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ISLAMIC BANKING CONTROVERSIES AND CHALLENGES

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Abstract

The concept of interest free financing was practised by Arabs prior to the advent of Islam, and was later adopted by Muslims as an acceptable form of trade financing. While the system had been used on a small scale for centuries, its commercial application began in 1970. Many countries in the world are now experiencing dual banking system, where the banks are involved in alternative form of banking along with conventional banking. Islamic Banking is based on two main pillars; one is economic Philosophy of Shariah and second is monetary theory of Islamic economics. Despite a substantial growth of Islamic banking in the last decade, there is not every thing right. There are some controversies and challenges which are prevailing about different concepts of Islamic banking and which need to be addressed. This paper basically examines and explores the different controversies which are in the minds of people which need to be addressed. The author has also tried to suggest suitable solutions to overcome these challenges and controversies.

Keywords: Islamic banking and its principal, monetary theory of Islamic economics, Riba, Controversies of Islamic Banking

Introduction

Islamic Finance is growing very rapidly across the world, becoming very popular among Muslim countries and as well as in most of the western countries because of growing number of Muslims in those countries. Many countries in the world are now experiencing dual banking system, where the banks are involved in alternative form of banking along with conventional banking. Muslims find it as the biggest challenge in the economic field in order to reform their financial institutions, and bring them according to their religious belief and traditions. In an environment where the system

of all financial institutions is based on interest, it seemed to be impossible to form such structure of financial system which is completely an alternative form of banking. Islamic banking is commonly defined as a form of banking system which operates without the norm of interest.

Mostly the people who are unaware of the Shariah and its economic philosophy are of the view that if interest is abolished from the financial institutions, it will make them charitable institutions rather than commercial, which will offer financial services without any return. This is a completely wrong assumption. In Shariah interest free loans are only for charitable activities not for the commercial transaction except in very partial range. In case of commercial finance, Shariah has different lay down of procedures. If a person gives money to another person he must decide whether he wishes to help him or wants some share in the profit. If he wants to help the borrower, he must not claim any additional amount other than his principal amount. But if he gives money to share the profits earned by the other party, he must share the profit as well as loss. It is thus obvious that exclusion of interest from the financial institution does not necessarily mean that the financier cannot earn profit (Usmani, T 2004). Most of the products offered by Islamic banks are similar to conventional banking (Malik, S *et al*, 2010). All is not good; there are some controversies about Islamic banks which need to be addressed in order to make it 100% Islamic banks. Islamic banks need not to copy the product of conventional banks but should introduce such products which completely differ from conventional banking products and according to Islamic laws.

This paper addresses some of the issues which make Islamic banking controversial. The paper is structured as follows: following the introduction section 2 will provide fundamental principles of Islamic banking and monetary theory of Islamic economics. Section 3 reviews the controversies and different point of view about Riba which is considered as the main difference between Islamic finance and conventional finance. Section 4 explores different controversies and challenges involved in Islamic banking. Section 5 concludes this paper.

So the important point is that what is the economic philosophy of Islam, and what are the bases of Interest, and what is the point of view about interest in Quran and Hadith.

Fundamental Principles of Islamic Banking

The concept of interest free financing was practised by Arabs prior to the advent of Islam, and was later adopted by Muslims as an acceptable form of trade financing. While the system had been used on a small scale for centuries, its commercial application began in 1970 (Naser, K and Moutinho, L 1997).

According to Gerrard and Cunningham (1997), the Qur'an (Muslim Holy book), clearly deals with economic-related matters and how they apply in Islam. Islamic finance is defined as a financial service mainly implemented to meet the terms with the main belief of Shariah (or Islamic law). The Shariah is derived from the Qur'an Hadiath (saying of Prophet PBUH), Sunnah (Act of prophet PBUH), Ijmah, Qiyas and Ijtihad and fatwa. "Riba" (i.e. payment over and above what has been lent - which causes the payment of interest or usury to be a wrong) is prohibited in Shariah. Sharia'h encourages profit acquired from a trading activity, the reasoning behind this

optimistic attitude being that there is a risk of loss concerned in any trading activity. Warde (2000) defines Islamic finance as follows: ‘Islamic financial institutions are those that are based, in their objectives and operations, on Quran’s principles. Islamic banks have had to develop financial products which are not in conflict with the Shariah, because of Riba prohibition. This has resulted in traditional deposit and lending products, which are made available by what can be called “conventional” banks, being restyled so as to satisfy the Shariah. The obligation has been achieved by creating a number of special financial products (Ali & Ali, 1994). All the products the depositors and lenders are operating in a partnership and shared associated risk. Both receive a rate of return based on the profit and performance not only on the interest which is pre-determined rate. For better understanding one need to be aware of the monetary theory of Islamic economics, which clearly describes why the system of profit and loss is more efficient and justifiable.

