

Issues and Challenges of Islamic Banking Today

It is easy for the uninitiated to underestimate the difficulty of applying classical Islamic law to modern commercial transactions. Some believe that the law's dictates can be summed up in a set of vague and general ethical and moral precepts, which do not entail any precise system of legal procedures. In contrast, others assume that the legal restrictions are relatively few in number, concrete in nature, specific in application, and readily dealt with, leaving the rest of the field free for innovation and development. In either case, the outsider may expect to find Islamic banking easily accommodated by Western financial practices, simply by observing a short list of do's and don'ts. Instead, the uninitiated finds, on closer examination, that classical jurisprudence (*fiqh*) relating to commerce and other financial matters is extraordinarily rich and complex. Moreover, whilst this law is derived from profound general principals, it is not stated in those terms but rather as innumerable detailed rules, which are interconnected at a level rarely made explicit. Furthermore, these rules and principles are not only legal edicts but also possess a moral dimension, which, at times, defeats any hope of a legalistic precision.⁸³

⁸³Vogel and Hayes, op cit, p. 28.

5.1 Obstacles to the Application of Islamic Law to Present Day Banking

The rationalising of those areas of Islamic law which relate to commerce and other financial activities, in order to create a legal framework for Islamic banking is not, according to Vogel's studies, all that simple then. First there is the nominalist or provisional nature of much of Islamic jurisprudence (*fiqh*), which relies as much on the interpretive skills of individual Islamic scholars, extrapolating from both primary and secondary sources, as it does on the principal tenets enshrined in Shari'ah law. Divergences of opinion between the different schools of law complicate the picture further, as do the different methodologies that may be called upon when elaborating on the law. Then there is the particular issue of the pluralism of the *fatwabs*, which again has its origins in the subjective and non-binding nature of many *fiqh* rulings.

What all this means is that Islamic jurisprudence lacks something of the consistency and predictability of a more codified system of laws and edicts — as we noted earlier, modern *fiqh* scholarship should be understood as representing the current state of thinking in terms of tolerance parameters and need not necessarily be regarded as the last word on the subject. Further complications inevitably arise when it comes to accommodating Shari'ah law to the existing legal system of a particular country, which more often than not is based on a European model, chiefly French or English, the legacy of the colonial era. Lastly, there are problems relating to proper accounting standards as well as regulatory challenges to ensure proper *halal* banking.⁸⁴ The path towards harmonisation of Islamic banking and conventional banking is fraught with interpretations of the *fiqh* and pluralism of the *fatwabs*. That is coupled by

⁸⁴Vogel and Hayes, op cit, pp. 50–51.

differences in the methods of interpretations and arriving at the *fatwahas*.

5.2 Derivation from Revealed Sources

As we saw in chapter 2, the English term “Islamic law” conceals an important distinction between Shari’ah (divine law) and *fiqh* (the human comprehension of that law). *Fiqh*, unlike Shari’ah, can be faulty, multiple, uncertain, and changing. Indeed, since the revealed texts are only finite and are often ambiguous, the norm is that *fiqh* rulings are uncertain and merely probable suppositions as to what God’s law truly is. Indeed, on most points of doctrine *fiqh* writings record multiple opinions, all from qualified scholars.

This situation is further complicated by the different positions taken by the various schools of law. By way of example one might consider the varying perspectives of the different schools in relation to *salam*, forward-purchasing contracts. The term *salam* refers to a contracted sale whereby the seller undertakes to supply specific goods to the buyer at a future date in exchange for an advanced sum fully paid up on the spot. Here the payment for the good is made up front and in cash, but the supply of the purchased goods is deferred. According to the Hanafi school, it is necessary that the commodity that is being sold remains available in the marketplace from the very day that the contract is initiated right up until the date of actual delivery. If the commodity is not available in the marketplace at the time of the contract, then *salam* cannot be effected in respect of that commodity, even though it may be confidently expected that the commodity *will* be available in the marketplace on the agreed date of delivery. The other three schools of law — Shafi’i, Maliki and Hanbali — differ on this, being of the opinion that the availability of the commodity at the time of the contract is not a condition for the validity of *salam*. What

is necessary, according to them, is that it should be available at the time of delivery.

This is but one example, but suffice to say, there can be considerable divergences between what is and is not permissible under Islamic law, depending on which school of law is consulted. Such inconsistencies are not in themselves conceived as some kind of failure on the part of Islamic jurisprudence, but rather as a reflection of the fallibility of man. Ultimately, *fiqh* rulings are taken as truly and certainly God's law only when they are established by a literal, revealed text, or when they have been agreed upon unanimously by all Islamic scholars of a particular age. The latter agreement is called "consensus" or *ijma*.⁸⁵

5.3 Methodological Differences

The legal rulings applied in today's Islamic banking and finance are, generally speaking, arrived at using one of the other of four different techniques: interpretation of the revealed sources (*ijtihad*), choice (*ikhtiyar*), necessity (*darura*) and artifice (*hila*). The selection of one technique over another to get a more favourable decision, according to the circumstances, also affects the consistency and predictability of many *fiqh* rulings.

