

13.1 Introduction

According to the noted scholar, Mahmoud El-Gamal, it is becoming more widely accepted, that when one studies the economics of classical jurists (ibn Taymiyyah, 'ibn Rushd, ibn Al-Qyyim, Al-Ghazali ...), one should not look to import their thought into current times. Instead, one should look to replace their historical economic thought with the present state-of-the-art knowledge, and replace their historical setting with the current legal technology. One would thus utilise their methods of understanding the Shari'ah in the light of the best knowledge of their times.²⁰⁹

Islamic banking is presently still in a nascent stage of development. Nevertheless, practical applications of non-interest bearing modes of finance have clearly demonstrated the feasibility of interest-free banking. However, great circumspection has to be exercised to nurture it on truly Islamic lines and to consolidate it so as to meet any future challenges.

The practical implementation of the concept of profit-loss-sharing to serve as the basis of Islamic banking has opened the way for economy-wide Islamisation of the banking and financial system in Muslim countries such as Malaysia and

²⁰⁹See El-Gamal, Mahmoud, "Updating our understanding of Shari'ah rules", The International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

Brunei. Progress in this direction will, however, depend on the circumstances of each individual country. Islamic banks working in isolation in different countries are faced with a number of practical problems in the actual conduct of Islamic banking. In many countries where Islamic banks have been established, the legal framework is not suited for the growth of Islamic banking. Still, they have shown encouraging results. There is evidence that even in those Muslim countries such as Malaysia and Brunei where a decision to Islamise the entire banking and financial system has not yet been taken, awareness is growing for the need of taking suitable measures to provide support and assistance to the Islamic banks in order to nurture their growth and development.

Islamic banks have to work hard to build up the wealth of experience which has been developed by the conventional banks over hundreds of years. They have to develop their instruments of finance and also the nature of their funding. The short-term nature of their funds with short-term private depositors' money does not easily lend itself to ventures into long-term finance. Despite this and the difficulties faced by Islamic banks trying to expand their medium and long-term activities, one finds that the results are not as bad as expected. On the contrary, these results, when compared with Islamic banks' age and experience, are far better than anticipated.

It is necessary to emphasise here that the top management of Islamic banks carries a very great responsibility for managing the affairs of these institutions so that all misgivings about the successful functioning of Islamic banks are removed and that an understanding of Islamic jurisprudence and the virtues of Shari'ah compliance for Islamic banking are fully demonstrated in practice.²¹⁰

²¹⁰Al-Harran, Saad, *Islamic Finance: Partnership Financing*, 1993, pp. 157–158.

Listed below are some of the tasks involved in converting from a conventional banking system to one embracing Islamic principles. The acceptance and practice of Islamic banking is due to its rising importance beyond the Middle East and into South-east Asia. In predominantly Muslim countries such as Malaysia, Indonesia and Brunei, the Islamic resurgence cements the need to understand and cater to Islamic banking.

13.2 Conversion Project Plan

According to Hussain Hamed Hassan, for anyone wishing to enter the realm of Islamic banking, there are a number of critical issues that need to be addressed and strategies that can be implemented. They can be summarised as follows:

- Treatment of share-holders, rights resulting from interest income
- Treatment of loans and advances with interest
- Treatment of deposits with interest
- Training programmes for senior management and all employees of the bank
- Modification/revision of computer systems (both hardware and software) to facilitate Islamic transactions
- Introduction of Islamic products and modes of finance
- Implementation of a strategy to deal with mismatch in source and uses of funds
- Selective recruitment of personnel with Islamic banking experience
- Re-structuring the bank to facilitate new activities and assign employees according to the new structure
- Re-assignment of employees to function in the revised structure, with training needs where applicable
- Revision of Articles of Association byelaws of the bank²¹¹

²¹¹Hassan, Hussain Hamed, "Conversion of National Bank of Sharjah into an Islamic bank: A case study", The International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

Some of the banking problems specifically associated with Islamic banking involves moral hazard, the possibility of fraud, delay in payment, insolvency and prohibition of future contracts in Islamic banking.

13.3 Moral Hazard and the Risk of Fraud

The risk of fraud, which is especially worrisome to the regulators, seems to have two sources. One is the possibility of underreporting of profits earned by the firm via maintenance of two sets of books which is in turn motivated by tax-avoidance. The other source of risk of fraud is the perception that since in risk-return sharing arrangements, the banks will have to carry the burden of potential financial losses, there is an element of moral hazard involved in these transactions.²¹² As discussed previously, most modern Islamic finance stems from *gharar* and the resolution of it through *mudarib* in the form of a PLS partnership.

In the Islamic banking system, according to Z. Ahmed,²¹³ it is necessary to determine the exact amount of profits earned by the *mudarib* in order to calculate the bank's share. An Islamic bank therefore faces a dual risk:

- (i) The moral risk which arises from the *mudarib* dishonestly declaring a loss, or a profit lower than the actual.
- (ii) The business risk which arises from the behaviour of market forces being different from that expected.

Another factor increasing the degree of risk is the lack of statistical data such as profit distribution ratios among the parties involved in various trade, industrial or service investment

²¹²Mirakhor, A., "Analysis of short-term asset concentration in Islamic banking", *IMF Working Paper*, Washington, October 1987, p. 10.