Monetary Theory of Islamic Economics

According to Siddiqi, N (1982), in any economy whatsoever, it is the expected rate of profit that actually guides the entrepreneurs and ultimately allocates resources to alternative uses. This is applicable to Islamic system as it is applicable to any free system. Then, as far as incentive to saver is concerned, the return on saving is not the only, nor the major, motivation for the savers to save. There are many other reasons for the savers to save. People save because they have more than they can usefully spend, people save to leave something for their children, and people save for future emergencies and the expected rate of return on saving plays a very minimal role. In so far as they play a role, there will be an expected rate of return in Islamic arrangement. The return is not determined but there is fair amount of expectation. The people who save and give their saving to the Islamic bank will expect a positive return. The return will not be known to them but they have a fair amount of idea in the light of past experience. The dividends are the profits actually distributed in the past period. So they will not be in dark and they will have something to guide them.

Actually interest determines the division of social surplus or whatever the entrepreneur has earned a profit on production process, between the financier, the actual innovator and the entrepreneur or the producer. This arrangement will be closed and replaced by a system of sharing. So there will be ratio of sharing the profit determined by the forces of supply and demand and it will also take care of the sharing of the social surplus. This has to go to three parties: the savers who provide the deposit, the bank as intermediaries who managed them capably, and the entrepreneurs, the producer who put them effectively and result an extra creation of wealth, this additional wealth created by using the resources saved in the present period is to be shared. There will be two ratios: One sharing profit between the producer and the financier or bank, and the other between the bank and the depositors. These both ratios will be determined by the forces of supply and demand in such a way that all three parties are satisfied. There is a supply of saving which sustains the demand of investors for investible funds and the depositors feel that the current expectation of profit will flow towards them and so they will supply the right amount of deposits. So it is clear that in this manner there will be nothing missed by giving up the concept of interest.

This system of profit-loss sharing is more efficient and also more justful as compared to interest-based financing. One reason for the inefficiency of interest-based financing is that

the bankers are interested only in the creditworthiness of the fund seeker without looking at the soundness of the project for which the fund is requested. The banks even don't care if funds are sought for low profitability as far as they are assured about the capacity of the borrower to repay the principal with the interest he is contracting for. Whereas in profit-loss sharing system, the bank's profit and as well as the repayments of the funds merely depend on the profitability and productivity of the project itself. If the project is not going to make profit, only the creditworthiness of the borrower does not guarantee for the bank to provide funds because the bank will get back its money if an actual profit result. So the bank will be very eager to analyse each project on the criteria of its productivity and profitability.

In issue of justice, the interest-based system results in a steady transfer of existing wealth from a segment of entrepreneur to the wealth owners. The entrepreneurs are those who actually lose, as the project they started doesn't provide additional wealth. As a result they compensate the principal and pay the interest they had contracted for from their private assets, which is a part of existing wealth. So to that extent in the economy as a whole there are always some losses in spite of an agreed rate of profit. So in some way the wealth flows from entrepreneur to the wealth owners.

As compared to this the justice of the profit-loss sharing arrangements of wealth will be transferred to wealth owners only if their wealth has resulted in the creation of wealth. Whenever the wealth of wealth owner passes to the producer through a bank it actually results in the creation of actual result. The additional wealth will be shared by the wealth owner, producer and the bank which offered the services. Whenever the entrepreneur by luck or by misuse of wealth or funds dose not succeed in creating additional wealth, the wealth owner will have to bear a loss and the intermediary, as well as the producer, will go unrewarded for their services of mediation and conduct of enterprise.

Interest (Riba): The Reality

There are many religious scholars and economists who believe that interest is prohibited in Islam because of the fixed return and the fact that there is no physical effort involved in it. This theory is only limited to interest earned from banks and not other forms of income which are earned without making any physical assets. Not all Muslims agree, some are of the point of view that such ban was due to the intention to prevent some pre-Islamic practices which resulted in the slavery of many people at that time, and that other form of interest is permissible and in accordance with Islamic belief (Kuran, 2001).

According to Kamran, R (no date), describes interest as 'rent of money'. Interest is expressed as percentage of the principal and the rate is dependent upon the time value of money, the credit risk of the borrower and the inflation rate. The interest is calculated upon the value of assets in the same way as money. Interest is compensation to the lender for the risk of not being paid back. Consider the borrower take assets from lenders and then enjoys the benefits of using those assets directly without making any efforts to obtain them, while the lender enjoys the fee paid by the borrower for the privilege. The principal value is held by the borrower on credit. Interest is, therefore the price of credit, not the price of money as it is commonly believed to be.