The first and metaphysically most pristine technique is *ijtihad*, or derivation directly from the revealed texts of the Quran and the Prophet's *Sunnah*. This method is increasingly being used in Islamic banking and finance, particularly when a

⁸⁵Scholars' construction of *ijma* differ. For some, no qualified scholar's view can ever be overridden by a later agreement. This gives more scope for variation than other positions on *ijma* holding that an *ijma* in a later generation disproves all the contradictory views of earlier generations. See Vogel and Hayes, *op cit*, pp. 34–35.

legal instrument or ruling is considered novel — that is never previously considered by scholars in the past. For example, contemporary scholars have found that the option contract has no counterpart in classical law and so must be evaluated afresh using *ijtihad*. Recourse to *ijtihad* is increasing as scholars move from everyday transactions to more complex and less commonplace exchanges.

A second method by which a ruling may be reached is that of choice, or *ikhtiyar*, which in this context means the selection of an appropriate ruling from views already propounded by scholars in the past. This method has the advantage of aligning the modern scholar's view with that of a great scholar in history, which at least lends the assurance that nothing about the opinion fundamentally offends the Shari'ah and that no disastrous innovation is afoot.

There are various subcategories of this approach defined according to the criteria by which a decision is reached. One method, the most ambitious, reverts to the Quran and *Sunnah* and to basic *fiqh* principles to decide which view offers the best or strongest interpretation of the revealed texts. A second method evaluates an opinion by the rules of decision internal to the school that espouses it, such as the degree of support from the school's founder or its consistency with the position taken by other schools (e.g. there are "stronger" and "weaker" Hanafi views). A third method examines which view best serves the general welfare or *maslaha* (a concept which includes religious welfare). In the latter instance a particular choice may be made simply because it conforms to prevailing practices or customs (*'urf*). One argument in favour of this last approach is that *fiqh* delegates freedom to act to those responsible for the general welfare as long as they do not offend fundamental principles of Shari'ah.

Vogel notes that conservative legal scholars prefer to avoid *ijtihad* wherever they can justify innovations by appeals to

precedent (*ikhtiyar*). In practice, though, the method of choice covers *ijtihad*, notably in contemporary deliberations about options, which are financial instruments critical to any effective future for Islamic finance.

A third method of deriving rulings, still lower in metaphysical status, permits one to adopt any position, even one contravening a categorical Shari'ah rule, when one is compelled to do so by stark necessity (*darura*). This necessity must be of great severity, usually one involving life-or-death situations. The basis for this approach is the Quran's frequent recognition that a person may be driven by necessity to eat otherwise forbidden food (e.g. 2:173) and also the Quran's disavowal of any divine intent to cause mankind hardship or to press human beings beyond their capacities (e.g. 2:286). One version of the doctrine holds that a mere "need" (*haja*), if it affects many, may be treated like a dire necessity affecting only one.

Scholars in Islamic banking and finance have invoked necessity to permit exceptional relaxation of rules. They have issued *fatwahs* (opinions) allowing Islamic banks to deposit funds in interest-bearing accounts, particularly in foreign countries, because these banks have no alternative investments at the necessary maturities. Typically, however, they place conditions on such *fatwahs*. For example, it may be required that the unlawful gains be used for religiously meritorious purposes such as charity, training or research. Such *fatwahs* are particular to the circumstances in which they are issued. If conditions change or if an alternative to the necessary evil arises, the scholars require that the practice end.

Classical Islamic law also indulged in one further method of attaining desired legal outcomes, namely that of legal artifice (*hila*, pl *hiyal*). The foundation of this method is a formalistic approach to contract, in the sense of a concern for the external form of transactions instead of the parties' substantive intentions. All classical scholars found *hiyal* acceptable when they

were merely clever uses of law to achieve legitimate ends. For example, a landlord, worried about a tenant cancelling unfairly, might stipulate payment in advance in the lease terms.

In the case of Islamic banking, one such instance of legal artifice is the artificial *murabaha*. As we saw in the previous chapter, one of the principal instruments of Islamic banking is *murabaha*, a perfectly legitimate means of financing a sale by charging markups to the current price at a future time. Because Islam accepts the time value of money but rejects making money from money, the bank financing a *murabaha* sale must actually buy the merchandise and then advance it to buyer. In practice, however, Islamic banks in Pakistan, Malaysia and elsewhere have devised artificial *murabaha*, whereby the creditor immediately releases the merchandise to the buyer without ever really possessing it or even fully identifying it.⁸⁶ The Fiqh Academy of the Organization of Islamic States has condemned this practice, yet many Islamic banks engage in such *hiyal*, perhaps because they lack the commercial expertise and warehousing capabilities literally to fulfil the conditions of a “real” *murabaha*. The major portion of outstanding credit extended by Islamic banks takes the form of *murabaha* but the proportion of it that is artificial is unknown. Any systematic attack on this particular artifice, however, could place the entire Islamic financial movement in jeopardy. Out of necessity Islamic banks are in need of new financial instruments.⁸⁷

5.4 Pluralism of *Fatwahs*

As explained in chapter 2, a *fatwah* is a non-binding legal opinion of a learned scholar, or *mufti*, issued in response to

⁸⁶An opinion put forward by Saiful Rosly, a professor of finance at the Islamic University of Malaysia.