²¹³Ahmed, Z., "Some misgivings about Islamic free banking", 1985, pp. 17-19.

ventures. The contractual agreements do include a ratio for the distribution of profit. However, as the parties lack experience in such investment schemes, one or the other may feel either deprived of a due share, or taken advantage of, often after additional facts come to light.

There are at least three possible ways in which this residual risk can be minimised. First is by implementing the Islamic law of contracts which requires that stipulations of agreements entered into must be faithfully observed, and which proposes well-defined retributive judicial measures to safeguard the terms of the contract. Second is the possibility of third-party insurance schemes with cost participation by the central bank and commercial banks. Third is the maintenance of loss-compensating reserves by the banks. It must also be noted that hardly any bank can be expected to finance a risk-return-sharing project without sufficient information regarding the managerial ability, competence and character of the entrepreneur.

13.4 The Problem of Delays in Payment and Insolvency

Another challenge identified by Ahmed in 1985, which an Islamic bank faces, is how to deal with delayed payment. Since Islamic banks do not charge interest, delays in due payments may cause a number of problems for them. There are three main elements which are germane to the possibility of defaults, viz:

- (i) The nature of the party to whom finance is provided.
- (ii) The purpose for which finance is provided.
- (iii) The type of supervision exercised by the bank on the end-use of funds.

If sufficient care is not exercised in regard to these elements, defaults would arise irrespective of whether the concerned

bank follows traditional banking practices or the principles of Islamic banking.²¹⁴

One way to solve this problem is to sell the collateral against which finance is provided by the Islamic bank. However, this may not solve the problem completely. The main difficulty is that it has to be done in a way that does not resemble the interest payment charged by conventional commercial banks in similar circumstances. It is therefore suggested that Islamic banks may impose some penalty on defaulters for delay in payment accordance with the stipulations of agreement in one of the following ways:²¹⁵

- (i) Claiming part of the profit which customers might have made during the period of default.
- (ii) Claiming the profit which a bank could have made if the held-up funds had been returned promptly.

It seems that the second course of action is more reasonable for an Islamic bank. Indeed, the first course of action could involve a situation in which a customer might not have made a profit during the period of default.

13.5 Problems with Futures Contracts

British academic Rodney Wilson's research found that there are two types of traders in futures markets.²¹⁶ The first are speculators who neither intend to sell or buy commodities, but merely wish to capitalise on the spread between sales and

²¹⁴Ibid.

²¹⁵Ahmed, Z., op cit, p. 67.

²¹⁶See Wilson, Rodney, "The need for more risk taking products", The International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

purchase prices. This is clearly an illegitimate objective of profiteering without true trade, and profits from non-guaranteed commodities, which is forbidden in as far as Islamic banking is concerned.

The second type of futures trader tries to hedge what he already possesses — he deals in futures in order to avoid possible losses. However, such hedging is only needed for goods that the trader wishes to monopolise for a long period; if the commodities were sold a few days after they were acquired, it would not be necessary to hedge. The second kind of trader only deals in futures when they wish to monopolise some commodities for a longer period to increase their profits. Thus, it is clear that merchants only need futures to hold goods for a considerable period, which quite often is done out of the illegitimate objective of monopoly profiting.

In the absence of a sophisticated legal system, named-contract rules of a *madhab* provided local followers of that school with the “legal fine print” for transactions known to be devoid of prohibition factors (e.g. *riba* or *gharar*) at the time of the ruling (e.g. *murabaha*, *ijarah*, *mudarabah*, *salam*, etc.). But it should be noted that a transaction satisfying that fine print need not be permissible today, and a permissible transaction today need not satisfy that fine print.

13.6 Moving Forward

Some of the problems identified by academic commentators on Islamic finance are now being overcome. Vogel and Hayes see the development of marketable instruments, organising financial markets and creating tools for risk management as key challenges.²¹⁷ Progress has been made on all

²¹⁷Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance: Religion, Risk and Return*, Kluwer Law International, The Hague, 1998, p. 295.

of these fronts. The development of Islamic securities can reduce some categories of risks; yet at the same time encourage other types of desirable risk-taking. The introduction of bills, bonds and notes that can be traded reduces the liquidity risk problems. Banks can move some liquidity from cash into Islamic securities, as the latter constitute an acceptable risk.

Islamic-managed funds consist of a portfolio of underlying equities and other securities, and the risks associated with a pooled fund should be lower than those associated with individual equities. Such funds have a proven track record in Islamic finance, dating back now, almost twenty years in some cases. Islamic-managed fund investment has proved popular for middle-income bank clients, and not only those of high net worth. Nevertheless according to Wilson, their contribution to equity financing in Muslim countries has been limited, largely because of perceived country risk and exchange rate uncertainties.²¹⁸

Successful innovation in Islamic banking and finance may have similar characteristics as with conventional banking, namely to preserve what is essential about the Islamic heritage in law and economics, whilst also vastly improving on past commercial techniques, enabling Muslims to join in and effectively compete with world economic and commercial advances.

