

# Current Issues in the Practice of Islamic Banking

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Islamic banking started in earnest in the 1970s with personal initiative of the concerned Muslims to address the problem for *riba*. The pioneers included committed and resourceful individuals, professional bankers, Islamic economists and religious scholars. There was no initial working model to act upon, except the thought that interest-based banking might be replaced by banking on the basis of profit-and-loss sharing. This effort took place when the financial system at large, as also the regulatory environment, was *riba*-based.

Things soon began to change in the late seventies and in the early eighties with recognition at the state level for the need to develop *riba*-free financial system in Iran, Sudan, Pakistan and Malaysia. In the meantime, Islamic bankers also organized themselves through International Association of Islamic Banks. This was soon followed by establishment of AAOIFI for achieving standardization in Islamic banking practices.

The current position is that there are more than 200 Islamic financial institutions all over the world with investment funds in excess of \$250 billion.<sup>1</sup> The annual growth rate of Islamic banking industry world-wide is 16%+. In some Muslim countries, total or partial transformation has taken place in favor of Islamic banking. Islamic banking has also gained approval by international financial institutions, professional bankers and the academia.

Islamic banking has established its identity. Alhamdulillah it is here to stay, grow and develop into a competitive alternative to interest-based financial architecture. AAOIFI has done commendable unification effort. Central banks of several Muslim countries have jointed hands in order to give it an international standard. Some issues are identified here that may help consolidation and growth of Islamic banking.

## 1. Standardization

Standardization is urgently needed in the following respects: (1) vocabulary of Islamic financing, (2) financial instruments and their documentation and (3) pricing formulas for Islamic financial products.

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This paper is to serve as basis for discussion on the subject at COURSE ON ISLAMIC BANKING AND FINANCE, TEHRAN, IRAN, 2-6 March 2003, under the auspices of Central Bank of Iran and Islamic Research & Training Institute of the IDB, Jeddah.

<sup>1</sup> These and other numbers reported in this paper need to be rechecked.

### 1.1 Vocabulary of Islamic Banking:

There is no universally followed terminology for Islamic financing. One finds inter-bank differences in the use of terms. For example, while majority of Islamic banks use the nomenclature Murabahah to stand for financing via sale on deferred payment, some label it *Bai' Thaman bil Ajil*.—Quite interestingly, these latter institutions also offer Murabahah financing products.<sup>2</sup>

In addition to the above, selective interpretation of Arabic terms creates confusion among the bank clients and the public. For example, *istisna'* originally means manufacturing and delivery of something against advance payment. But in Islamic banking quarters, *istisna'* financing signifies payment by an Islamic bank to the manufacturer of a thing for its delivery to the bank's client with whom the bank has sale-on-deferred-payment relationship. Thus the term *istisna'* financing is somewhat of a misnomer. This and some other terms are likely to be a hurdle in communication among Shari'ah scholars. And, this may also hinder popularization of Islamic banking.

### 1.2 Financial Instruments and Their Documentation:

It is difficult to think of "identical" documentation for all Islamic financial institutions in lieu of a given Islamic financial instrument. This is because practical concerns may vary from institution to institution, practical needs may not always be the same, and, last but not least, door for financial innovation in emergent situations will always remain open. Nevertheless, there has to be some measure of standardization in financial instruments for speedy migration to Islamic financial system in the Muslim world. This is almost a must for regulatory purposes.

### 1.3 Pricing Formulas for Islamic Financial Products:

Any financing operation by an Islamic bank will involve accommodation of interests of the bank's principals, the bank staff and the fund-seekers. These concerns are addressed mainly through "pricing" of the financial products.—Of course, security for financing also matters (*see below*). Standard pricing formulas, in the light of Shari'ah principles, are needed for those on the front desk for efficient working of the Islamic financing model. Their development will also help promotion of Islamic financing in academic and professional circles.

## 2. Public Awareness

Islamic financial model is feasible. There is no question about this. In fact, with the availability of more financing modes than those recognized at present, it is bound to

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<sup>2</sup> References to actual banks are avoided in this paper. If found desirable, they shall be included in final draft of the paper.

be more versatile and efficient.<sup>3</sup> But it faces problem of general acceptability. This is mainly due to unfamiliarity with the various Islamic modes of financing. This problem is likely to be solved over time. But pace of development of Islamic banking can be expedited through the following: (1) public education campaigns, (2) inclusion of Islamic banking concepts in school curriculum, (3) making Islamic financing course a part of business administration programs and (4) offering full fledged degree programs in Islamic financing. There is already some progress on (3) and (4).