⁸⁷Henry, Clement M., “Guest editor’s introduction”, *Thunderbird International Review of Business*, Special Issue on Islamic Finance, July 1999.

a request for a legal opinion by one party or another. There is no obligation on the part of the person who asked for the opinion to implement what he is told; it is left to his conscience whether to accept that ruling or to turn from it and he bears the responsibility for that. The pluralism of *fatwahas* relates to differences and disagreements between different applications of law (*furu'*) as distinct from the actual principles of law (*usul*). For example, the prohibition of *riba* (interest) *vis-à-vis* the prohibition of *'inah* sales (double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, the net result being a loan with interest). Whilst pluralism is not accepted in matters of principle such as faith, the basic tenets of Islam and clear-cut principles of law, which are divine in character, Islam must nevertheless confront the problem of legal pluralism in other areas if it seeks to ensure that the rule of law be maintained.⁸⁸ The key issue here is how to maintain the rule of law in the face of multiple, but equally authoritative legal interpretations backed by differential levels of power? Some of these disagreements need no harmonisation because the divergences of opinion relate to the choice of contract rather than the issues of "Islamicity".⁸⁹

5.5 The Problem of Applying Islamic Law in a Western Legal Environment

Again, according to Vogel, although parties may agree by contract to abide by Islamic precepts, they cannot alter the

⁸⁸Bakar, Mohd. Daud, "Pluralism of fatwas: Bridging the differences and disagreements", The International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

⁸⁹"Legal rationality vs. arbitrary judgement", *Muslim World Book Review*, October–December 2000, pp. 3–12.

surrounding legal system which in the end enforces their agreements. In nearly all Muslim countries today, civil and commercial codes have been greatly influenced by European legal civil systems, most commonly French, followed by English common law. For example, Egyptian law and jurisprudence, which are inspired by French and other continental European legal systems, have been widely emulated in other Arab countries and the same goes for the legal institutions and laws of procedure in most other Muslim countries, including those in South-east Asia, which are also derived from Western models. Only in Saudi Arabia, Oman and a few other countries of the Arabian Peninsula do legal rules and institutions resemble those of the classical era, but even in these countries, Western legal influences have made strong impacts. In Saudi Arabia, for example, which is the world's most traditionally Islamic country, the general civil law is that of the classical Hanbali School and is applied by judges trained in Islamic law using largely Islamic procedures and rules of evidence. However, in areas of the law explicitly involving commercial matters, such as company law, banking and commercial paper laws, the laws applied strongly resemble French and Egyptian laws.

Bearing in mind that Islamic banking began with the purpose of benefiting all society, situations such as bankruptcy, merely offers delay and immunity from collections, not release, and the creditor's grant of delay is not compensated. European legal systems do not give that much leeway to the debtor as they do not take into account of the Quran nor accommodate the Shari'ah.⁹⁰ Thus we see the historical reasons for

⁹⁰Vogel and Hayes, op cit, p. 61.

the challenges of integrating Islamic law into these various European legal systems.

5.6 Accounting and Corporate Regulatory Practices

A major problem challenging the growth of Islamic banking was the absence of recognised guidelines on prudential, supervisory, accounting, auditing and other corporate regulatory practices. This resulted in ineffective accounting standards and created considerable difficulties when it came to comparing financial statements issued by Islamic financial institutions and those of conventional financial institutions. Two organisations, namely the Accounting and Auditing Organisation for Islamic Financial Institutions (hereinafter referred to as AAOIFI) and the Islamic Financial Services Board (IFSB), are both involved in addressing these issues with the ultimate aim of harmonising corporate governance with the ethical requirements of Shari'ah law.

AAOIFI is an autonomous, international, non-profit-making corporate body which draws up Shari'ah-compliant accounting procedures, auditing methods, corporate governance frameworks and business ethics for Islamic financial institutions. It was established in accordance with an Agreement of Association, signed by major Islamic financial institutions in Algiers on 26 February 1990 and registered in the State of Bahrain on 27 March 1991.⁹¹ The principal aims of the AAOIFI are to standardise on-balance-sheet accounting; adopt uniform Shari'ah standards for the most popular Islamic finance contracts; lobby national regulators to adopt these

⁹¹ www.aaofi.com.

standards; and mimic as closely as possible the approach of the Basle Committee on Banking Supervision,⁹² whilst accounting for Islamic-contract peculiarities in capital adequacy, risk assessment and asset quality assessment.

There are three main areas of difference between Financial Accounting Standards (FAS) developed for Islamic banks and conventional accounting frameworks. They relate to the treatment of investment accounts, the concept of substance over form and the time value of money.⁹³

(i) The Treatment of Investment Accounts

FAS distinguishes between Unrestricted Investment Accounts (URIA) and Restricted Investment Accounts (RIA) on the basis of *mudarabah* contracts between the bank and investors (*mudarabah* contracts it will be recalled, are a form of partnership to which some of the partners contribute only capital and the other partners only labour). An unrestricted *mudarabah* agreement permits the Islamic bank to co-mingle its own assets with that of URIA unconditionally and without restrictions. FAS, therefore, requires these assets to be reflected on the balance sheet of

⁹²Task Force on Accounting Issues was established by the Basle Committee on Banking Supervision in 1996, with the mission to foster effective and comprehensive supervision and safe and sound banking systems. The Task Force carries out this task by identifying accounting issues that are important from the point of view of banking supervisors, contributing to international accounting harmonisation efforts and developing supervisory guidance on sound accounting practices in banks. It consists of supervisory experts on accounting issues from the member institutions of the Basle Committee. The Task Force is chaired by Mr Nick LePan, Deputy Superintendent at the Office of the Superintendent of Financial Institutions, Canada, and a member of the Basle Committee.

⁹³Jamall, Ashruff, "Role of western institutions with Islamic windows", The International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

an Islamic bank. RIAs, on the other hand, impose investment restrictions on the Islamic bank and, therefore, do not qualify for inclusion in the Islamic bank's balance sheet. Under conventional accounting frameworks, the assets of URIA would not qualify for recognition as assets of the bank because the economic benefits embodied in those assets flow to holders of URIA and not to the bank.