13.7 Conclusion

This book has examined the development of Islamic banking and finance in South-east Asia. Much of the introductory research came from the early scholars involved in religious and historical studies. The later work has relied heavily on

²¹⁸See Wilson, Rodney, *op. cit.*

the analysis and reviews of modern-day academics such as Wilson, Hassan, Ahmed, Vogel and Hayes.

Islamic finance is now on the verge of either a major transformation, or a period of frustration and therefore possible decline. Should this turning point be negotiated successfully, Islamic finance will enter a new and even more successful era. Until now Islamic finance has largely been confined to the activities of Islamic banks which have tried to practise a Muslim version of conventional retail commercial banking. Elementary knowledge of Islamic law shows, however, that retail commercial banking is one the most difficult commercial functions to perform in a religiously acceptable manner. Legal rules force Islamic banks to forego two basic features of conventional commercial banking — security for deposits against losses (achieved conventionally through the concepts of depositors seniority in banks' capital structures as well as supplemental deposit insurance) and stability and predictability of returns on the bank's assets (achieved through senior interest-bearing loans to a diversified portfolio of borrowers). Regardless of theory, Islamic banks have found that their competitive and regulatory context compels them to mimic conventional banks in both of these characteristics, pushing them into short-term, low-risk investments in an effort to offer their depositors' returns similar in quantity and risk to those obtained by conventional depositors. This circumstance, and others, have prevented them from becoming the profit-and-loss investment intermediaries that Islamic economic theory demands. This in turn causes them both a legal and a financial embarrassment — a legal embarrassment because Islamic banks have survived not on profit-and-loss principles (*mudarabah*) but via markup (*murabaha*) transactions; and a financial embarrassment because the greater complexity of the transactions involved puts them at a disadvantage *vis-à-vis* conventional

banks; some are saved only by the loyalty of their base of religious customers.

A crucial question asked by Vogel here is, “Does Islamic jurisprudence (*fiqh*), as elaborated by the scholars and institutions devoted to it, have the potential to meet all the needs of modern Muslims in the commercial and financial sector, in the traditional sense of offering normative guidance for various aspects of daily life?” A success in this field would augur well for the law’s extending its influence to other aspects of public life in Islamic societies now almost entirely unaffected by it, such as constitutional law, state economy (taxes, social services), public administration or educational reform.

Contemporary *fiqh* has shown much capacity for development already, in permitting modern Islamic banking and finance to emerge in their present form. The solutions the scholars have reached have been generally accepted by participants as religiously sound. But much concern and even suspicion remain. Participants, both customers and practitioners, are lately demanding that the financial institutions achieve even higher degrees of religious legal compliance. For example, many now demand that the banks eliminate or reduce use of “synthetic” *murabaha* transactions. This new era of religious strictness now is combining with competitive pressures from the marketplace (such as the need to invest long-term to improve returns on investments) to push banks and their religious-legal advisory boards into new and uncharted territory.

No doubt many of the legal challenges now facing Islamic finance are disquieting and difficult — such as creating derivatives or other risk-hedging devices or encouraging trade in financial instruments. If *fiqh* scholars take too cautious and literalist an approach, backing away from the deeper

comparative and functional analysis and bolder legal reasoning or *ijtihad* which is now needed, Islamic finance could languish. Given the record to date, however, one can be optimistic about the future.

Finally, Islamic banking is facing another challenge: the lingering suspicion that it is connected to terrorism. So far, there is little evidence that its activities are any more suspect than those of conventional banks. (The US Government's list of terrorist organisations included one small Islamic bank, Al-Aqsa Al-Islami in the West Bank.) Islamic finance has always had more to do with conservative, devout Islam than radical, political Islam. Nonetheless, 11 September has put the industry on the defensive, with some depositors withdrawing money for fear it would get caught in an anti-terrorism dragnet. "A lot of investors were frightened, to be honest," says Atif Abdulmalik, CEO of First Islamic Investment Bank in Bahrain. "Collateral damage"!

As previously noted, amongst the optimists is Vogel, who believes, "It's very much in our interest that it succeed, yet I'm afraid that we're going to be against it, that we're going to make all these snotty remarks. Time is running out for healthy, happy experiments like this. The radicalisation, the desire to make yourself as ugly to the West as you can — that rage isn't only at us, it's at the secular forces in their own societies. We need Islamicisation, because they're not going to stop being Muslims overnight."

Oddly, Professor Samuel Hayes III, co-author with Vogel, of *Islamic Law and Finance: Religion, Risk and Return*, gives a different slant. In his view, literalist interpretations of the Quran threaten to choke off Muslim participation in the global economy. "Prophet Muhammad's teachings take very practical account of commerce in the seventh century," says Hayes. "It's not up to me to say, but if he were living today, I think he

would find some accommodation. Otherwise, there's no way a business can operate competitively."²¹⁹

Ultimately, even Islamic scholars concede that Hayes might have a point. "Once you face reality," Yaquby says, "it's not possible to isolate yourself from the whole economic system of the world."²²⁰

²¹⁹Useem, Jerry, *op. cit.*, pp. 61–65.

²²⁰*Ibid.*