001.