(ii) The Concept of Substance over Form

In conventional banking, accounting for items according to their substance and economic reality and not merely their legal form is one of the key determinants of reliable information. For most transactions there will be no difference, so no issue arises. In some cases however, the two diverge and choosing how to present these transactions can lead to very different results. Differences arise when an asset or liability is not recognised in the accounts, even though benefits or obligations may result from the transaction. The concept of substance over form is one of the fundamental qualitative characteristics of accounting information under conventional accounting frameworks, but this distinction is not recognised by FAS.

(iii) The Time Value of Money

In conventional banking, "net present value" (NPV) is a way of comparing the value of money now with the value of money in future. A dollar today is worth more than a dollar in future, because inflation erodes the buying power of the future money, while money available today can be invested and grow. "Constant dollars" refers to the NPV relative to a fixed date, whilst "current dollars" refers to the unadjusted value of the money. The term "discount rate" refers to a percentage used to calculate the NPV, and reflects the time value of money.

Conventional accounting frameworks recognise NPV as an acceptable basis of measurement — indeed, the Financial Accounting Standards Board (FASB) and International Accounting Standards (IAS) are increasingly moving towards a fair value basis of measurement and encourage the use of NPV as a unit of measurement when market values are not readily available. Unfortunately, this understanding of the relationship between time and money in conventional accounting runs into difficulties when it comes to Islamic banking for the simple reason that in terms of Shari'ah law, money is not a commodity and, therefore, does not have a time value. Consequently, NPV is not admissible as an acceptable basis of measurement under FAS, which recognises only the historical cost basis and the cash equivalent basis for impaired assets.

5.7 Depositors and Regulators

The complete absence of interest in Islamic financial institutions changes the role of depositors and regulators, and the way in which deposits are handled. A depositor places his money in the bank, whilst the regulator is an officially appointed party who is there to ensure proper control and supervision of the banking activities. The difference between conventional and Islamic banks as regards the role of depositors and regulators is that in conventional banks, private or public, regulators act as a proxy for debt-holders and take control away (perhaps through a regulator) from equity holders in bad times. To unsophisticated depositors, just because an Islamic bank seems to hold quasi-equity Profit-Sharing Investment Accounts (PSIAs) instead of debt (guaranteed deposits), they as depositors do not have the shareholders' voting and control privileges and thus, public regulators should act as their representatives.

The following two models of Islamic banking methods, as regards the role of depositors and regulators, are both considered to be fully consistent with Islamic rules and guidelines.

(i) The Two-tier *Mudarabah* Model (scheme A)

In this scheme of things, the assets and liabilities sides of a bank's balance sheet are fully integrated. On the liabilities side, depositors enter into a *mudarabah* contract with the bank to share the overall profits accruing to the bank's business. Here, the depositors act as financiers by providing funds and the bank acts as an entrepreneur by accepting them. On the assets side, the bank, in turn, enters into *mudarabah* contracts with agent-entrepreneurs who search for investable funds and who agree to share profits with the bank according to a certain percentage stipulated in the contract. In addition to investment deposits, banks are allowed to accept demand deposits that yield no returns and may be subject to a service charge. These deposits are repayable on demand at par value. However, depositors are also aware that banks will be using demand deposits for financing risk-bearing projects. Under this arrangement, banks may grant short-term interest-free loans (*qard al-aasanah*) to the extent of a part of total current deposits. Finally, it should be noted that, although the concept of reserve requirements is recognised in Islamic banking, the two-tier *mudarabah* scheme does not mandate specific reserve requirements on either type of deposits.⁹⁴

(ii) The Two Windows Model (scheme B)

Under this arrangement, bank liabilities are divided into two windows: one for demand deposits, with 100 per cent

⁹⁴Traditionally, banks operating with the two-tier *Mudarabah* scheme have kept substantial reserves against demand deposits (even if they were not considered *Amanat* or safekeeping) and little (sometimes none) on investment deposits.

reserves being held, and the other for investment accounts, with no reserve being held at the bank. In both cases, the major tool of operation is *mudarabah* or *musharakah*. The choice of the window is left to depositors. Demand deposits are assumed to be placed as *amanat* (safekeeping) and in this respect they are considered to belong to depositors at all times. Hence, they cannot be used by the bank as the basis to create money through fractional reserves. Consequently, banks operating according to this arrangement must apply a 100 per cent reserve requirement ratio on demand deposits. By contrast, investment deposits may be used to finance risk-bearing investments projects with depositors' full awareness. These deposits are not guaranteed by the bank and reserve requirements are not applied to them. The bank may charge a service fee for its safekeeping services. Interest-free loans may only be granted from funds specifically deposited for that purpose.