### **3. Training of Banking Professionals in the Use of Islamic Financial Products**

Lack of qualified manpower is one of the biggest hurdles in the advancement of Islamic banking. Pioneers in Islamic banking developed their financial instruments and painstakingly trained their staff. There is no training institute to meet manpower needs of existing and future Islamic banks. Some of the reasons for this lacuna are understandable. For example, lack of consensus on form and details of Islamic financial instruments and nonexistence of Islamic reporting and accounting procedures. Some work has been done. But a lot more is still needed, especially on the fundamentals. Nevertheless, there is enough material to offer short training courses in Islamic banking.

It is pertinent to note here that bank staff shall need a different orientation in the Islamic framework. At present, financial institutions are mainly interested in safe recovery of their principal along with a return. Evaluation criteria for processing funding requests and security provisions in agreements with clients, serve this purpose. But the said goals and process have resulted in a particular psyche and business culture in the financial world. Bank functionaries at the branch level mostly act passively. They “entertain” requests for financing rather than “going out and seeking investment avenues”. As far as we can understand, the root cause for this situation is dichotomy between financing and the actual use of funds due to the financial instruments being loan-based. In Islamic banking industry, the nature of financial instruments will affect banking in two ways:

- (1) Islamic bankers will be forced to adopt an outreach approach in pursuit of economic applications of funds in the marketplace.
- (2) Follow-up of financing, such as delivery matters in trade-based financing or monitoring musharakah financing.

The need for aggressive marketing of Islamic financial products and the follow-up considerations will add a new dimension to training programs for Islamic bankers.

### **4. Emphasis on Shari’ah Audit instead of Reliance on Shari’ah Supervision**

In the early phase of Islamic banking, professional bankers took the lead. But they were not well-versed in the Shari’ah. Therefore, Islamic banking model emerged as

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<sup>3</sup> Virtually all existing bank financing instruments are variants of loan transaction. As against this, Islamic banks will have trade-, leasing- and partnership-based instruments.

“banking under Shari’ah supervision”. Practically this was done through delegating authority for the Shari’ah matters to the respective Shari’ah Boards, absolving Islamic bankers of their responsibility in Shari’ah violations. Of course, in principle, Shari’ah Boards have the authority to impose their viewpoint. But logistic considerations do not permit timely vetting and/or monitoring of all banking operations.

In view of the above, it will be more fruitful if the following approach is adopted:

- (1) The Islamic financial instruments should be properly and fully developed, accommodating all relevant factors.
- (2) Principals of Islamic banks should set economic and Shari’ah parameters for providing bank financing.
- (3) Bank officials at the branch level should be given full freedom for making routine financing decisions, of course, in the light of the abovementioned parameters.
- (4) There should be both random and regular, either biannual or annual, Shari’ah audit of all financing operations.
- (5) The prospects of Shari’ah compliance should be enhanced through introduction of penalties for the bank staff and Shari’ah-rating of the bank.

The above approach shall be needed in any case for expediting Islamic banking at the retail level.

## **5. Reduction in Financing Costs**

In the first place, financial instruments need to be developed such that the number of practical steps at bank level is reduced to bare minimum required by the Shari’ah. This may be done by delegating maximum number of functions to third parties, including the client, without compromising on the dictates of the Shari’ah. For example, in Murabahah financing banks can avoid physically taking possession of the goods sold by instructing the original sellers to deliver them directly to the bank client.

In addition to the above, financing costs can also be reduced through provision of adequate leverage for financial institutions in the settlement of transactions. This can be done as follows. The financial contracts may be engineered with divisible collateral. They can also be registered with the judicial authorities before putting them into effect. Of course, this latter step will involve some initial costs. But those costs will be outweighed by gains stemming from their reflection in the price of financial products and ensuing reduction in litigation costs.

## **6. Establishment of Real Market Links**

Trading modes of financing require contact with suppliers in the case of murabahah financing and marketing channels for disposing of merchandize produced in the name of financial institutions under salam financing. Similar considerations also arise in other Islamic financing modes, for example, leasing. Standing arrangements with suppliers and marketing agencies can considerably reduce transaction costs and

financial risks for Islamic banks. Retail Islamic banking shall also be helped in this way.

