

# Challenges facing Islamic banks

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ISLAMIC banking industry has been trying for the last over two decades to extend its outreach to bring it at least to the level of conventional banking. But the absence of Shariah-compliant legal framework — needed to make interest-free banking acceptable (and create sound financial institutions) — is the major snag behind its low penetration in the financial market.

It is the time to take stock of challenges faced by the Islamic banks as they need a number of supporting institutions/arrangements to perform functions which are being carried out by various financial institutions in the conventional framework. Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws.

Some of the most important challenges facing the Islamic banking industry are identified as follows.

**Legal Support:** Islamic law offers its own framework for execution of commercial and financial contracts and transactions. Nevertheless, commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Islamic banking contracts are treated as buying and selling properties and hence are taxed twice.

The commercial, banking and company laws contain provisions that are narrowly defined and prohibit the scope of Islamic banking activities within conventional limits. It is necessary that special laws for the introduction and practice of Islamic banking be put in place. The legal framework of Islamic banking and finances might include the following:

a. **Islamic banking courts:** The disputed cases of the Islamic banks are subject to the same legal system and are dealt with the same court and judge as the conventional one while the nature of the legal system of Islam is totally different. To ensure a proper, speedy and supporting Islamic legal system, amendments in existing laws, which are repugnant to injunctions of Islam, are required to promulgate Shariah compliant law for resolution of disputes through special courts.

b. **Amendment of existing laws:** Islamic banking has some kind of resemblance to universal banking, therefore, laws and regulations have to be amended accordingly to accommodate this new concept such as sections 7 (forms of business in which the banking company can engage) and 9 (prohibition of trade) of the Banking Companies Ordinance 1962 while Islamic banks are big or wholesale traders in reality.

c. **Islamic banking law:** In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and

companies' laws in several countries require suitable modifications to provide a level-playing field for Islamic banks. Furthermore, international acceptance of Islamic financial contracts requires them to be Shariah compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

d. Islamic banking balance sheet: Islamic banks do not show assets financed through Ijara, Murabah etc., on balance sheet because section 7 of Banking Ordinance 1962 does not allow a bank to own property or asset which section 9 prohibits to enter into any kind of trade. However, all the assets owned by Islamic banks be mentioned in their balance sheets.

e. Monthly payment agreement: The housing finance is executed on the basis of Diminishing Musharaka by the Islamic banks. Under this mode the house is jointly owned by the bank and the customer. The bank rents out its share to the customer on Ijara basis. The Islamic bank while executing Ijara with the partner/customer, uses the term 'Monthly Payment Agreement' instead of having the Ijara agreement with the customer. It is so named as to safeguard the bank's interest in case of refusal by the customer to pay rentals. No legal cover is provided to the Islamic bank to overcome this risk.

f. PLS deposits: Deposits in Islamic banks are usually based on principle of profit and loss (Musharaka or Murabaha). If something happens and the bank suffers loss it has to be transferred to the depositor directly.

This fear of loss is the biggest barrier to deposit mobilisation in Islamic banks. In some cases, it leads to withdrawal of funds. The depositors should be provided with some kind of protection.

Islamic prudential regulations: Supervision of Islamic banks is equally important. At present, lack of effective prudential regulation is one of the weaknesses of the Islamic banking industry. For instance, leasing prudential regulations are applied to Ijara where the nature of both is different, such as taking advances. The bank is the owner in Ijara; so taking advances will render the contract of Ijara for conversion into Musharakah whereas the rules of Ijara are applied to it, which is illegal. And some of the Islamic banks are using the term of security, hence making the Ijara contract non-Shariah compliant as using the deposited sum under the heading of Ijara security ('Rahn') is nothing but Riba which is strictly prohibited by Islam.

Moreover, Ijara financing is subject to compulsory insurance which is essentially prohibited.

Risks: The nature of risk in Islamic banking is different from those of conventional banking and therefore some special prudential, accounting and auditing standards should be applied to them.

Benchmark: Taking the conventional interest based benchmarks (Kibor etc.,) as the base of pricing an Islamic financial product puts Islamic banks at the mercy of their

conventional peers. A negative perception is created among the clientele that there is no prudent difference in Islamic bank products as these are also using the same interest based benchmark. The mechanism for long-term financing could be devised on the basis of prevailing renting system adopted by the private landlords while renting their assets/properties etc.

Shariah based product: All Islamic financial institutions offer the same basic products, (90 per cent Murabaha and Ijarah) but the problem is that each institution has its own group of Islamic scholars on the Shariah board to approve the product. Consequently, the very same product may have different features and will be subject to different kind of rules in these institutions.

Lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered.

Nature of Islamic banking: Islamic banks are offering only Murabaha and Ijarah while leaving the core and difference making Islamic financial instruments such as Musharakah and Murabah. It is necessary to enhance and facilitate the implementation of real Islamic banking activities i.e. promoting risk sharing through equity type facilities on the asset side and profit sharing investment accounts on the funding side.

Lender of last resort facility: Islamic banks are reluctant to enter into long-term transactions due the lack of availability of liquidation through secondary market. There is liquidity support in the form of lender of last resort facility.

There is no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah.

Islamic future exchange: In conventional system, long-term finance is provided through long-term bonds and equities. Apart from the general public, the most important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, their need for equity markets is much higher. On the top of it, the most of the products in Islamic banks are based on goods and commodities while prices and currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of Salam and Istisna'a. To hedge the risk, they are in need of derivative products and consequently of Future Exchanges.