Islamic banks can use all of their deposits (demand and investment) for their financing and investment activities in scheme A, whilst only investment deposits can be utilised for such purposes in scheme B. This makes scheme A, where banks' assets and liabilities are fully integrated, far riskier than scheme B, where banks' liabilities are divided into two windows.⁹⁵

5.8 Regulators' Concerns

Several concerns have been raised by regulators, relating to the accounting standards of Islamic banking and the possibility of a conflict of interest between bankers and their clients. They

⁹⁵Errico, Luca and Farahbaksh, Mitra, 1998, pp. 9–11.

include the following areas of concern:

(i) Capital Adequacy Ratio

The existence of PSIA raises some fundamental issues in calculating the Capital Adequacy Ratio (CAR) for an Islamic bank. The basic problem has to do with the possibility of including PSIA as a component of capital because they have a risk-absorbing capability. In this respect, AAOIFI's Discussion Memorandum on the Calculation of the Capital Adequacy Ratio for Islamic Banks (issued in January 1998) is relevant. This document set out to try to design a capital adequacy framework for Islamic banks within the Basel's capital adequacy framework. Following this, AAOIFI issued a Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks in March 1999. According to this statement, Islamic banks' own capital is exposed to normal commercial risk, fiduciary risk and displaced commercial risk,⁹⁶ the implication here being that these types of risk should underlie the design of the capital regulations. The AAOIFI statement proposed three things. First, that there should be no inclusion of in the risk-bearing capital PSIA.⁹⁷ Second, that all assets financed by debt-based liabilities and own-equity should be included

⁹⁶Displaced commercial risk expresses the possibility that depositors will withdraw their funds if the return paid to them is lower than that paid by the other banks. As a result, some Islamic banks give minimum guaranteed returns to depositors, although it is prohibited by the Shari'ah principles (AAOIFI, 1999).

⁹⁷PSIA^R — restricted profit-sharing investment deposits; PSIA^U — unrestricted profit-sharing investment deposits. The PSIA^R depositors have the right to determine the investment types chosen; the banks merely provide them with information about feasible investments. Therefore, in PSIA^R the depositors take responsibility for investment risk. In fact, the statement does not distinguish between PSIA^R and PSIA^U; arguably, the former should be included in the capital base.

in the denominator of the CAR. Third, that 50 per cent of PSIA-financed assets should be included in the denominator of the CAR. The last measure is needed to cover possible losses arising from misconduct or negligence in investment activities.⁹⁸

Taking a closer look at these proposals, one should note that first of all, the existing CAR developed by AAOIFI is only designed to assure a given level of solvency and ignores the agency roles performed by Islamic banks and the principal/agent relationships involved. Second, there has been an inconsistency in defining the restricted-investment deposits. According to the IAS developed by AAOIFI in 1997, the restricted profit-sharing investment deposits, (PSIA^R deposits) cannot be recognised as liabilities of Islamic banks and should not be reflected on the banks' statement of financial position. This is because the depositors are highly involved in investment decisions. Thus, it can be argued that PSIA^R-financed assets should be excluded from the risk-weighted assets in the denominator of the CAR. Yet in the CAR, no distinction is drawn between PSIA^R and PSIA^U. A third point raised by the AAOIFI proposals, is the possibility of a bank facing "an abnormal risk" arising from a managerial dispute (i.e. where the PSIA^U depositors consider that a bank has neglected or breached the contract agreed upon). This should be seen as legal risk and should ideally involve a case by case approach (i.e. depending on the terms used in the contract), in which case, the banks should be able to identify the difference between deposits taken on a pure PLS basis and those representing a hybrid contract. Deposits with any

⁹⁸If the bank's management acts in breach of the investment contract, or is guilty of misconduct or negligence in the management of the investors' funds, then the bank may be legally liable in respect of losses sustained on those funds (AAOIFI, 1999).

potential claim (partly) should be classified as hybrid-based deposits.⁹⁹

Without distinctions between PSIA^R and PSIA^U, the CAR is not a clear representation of the bank, coupled by the exclusion of the liabilities portion in the form of PSIA^R deposits from the bank's balance sheet, the AAOIFI proposals have not adequately provided for the difference in the role of Islamic banks from the conventional banks from the customer's point of view.

Even the AAOIFI/Basle accounting standards (cost-of-acquiring accounting) pushes managers in the direction of gains trading in that risk-cushioned shareholders of the bank encourage excessive risk-taking in bad times and insufficient risk-taking in good times. What this means for PSIA-holders is that while their risks will be amplified during bad periods, equally, too little risk-taking during good times will be reflected in lower returns on their investment. When private rating and auditing agencies raise a flag of warning, they exacerbate the crisis of confidence and increase risk-taking, creating a double moral-hazard problem for Muslim investors. And because AAOIFI standards focus on "bank's own capital" risk measures, this gives managers and shareholders the incentive to shift even more risks onto the PSIA-holders, especially when responding to major downturns in global financial markets.

This is against the spirit of Islamic banking which is not to disadvantage one party for the unfair benefit of another.¹⁰⁰

⁹⁹Muljawan, Dadang, Dar, Humayon A., and Hall, Maximilian J.B., "A capital adequacy framework for Islamic banks: The need to reconcile depositors' risk aversion with managers' risk taking", Department of Economics Discussion Papers, Loughborough University (www.lut.ac.uk), 2002.

¹⁰⁰See El-Gamal, Mahmood, "Western regulatory concerns about Islamic banks", International Islamic Financial Forum, International Institute of Research, Dubai, March 2002.