According to Dr. Aqdas, A. Kazmi (2009), the concept very common throughout the Muslim world is the misinterpretation of the word RIBA mentioned in many Quranic

verses, through which Shariah scholars have agreed upon and created so influential point of view that Riba, prohibited in Quran and the bank interest are identical and so interest should be abolished from all tiers of economy. There are a lot of Quranic verses found in the literature about Riba, but Muslim scholars never seriously discussed three basic questions.

1. What is Riba?
2. What is Interest?
3. Are Riba and Interest same and identical?

The word that is being used for interest is SOOD meaning 'black color'. Interestingly this word has no existence in Quran, Hadith or Sunnah with reference to interest; instead the word used there is RIBA in the Holy Quran. The simplest and common meaning of Riba is disproportionate profit. This mean that proportionate profit is allowed and disproportionate profit is forbidden. The question here arise that who will decide what is proportionate profit and what is disproportionate profit. The decision here is left merely to human beings, common man. It's true that everyone some-where in core of his heart has a fair idea of what is wrong and what is right. Let's see this by example: suppose a shopkeeper purchases a commodity of Rs 5 and sells it for Rs 15, he is earning disproportionate profit which is Riba as it means. On the other hand a shopkeeper is said to be earning a proportionate profit when he sells a commodity for Rs 15 having purchased it for Rs 12. When you deposit money in Bank, suppose 100000Rs and the Bank informs you that you will receive 6% per annum profit, it means you will be getting 500 Rs every month, 6000 Rs in a year. If you are getting 500 Rs per month on depositing 100000Rs it is not disproportionate. But there is an ethical element which is present in this transaction that you would be spending your money all by yourself and you should not invest that money (500 Rs) somewhere else. It should be clear that Banks do not pay you interest from their own pocket by keeping your money with them. They invest that money in running businesses and make profit from it, out of which a nominal percentage is given back to you.

Many religious Scholars have termed not only interest but also working in banks as forbidden (haram). This belief has influenced many people that they avoid doing job in banks and financial institutions even at very high salaries. They prefer to stay jobless as they consider being jobless far better than earning from such institutes which are supposedly working in such a way that is not permissible in Islam (Kamran, R no date)

Controversies and challenges involved in Islamic Banking

Islamic banking has been introduced in 1980 in Pakistan and from now it has achieved a tremendous growth and now there are many full fledge Islamic banks operating in Pakistan. It is expected that Islamic Banking will capture 12% of the deposit market by 2012 (Sheik, A, 2007). Even in global perspectives, Islamic banks have achieved an attracted growth during world financial crisis and many international players are interested in Dual Banking system in many western countries. However, all is not good; there are certain controversies and challenges faced by Islamic banks. The review of the certain controversies is the main purpose of this paper.

As mentioned earlier Shariah is derived from fatwa, the Islamic financial and economic concepts which are not clearly understood from Quaran and Sunnah are better clarified through Fatwa. As Islamic financial products have been developed in the light of the fatwa, therefore, fatwa is very important in Islamic banking. According to Ali (2005), Fatwa is basically a religious ruling on matter of Islamic laws not clearly mentioned in Shariah. Fatwa is required on those matters which are uncertain in Islamic banking activities and are not in line with Shariah. The main problem arises, as far as fatwa is concerned that at present there is no single authority that governs Islamic financial industry. There is no harmony among the Shariah scholars who give ruling about Islamic financial products. All the Islamic banks have their own Shariah Supervisory Board (SSB) who has knowledge of both finance and religion. According to Briault, C. (2007) the challenge facing Islamic bank is the diversity among the Shariah scholars, due to which leading consumers and investors are uncertain whether the particular practice or product, is Shariah compliant. Even common Muslims have unclear concept about the different products offered by Islamic banking. According to Malik, S *et al* (2011), relating to the issue of fatwa, the other major concern for the Islamic banks is the interpretation of different Shariah rulings. This different interpretation is due to the fact that there are different sects in Islam and all sects have their own authority or body which provide guidance and interpretation on Shariah issues. There is always a possibility that the interpretation on certain Shariah issues given by one sect committee or scholars is different from the interpretation of other sects, which makes things more complicated. For example, in Jordan a prominent Muslim scholar criticised the penalty imposed by the Islamic banks in case of client default in Murabaha and declares that it is a kind of riba. Similarly a famous British scholar advises against the Islamic mortgage due to the fixing of rent and profit percentage with interest rates (Asad, I 2009).