## 7. Institutionalization of Recovery of Debt

Timely recovery of debt is critical for the success of Islamic financing. In general, debt is created with actualization of obligations of a client. Payment defaults, whether in lieu of some installment or the principal, can adversely affect business plans of Islamic banks, their working and, above all, settlement with different groups of depositors. The Shari'ah bars creditors from charging for payment delays (***al-Baqarah 2: 279***). And, the prohibition of indexation for inflation of loans and debts can make the matters worse in inflationary regimes. In an Islamic environment, these problems will have to be addressed at several levels.

Measures available to Islamic banks may include careful evaluation of financing requests (including credit rating of the clients), proper pricing of Islamic financial products, effective covering contracts and efficient machinery for enforcement of contracts. Notwithstanding these, however, as the financial system grows in size, institutions specializing in recovery of debts would be needed. Factors leading to their emergence are likely to be economies of scale enjoyed by such institutions and potential reduction in recovery costs for the financial institutions.

There is also need for redefinition of legal rights of the creditors. For example, debts may be recognized as first charge on the assets of the debtors as soon as they become due. Of course, a margin may be given for Shari'ah-recognized basic personal needs of the debtors.

## 8. Risk Management

Nature of Islamic financial instruments implies that Islamic banks face not only the traditional commercial credit risk of their clients but also other risks associated with the instruments. For example, market risk for salam financing or potentially damaging claims due to ownership of assets in lease financing. Several such risks can be addressed through design of financial contracts. As for commercial credit risk of the client, Islamic banks can reduce it through the following action:

- (1) Innovative collateral arrangements, third-party guarantees and credit rating of clients by specialized institutions
- (2) Choice of an appropriate financial instrument available in the Islamic setup
- (3) Pricing of Islamic financial products

Islamic banks are likely to have advantage in risk management as compared with their interest-based counterparts who can make recourse to only the first and the third option.

## 9. Accounting

Accounting represents by far the biggest challenge in the implementation of the Islamic financial paradigm. At present, efforts at AAOIFI are leading toward standard accounting norms for Islamic banks. But some serious questions are yet to be asked.

The Shari'ah is about rights and responsibilities. When question of property rights comes, parameters are exogenously given in the Qur'an and Sunnah. Some implications of this point for accounting purposes are as follows:

- (1) Income is not realized when it accrues but when it is materialized. In the case of murabahah financing, therefore, there is need to bring in new steps whereby banks acquire claims of the parting depositors to the funds tied in financing. A parallel step will be needed to accommodate new depositors in the bank's future income from the investments tied in murabahah financing.
- (2) The Shari'ah is relevant for the cost side also. When depositors offer funds to the banks on partnership basis, they are dealing with the legal person "bank" that is personified by infrastructure of the bank, its staff, etc. This legal person is supposedly responsible for providing investment services to the said depositors. With this being the case, Islamic banks cannot charge their establishment costs to operating expenses for deposits raised on the basis of musharakah or modarabah.
- (3) In the Shari'ah, costs are associated with acquisition of property rights. If this understanding is correct, then costs should normally be payments to third parties in lieu of acquisition of ownership of some thing or exclusive rights to some service. This places question mark on treating depreciation charges on fully owned durable assets for a business venture as costs.

These examples can be multiplied. No doubt, the concerned parties might have genuine concerns. But fresh thinking is necessary to ascertain how these and similar other issues can be resolved in Shari'ah-compliant and beneficial ways.

## 10. Financial Products Yielding Stable Income Flows

These are needed for pensioners, widows, orphans and similar other vulnerable groups in the society that rely on fixed income schemes. This is a challenge that Islamic banking has to answer.

## 11. Divisible and Tradable Financial Instrument for Government and Industry Needs

Government is the largest user of credit in any country. The situation is precarious in the Muslim countries where tax revenues are consistently outstripped by government expenses for miscellaneous purposes. The problem of ever-rising public debt has made the matters worse. This situation underlines the need for Shari'ah-compliant

divisible and tradable financial instruments for meeting government needs.<sup>4</sup> The same can be used for large-scale investments in the private sector.

## 12. Regulation and Control of Islamic Financial Institutions

This is a vast subject. We restrict our observations to regulation and control of Islamic banks.