It is generally agreed that Islamic banking should go beyond mimicking the Basle solvency-orientated formulas (which were designed to protect debt-holders). The true goals of regulation are to safeguard the interests of small un-represented investors and to protect the financial system against meltdowns. Therefore, a coherent Islamic bank regulatory framework is required to protect PSIA-holders from managers adopting inappropriate strategies (too much or too little risk-taking) in order to cater to interests of the bank's shareholders. One possible framework would include efficiency and risk monitoring of Islamic bank management, and/or alternative Islamic-banking claims structure to reduce the gap between PSIA-holders' rights and that of the debt-holders.¹⁰¹

5.9 Legal Challenges

Several legal challenges exist in Islamic finance. They relate to the management of investment risks, consumer protection laws, the lack of legal precedents, situations involving uncertainty, integrating Shari'ah rulings within a conventional banking framework, accommodating Shari'ah references in conventional legal documents and property law issues. In order to provide proper legal foundations for the supervision of Islamic banks, it is necessary that the nature of these banks and their specific operating relationship in relation to a particular country's central bank and other conventional banks, if applicable, be defined in detail by that country's banking laws. Such a legal framework should contain provisions relating to licensing and permissible modes of financing, and state, clearly, legislative powers to address compliance with laws

¹⁰¹Ibid.

and regulations. In particular, such provisions should determine which enterprises may call themselves Islamic banks, collect deposits and carry out banking practices on the basis of Islamic principles. Moreover, it should be clearly established that the central bank (or a separate supervisory authority) has the authority and all necessary powers to supervise Islamic banks as well as conventional banks, if applicable.¹⁰²

5.10 Developing an Efficient Regulatory Framework

Prudential supervision is just as necessary in Islamic banking as in conventional banking in order to reduce risks to the soundness of the banking system and to enhance the role of banks as active players in the development of the economy.¹⁰³ This is so for a number of reasons.

First, it is worth keeping in mind that even in a paradigm version of Islamic banking, insolvency risks cannot be ruled out altogether, most notably in cases where banking operations are carried out according to a two-tier *mudarabah* arrangement, that is, when the assets and liabilities sides of a bank's balance sheet are fully integrated.

¹⁰²The above approach has been adopted by the authorities of countries where all banks and financial institutions operate according to Islamic principles (i.e. Iran, Pakistan and Sudan), as well as a number of countries where Islamic banks operate alongside conventional banks (e.g. Jordan, Malaysia, Egypt and United Arab Emirates).

¹⁰³In some Islamic countries a significant portion of the banking sector is state-owned (in the case of Iran, all banks). Prudential supervision of state-owned banks, however, is equally as essential because any deterioration of their financial position would ultimately affect the State budget. Such deterioration could develop progressively, remaining unnoticed for a long period, because there would be no concern about banks' solvency. When finally discovered, such deterioration would materialise in the form of a need for recapitalisation, at the State's budget expenses.

Second, risks of economic losses, or losses incurred as a result of poor investment decisions, are just as likely whether banks operate the two-tier *mudarabah* system of investment or the two windows framework. Poor investment decisions may derive from a mix of factors, including a volatile operating environment, weak internal governance (notably mismanagement) and limited market discipline. Economic losses here would not only be reflected in the depreciation of the value of depositors' wealth, but also in a decline in banks' profitability. If not corrected, these factors, in due course, could jeopardise a banks' soundness, which in turn, would progressively reduce banks' intermediation role in the market and discourage the mobilisation of private savings towards investment.

Third, weak banks may detract from the achievement of fundamental macroeconomic objectives, such as the efficiency of the payment system or the effectiveness of monetary policy, particularly if the latter is implemented through the use of indirect instruments. Unsound banks may also reduce public confidence in the financial system, thus impeding or delaying necessary structural reforms in this area.

Fourth, a weak banking system is likely to prevent the economy from benefiting from the ongoing process of globalisation and the liberalisation of capital markets, particularly in developing and emerging market countries (which are often the ones where Islamic banking principles are followed) where banks are the major (or even the sole) players in domestic financial markets.

As in the case of conventional banking, an appropriate regulatory framework for an Islamic financial system should aim, therefore, at reinforcing the operating environment of banks, as well as their internal governance, and market discipline. To help develop such a regulatory framework, standards and best practices established by the Basle Committee on Banking

Supervision are useful and provide a valuable reference.¹⁰⁴ However, these standards cannot always be applied to Islamic banking in the same way that they are in conventional banking systems.

5.11 Special Requirements of Islamic Banking

According to Errico and Farahbaksh, Islamic banking entails special issues that need to be recognised and addressed to help make the conduct of banking supervision more effective. First, it is most important to recognise the impact of PLS modes of financing on Islamic banks and, in particular, the fact that when Islamic banks provide funds through their PLS facilities, there is no recognisable default on the part of the agent-entrepreneur until PLS contracts expire, barring proved negligence or mismanagement on the part of the agent-entrepreneur. In fact, a “default” of PLS contracts means that the investment project failed to deliver what was expected — that is to say, it came in with a lower profit margin or no profit at all, or even a loss. In such instances, the lower profit or loss is shared between parties according to the stipulated PLS ratios.

For example, in the case of a *mudarabah* contract, the bank is entitled to receive from the entrepreneur the principal of a loan at the end of the period stipulated in the contract, if and only if, profits have been accrued. If, on the contrary, the enterprise’s books showed a loss, the bank would not be able to recover its loan.¹⁰⁵ Such a situation would not normally constitute default

¹⁰⁴See “Core principles for effective banking supervision”, Bank for International Settlements, April 1997.