According to Patel, I (2010), which clearly describes that Islamic banks are not completely Shariah compliant in true sense, while the Shariah comitte of the banks mentioned in the annual report that all the affairs of the banking division is carried out in accordance with Shariah rules and principle. It is a matter of fact that Islamic banking system requires an independent and specific Islamic banks, and as there is nothing like half Islamic or 75% Islamic. There are certain bodies and regulatory authorities like IFSB (Islamic Financial Services Board) and AAOIFI (Accounting and Auditing Organization for Islamic Financial Institution) which are trying to resolve to resolve the issue of standardisation (Ainely *et al.*, 2007). According to SOLE, J. (2007), one of the main goals of this organization is to design and disseminate accounting and auditing standards that can be applied internationally by all Islamic institutions. However Malik, S *et al* (2011), is of the point of view that without a consensus of religious experts, there can not be any binding and universal set of Islamic banking rules. Another challenge faced by the Islamic banks is the shortage of skilled peoples both at operational level as well as there is shortage of Shariah scholars'. The people working in conventional banks can easily understand the operation of Islamic banks but to develop an Islamic product one should know the Shariah rules and regulations. According to Ainely *et al.*, 2000, there is shortage of knowledgeable Shariah Scholars with banking experience and knowledge. According to the survey of Khaleej Times (2008), the number of Shariah scholars is about 250-300 around the world. It has also been criticised that these Shariah scholars are serving not only more than one Shariah board but they are also providing the advisory services to direct competitors and earning million of dollars. One of the main pillars of Islamic finance is profit and loss sharing. It means that all activities in the Islamic banks are backed by some tangible assets not by any visionary or non-tangible assets as happens in

conventional banking (Ali, 2005). Unfortunately most of the Islamic banks are operating parallel to conventional banking. Most of the Islamic banks have taken up the mode of financing on fixed return basis, not on profit and loss sharing. The pure Islamic modes of finance under Islamic banking system are Musharakah and Mudarabah based on profit and loss sharing. But these two modes of financing have contributed very less in total financing done by Islamic banks. In 2008 in Pakistan the Islamic banks allowed only 2.3% of their total financing under the mode of Musharakah and Mudarabah while 92% under Murabaha, Ijarah and diminishing Musharakah which is based on the mutually agreed fixed return corresponding to the fixed interest rates system under the conventional banking system (Patel, I 2010). Another severe criticism on Islamic financial institutions is the linkage of profit percentage with KIBOR (Karachi Inter Banks Offered Rates). Most of the Islamic financial institutions are of the point of view that they are competing with conventional banking that's why they are fixing the profit percentage with KIBOR, and comparing or fixing with other bench mark might make it more expensive than conventional banks. This view point of Islamic financial institutions does not carry any weights and adds a negative perception in the mind of consumers. There is no difference between conventional banking mortgage and diminishing Musharakah the percentage of rent or profit increases as KIBOR rate increases. The only notable argument put forward by the Islamic financial institution regarding diminishing Musharakah is that bank bears the risk which is also a myth (Hanif and Hijazi, 2010., Sheikh, A, 2007). Same happens with Sukuk, the percentage of profit is fixed with LIBOR or KIBOR, and these are interest rates proxies are completely driven by market consideration and not by Shariah (Siddiqui, 2006). The Shariah Scholars need to work on introducing IIBOR (Islamic Inter bank Offer rate), but even in Malaysia which has about 16% penetration of Islamic bank doesn't introduce IIBOR. According to Aioanei (2007), the most important issue which Islamic banks and financial institutions need to rectify is the harmony among Shariah scholars about the financial products which will help depositors and other players in the market to show some confidence on Islamic products. For this purpose, two important steps are required or need to be taken. First step is that Shariah board should give clearance about the products that they are in accordance with Shariah rules, and second step is to provide assurance that all transaction are also fulfilling the verdicts of Shariah board. Another challenge faced by Islamic banks is the Shariah auditing. Islamic banks need not only to follow the international rule and regulation but should also the rule and regulation those defined by AAOIFI must also be met. This subject is still undeveloped and all IFI should recognize its importance. According to Iqbal *et al*, 2010 Islamic Scholars should not waste their time and energy to convert conventional products into Islamic. They need to develop certain innovative products which are completely in accordance with Shariah ruling.

Conclusion

After the end of colonial era, some newly formed independent Muslims states reassessed their economic policies on the basis of Shariah. Islamic Banking concept goes back to as early as the 7th century, but it was commercially implemented in last century. Islamic finance is growing stronger in Islamic as well as in western markets. Islamic finance is developed under the umbrella of religious beliefs and its success depends not only on fulfilling the economic goals but also satisfies the faith. Islamic banks need not to replicate the products of conventional banks but develop their own products with great innovation which should be in accordance with Shariah rule and regulation which will ultimately boost the confidence of investors and consumers. Islamic banks have to

provide a greater return to the investor as compared to the rate to interest, so they need to invest in all sectors which can yield a greater return and that too in longer term. Islamic banks need more expert people both in field of Shariah and finance and try to bridge the gap between Shariah scholars and develop a single authority that has the authority to assure that the product provided by Islamic banks is completely in accordance with Shariah rule and regulation. The future of Islamic banks depends not only upon innovating and investing in new products according to the demand of the markets but also upon on satisfy the faith of the stakeholders.

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