Regulation and control of Islamic banks would be necessary to ensure that they remain “financial institutions”. That is, their role should not go beyond plugging financial gaps that bar real transactions from taking place in the economy. To allow Islamic banks to go beyond this would be sowing the seeds for monopolies and oligopolies in the economy, something against the express Desire of Allah SWT (*al-Hashar 59: 7*).

Islamic banks may be required to maintain reserves in lieu of their obligations to depositors who keep funds with them for safekeeping. But as deposits mobilized on partnership basis, no similar restrictions may be imposed on profit-sharing ratio. This is because Islam permits the competent authority to regulate entry into marketplace. But the matter of terms of contracts is left to willing consent of the contracting parties. Notwithstanding this, however, goals of controlling the volume of liquidity may be achieved by imposing quantitative restrictions on the stake that Islamic banks should put in before soliciting funds from others.

In the larger interest of the economy, sectoral targets might be prescribed for Islamic banks. That is, the banks may be called upon to utilize some of their expertise and resources to finance priority sectors in the economy. Such a requirement would be akin to a parameter for entering into and remaining in banking activities.

The equivalents of existing open market operations by central banks can take place in the Islamic money market. But their nature and scope would depend on two things. First, the central banking authority should remain neutral among the existing Islamic banks when it comes to offering fresh liquidity. Second, the authority ought to use Shari’ah-compliant financial certificates and securities of government, corporate sector and Islamic banks.<sup>5</sup>

Note that the above points are in addition to what a central bank may prescribe as part of prudent regulations.

## 13. Migration from Riba-Based to Riba-Free Banking

Some Muslim countries have adopted a dual banking system in the hope of gradually shifting to riba-free banking. The Pakistani model allows for establishment of full-fledged Islamic banks, Islamic subsidiaries by conventional banks and Islamic banking branches by conventional banks. This process needs to be carefully handled so that the interests of those opting for Islamic investments of their funds, are

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<sup>4</sup> Several useful options for this purpose are outlined in Chapter 5 of *IIIE's Blueprint of Islamic Financial System* (Islamabad: International Institute of Islamic Economics, 1999).

<sup>5</sup> Details of these points are given in Chapter 7 of the *IIIE's Blueprint*.

protected, both against mismanagement by Islamic banks and mixing with interest-based operations of the conventional banks.

## 14. Legal Framework

At present Islamic banks are working in many Muslim countries without proper legal cover. Of course, Iran, Sudan and Malaysia are exceptions.

In general, legislative needs for Islamic banking can be minimized by legislating the Shari'ah principles and the Shari'ah restrictions for contracts, while leaving practical details for adjudication by the courts. Nevertheless, attention will also have to be paid to the following and similar other points.

Murabahah financing means purchase and resale, i.e. two trading transactions. This need not be seen as such for sales tax purposes because Islamic banks do not buy things under financing for their personal needs. Registration requirements associated agreements need to be simplified as the associated costs may impede lease financing. There is also need for special legal cover in order to facilitate and implement musharakah (partnership) agreements by Islamic banks. Adjudication of recovery of bank receivables is presently interest-based. Its alternatives need to be developed and provided for in the law.

One issue that will continue to be relevant in the foreseeable future is prospect of Islamic banks working in the prevalent interest-based framework. It is obvious that Islamic financial instruments and their documentation and accounting requirement would be different. Therefore, the room for putting Islamic financial norms into practice in the existing framework would be limited. This, in turn, implies that Muslim countries should consider providing separate legal cover for Islamic financing.

## 15. Further Shari'ah Research

This is both important and sensitive matter. Its importance is self-evident. The long fiqhi tradition of last fourteen centuries warrants utmost care for any fresh attempts. We respectfully draw attention to the following points.

Is it not that, notwithstanding complexities in the transactions and the institutions that developed after the first century of Islam, in particular last two hundred years, the transactions as well as institutions represent derivatives of those prescribed in the Qur'an and Sunnah? Should the argument on various matters be developed in the light of the principles laid down in the Qur'an and Sunnah? Is there not a need review and reaffirm the received doctrines through a systematic and integrated analysis of the vast Hadith sources compiled in the 3<sup>rd</sup> Century after Hijrah?

A consideration of above points is very likely to be fruitful for expeditious development of Islamic financial paradigm, as also for making it a living reality.

Emergence of Islamic banking has provided a golden opportunity for unifying the fiqh. Moves are already underway to look for common ground and to define common fiqh for all Muslims.

**The above are just some of the current issues about the practice of Islamic banking.**