¹⁰⁵Of course, in the typical case of a restricted *Mudarabah*, the bank seeks to stipulate in the *Madarabah* contract certain conditions that it considers essential for a successful outcome. However, this is done ex-ante and the contract’s terms and conditions cannot be altered during the life of the contract except with the mutual consent of the parties.

on the part of the entrepreneur, whose liability is limited to his time and efforts. Moreover, banks have no legal means to control the agent-entrepreneur who manages the business. This individual has complete freedom to run the enterprise according to his best judgement. Banks are contractually entitled only to share with the entrepreneur the profits (or losses) stemming from the enterprise according to the contractually agreed PLS ratio.¹⁰⁶ In *musharakah* and direct investment contracts, banks have better opportunities to monitor the business they invest in. Indeed, in these arrangements, all partners may concur to the management of the enterprise and banks hold direct voting rights.¹⁰⁷

5.12 Assessment and Management of Investment Risks

As the above situation indicates, investment risk is the most critical operational risk affecting banks operating according to a paradigm version of Islamic banking because it is inherent in their core activities, namely those involving PLS modes of financing. Errico and Farahbaksh state that the assessment and management of investment risk is more difficult in an Islamic environment than in conventional banking because of

¹⁰⁶By contrast, Khan and Mirakhor, 1993, contend that banks have direct and indirect control over the agent-entrepreneur through both explicit and implicit contracts. This is so because banks could refuse further credit or blacklist the agent-entrepreneur and (an important consideration in the Islamic ethos) because the agent-entrepreneur puts at stake his credibility and respectability; therefore, a strong deterrent to irresponsible behaviour would be put in place. However, it still remains a matter of fact that the bank has no legal means to intervene in the management of the current enterprise whilst it is being run by the agent-entrepreneur.

¹⁰⁷Errico, Luca and Farahbaksh, Mitra, 1998, p. 13.

the following four factors:

- (i) In *mudarabah* contracts, the bank cannot exert control over the management of the investment project.
- (ii) PLS modes of financing cannot systematically be made dependent on collateral or other guarantees.
- (iii) The administration of the PLS modes of financing is more complicated compared with conventional financing and may involve several complex activities that are not normally performed by conventional banks. These activities include the determination of PLS ratios on investment projects in various sectors of the economy and the ongoing auditing of financed projects to ensure that Islamic banks' share of profits are fairly calculated.
- (iv) The existing legal framework supporting bank-lending operations, which is relatively weak.

In order to safeguard invested funds and realise profits, Islamic banks are more dependent than conventional banks on the existence of an adequate and appropriate set of policies and infrastructure for portfolio diversification, monitoring and control. They also need a sufficient supply of trained banking staff skilled in investment and Islamic banking practices to implement these policies. Unfortunately, as the experiences of other developing and transition economics indicate, appropriate policies and infrastructure for risk-management and human technical expertise are difficult to establish and require a considerable amount of time to develop.¹⁰⁸ The regulatory framework for banking supervision should therefore be designed to specifically address these issues.

¹⁰⁸Khan and Mirakhor, 1989, argue that the shortage of expertise in PLS financing in commercial banking is one of the most important reasons explaining the slow growth of PLS modes of financing in Iran.

Information disclosure is also more important in an Islamic environment than it is in a conventional banking system. This is the case because the absence of protection for investment depositors is at the core of Islamic banking.¹⁰⁹ Indeed, the more depositors are left unprotected, the more public disclosure of information relating to the policy objectives and operational strategies of banks is necessary, in order to enable creditors and depositors to monitor their performance. Indeed, depositors have more incentives to monitor a bank's performance in the case of Islamic banking than in the case of conventional depositors. This is due to the fact that neither the capital value of investment deposits, nor their returns, are fixed and guaranteed, but, as noted previously, depend on a bank's performance in investment depositors' funds. Hence, depositors need to be able to monitor Islamic banks not only to protect the capital value of their funds, but also to seek to ensure that the rates of return paid to them reflect a fair application of the PLS principle on a bank's net profit.

By reducing information asymmetries, a clear and concise disclosure of key data and information allows depositors more flexibility in choosing a specific bank to which they can allocate their funds according to their risk preferences. This is the case in the paradigm version of Islamic banking (where the relationship between banks and depositors is regulated according to an unrestricted *mudarabah* contract) because depositors would be able to choose among different banks disclosing different investment objectives and policies. It is even more the case if banking practices diverge from the paradigm version

¹⁰⁹It should be noted, however, that, in principle, a deposit insurance arrangement, whereby a third party (excluding the central bank, the government and the interested deposit bank) agrees, against the payment of a price, to ensure investment depositors is possible in an Islamic banking framework.

as, for instance, in the Islamic Republic of Iran, where banks are allowed to accept depositors' funds for investment in specific types of projects (in this case, a restricted *mudarabah* is also possible on the liabilities side). Additionally, appropriate information disclosure can provide the supervisory authorities with a better understanding of banks' strategies and their relevant risks. This places the supervisors in a better position to exercise effective prudential supervision, hence reducing systemic risks.

5.13 Proposals for a Regulatory Framework for Islamic Banking

Based on the above considerations, an appropriate regulatory framework for banking supervision in an Islamic environment should be designed to ensure that:

- (i) Legal foundations for the supervision of Islamic banks are in place.
- (ii) Investment and other risks are adequately dealt with, taking into account that financing through the PLS modes adds an element of complexity to the already difficult task of investment banking.
- (iii) Adequate information is disclosed to allow supervisory authorities to exercise a more effective prudential supervision and to enable the public to make reasonably informed investment decisions.

Placing greater stress on these key issues, particularly during the licensing process, is likely to strengthen financial system surveillance in countries where Islamic banking is practised and this can only be a good thing for Islamic banking and finance generally.¹¹⁰

¹¹⁰Errico, Luca and Farahbaksh, Mitra, 1998, pp. 11–15.

5.14 Conclusion

According to Dr Shahul Hameed M Ibrahim, accounting is coming full circle. Since the 1930s, accounting in the West has been narrowly focused within the economic domain, where it has been almost entirely identified with the growth of large corporations and the dominance of utilitarian economics. However, given the evident adverse effects of such a narrow world-view on both society and the environment generally, in terms of the depletion of natural resources, environmental pollutions and so forth, there have been increasing calls for a more holistic and sophisticated system of accounting, which will allow capitalism to coexist with conscience. Islamic accounting, in addition to meeting its own religious and cultural prescriptions, can be seen to be an answer to this call for a more holistic and accountable response on the part of global financial institutions in relation to the betterment of mankind and maintaining the world's natural resources and environmental balance for future generations.

Thus one can see accounting as increasingly broadening its scope, both in terms of the matters accounted for (which include not only economic activities, but also the physical and social environment in which they are enacted) and the units of measurement that are employed (which means breaking away from the existing framework which reduces everything to a monetary value). Unfortunately, globalisation and the Westernisation of the Islamic world may, in the short term, pull Muslim countries towards a more Western-style system of accounting in order to harmonise with global international accounting standards. But today, one lives in a neo-pluralist¹¹¹ world where different power groups compete

¹¹¹Pluralist: a philosopher who believes that no single explanation can account for all the phenomena of nature.

with one another to pull accounting into their grasp in order to use accounting to serve their own interests. At present, Dr Shahul Hameed M Ibrahim believes that it is the turn of multinational corporations, institutional investors and positivist academics to host the party, which is not to say that at other times other groups or stakeholders may gain power, for example, the trade unions, consumer groups, greenies and the like. They in their turn will seek to manipulate accounting for their own interests, until they too fade away. If, however, good sense prevails and Muslim societies do not forgo their Islamic legacy, Islamic banking does stand more than half a chance at competing professionally alongside conventional, capitalist-driven financial systems.¹¹²

At present, Islamic financial markets are highly segmented and differ considerably between nations. This has arisen out of divergent interpretations of the Shari'ah, differing legal systems and recourse to different financial instruments. However, globalisation is likely to bring about standardisation of financial products. Moreover, adherence to international regulations from designated Islamic institutions such as AAOIFI and IFSB, and, where relevant, secularist institutions such as the International Monetary Fund (IMF) and Bank of International Settlements (BIS), would place Islamic finance on par with conventional finance in the pursuit of best practices.

Islamic financial instruments add considerable variety and choice not only for Muslims but also for non-Muslims, giving Islamic finance a truly pluralist flavour. Religious orientations aside, all those who do care about the ethical content of their

¹¹²Shahul Hameed Bin Hj. Mohamed Ibrahim, "From conventional accounting to Islamic accounting: A review of the development western accounting theory and its implications for and differences in the development of Islamic accounting" (1997), <http://vlib.unitarklj1.edu.my/htm/account1.htm>, 17 June 2004.

financial transactions are likely to be inclined towards Islamic finance in that there is much more to Islamic finance than the mere elimination of *riba* or interest. Islam prohibits transactions of a fraudulent nature, for it to be truly Islamic, financial instruments must be free from all forms of deceit, exploitation and ambiguity. Such universal values mean a lot to many people regardless of their religious backgrounds and the number of non-Muslims using Islamic financing is on the rise. Thus, for example, about one-fifth of the HSBC Amanah financing in Malaysia caters to non-Muslims.¹¹³

Globalisation is also likely to narrow differences in the yields of Islamic financial instruments between countries, due to a freer flow of funds. Competitive pressures and client expectations may push the rates of return on Islamic financial instruments closer to that of secular markets, notwithstanding the fact that the higher risks normally associated with Islamic finance would warrant higher returns.¹¹⁴ And as Islamic banking plays an increasingly important role in mobilising deposits and providing financing, the development of an Islamic capital market allows the corporate sector to source their long-term financing needs based on Islamic principles. This, in turn, would increase the range of Islamic financial instruments available to meet the demands of the Islamic investors.

As Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia believes, at present, the absence of a truly global Islamic financial system based on Shari'ah principles, means that the continued growth and development of Islamic banking and finance is somewhat haphazard. In this last respect, governments could assume a more active role in promoting the

¹¹³Ibid.

¹¹⁴Ariff, Mohamed, "Islamic finance can benefit from globalisation", *The Malayan Institute of Economic Research* (www.mier.org.my), 29 August 2002.

development of Islamic financial systems. In particular, they need to provide the necessary infrastructure that will favour the growth of Islamic banking in their respective countries and this means putting in place, from the outset, a comprehensive, Shari'ah-compliant, legal and regulatory framework. Compliance with Shari'ah principles is not, however, in itself sufficient to guarantee the future success of Islamic banking and finance. In the long run, the sustainability of Islamic banking rests on satisfying the demand for quality in the products and services that Islamic finance can offer. This is the ultimate challenge for Islamic banking and finance, namely to be able to provide a comprehensive range of Islamic financial products and services that are not only Shari'ah compliant, but also innovative and competitive with conventional financial instruments.¹¹⁵

¹¹⁵"Building a comprehensive Islamic financial system — New financial opportunities", Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Institute of Islamic Banking and Insurance's International Conference on Islamic Insurance, London, 26 September 2003.