

Islamic Banking: Emerging Issues, Challengers and Way Forward

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ABSTRACT

Increased economic activity among Muslims of the world and others well has resulted in the need for Islamic banking services to increase by leaps and bounds. In recent years, there has been a growing tendency of claims that the Islamic Bank (IB) is the mirror image of the conventional bank. IBs need to assure both Muslim and non-Muslims alike that there has been no compromise of Islamic banking principles in the industry and any such view is a misperception. This paper addresses the issue by reviewing the current issues of, murabaha, Islamic regulatory framework and Islamic corporate governance of the IB. The paper ends with the suggestions that the IBs should rethink the inculcation of Islamic values in their operations and implement a system that is closely in accordance to Islamic banking procedures. The massive global growth of the need for the Islamic concept of financing has made it imperative for Islamic banking to manifestly depict its Islamic features and be clearly different from conventional banks so as to repel even the remotest doubt that customers may have. The most pertinent matter is that it is compulsory for IB to be distinct from conventional banking so as to cater to the needs of the Muslim society in general and others as well.

KEYWORDS: Islamic Banking, Mudaraba.

INTRODUCTION

Through the passage of time, Islamic Bank (hereafter known as IB), has become a legitimate institution and is acknowledged worldwide. The legitimacy of IB is gained through hardship, perseverance and persistence of the Muslims [1, 2, 3, 4]. Hitherto, various confounding issues have circulated and are still circulating [5, 6, 7, 8, 9]. From modest beginnings, it now stands as one of the fastest emergent financial institutions.

Its presence is perceived throughout the entire region. Despite its legitimacy, IB is being accused as being identical to conventional banks [1, 2, 4]. Is IB identical to conventional banks? In what way does IB seem to resemble conventional banks? Does IB lack expertise and mutual understanding of how accounting is embedded in Islam? Does the sacred intention of IBs turn secular [3]? Till date, the issues of accounting treatment on mudaraba, for example is a never ending story.

The conventional accounting advocators claim that IB accounting treatments is similar to conventional accounting practices [2, 4, 10]. Their verdict is that IBs' financial accounting treatment of mudaraba and other products is identical to conventional banking. The distinction is due to the terminology that is being in use for the products. Others mentioned that IB owes its existence to the resurgence of Islam worldwide in the early 1970s [1, 3].

Consequently, extensive literature reviews give valuable insight into issues of profit loss based on sharing compared to interest bearing practices of conventional banks. Similarly, the equity based practices of IB as compared to debt is also questioned by the advocates of conventional banks. In addition, different orientation of accounting treatments and accounting standards of IB vis-a-vis with International Accounting Standard (IAS) has spurred various dissatisfaction amongst conventional banking advocates. This section sheds light on selected examples of the many confounding issues of IB. Though IB has been in existence for thirty years, the issue of profit-loss-sharing is still undermines the credibility of IB as an Islamic institution. Next, the discussion is about financial regulation for IB and lastly the corporate governance issue is discussed.

PROBLEM STATEMENT

Muslims, as everyone else need to buy a car, finance new businesses, undertake trading activities etc., due to these, they need banking services to facilitate all their needs. According to [11], the IB industries are in the midst of a phenomenal expansionary phase. This rapid growth has been influenced by the demand for syari'ah compliant products from financiers who are not only from the Middle East and other Muslim countries, but also by other investors around the world as well. Thus, expansion of IB has become a global phenomenon of massive proportions. All these developments underscore the fact that IB has established itself as a permanent element within the global financial landscape. Nevertheless, despite the recent advances, important challenges lie ahead. This paper provides a brief overview of the main IB principles (Mudaraba) and also discusses the financial regulations for IB and corporate governance, before discussing some of the challenges faced by IB.

Mudaraba-Unresolved Issue

“Ask “the man in the street” what Islamic banking and finance is about and they are likely to respond (if at all) by talking about “negatives”-Islam bans interest, prohibits gambling and speculative activities and does not allow involvement in, or the financing of, alcohol and the production of pork. That is against, rather than what it is for” [9:42]

The above citation portrays the misinterpretation of IB's underlying principles from the perspective of the westerners. Nevertheless, a unique feature of IB is the financial mode that it offers. As an alternative to conventional banking products (i.e. which is interest bearing), IB introduces profit-loss-sharing (PLS) products such as mudaraba (profit sharing based) and Musyarakah (joint venture), naming a few. Mudaraba is not unique to Muslims and Islam as it has been practiced by the Prophet (peace be upon him) and his companions in their trading system.

So what is mudaraba? Literally, mudaraba is referred to as “making a journey”, as the agent or the mudarib used to travel from one place to another to trade their mercantile. Islamic scholars from the four prominent schools of thought unanimously agree that mudaraba is a contract of partnership between the capital provider (who provides capital) and the investor (who provides labour and expertise), subsequently they share the profit. It is not mentioned that the investors have to bear the losses as well, thus losses is borne by the capital provider.

In making sense of the issue of “losses”, logically, the capital provider is a sleeping partner in the business. He or she is not involved in managing the business. The task of monitoring and handling the business or project is in the hands of the investors. Islam encourages productivity and justice in all aspects of life including commercial activities. The investor with all the expertise, knowledge and time that he has put into the business or project to ensure that the business is successful (and reap profit) sometimes unfortunately fails and suffer losses. Thus, justice is prevailed when losses are borne by the capital providers and not by the investor. The rational is that, the investor has put forward his or her effort, energy, expertise and time for the specific project. Accordingly, the Hanafi school of thought allows for credit transaction by the investor, though the Maliki school of thought and Shafie school of thought argues that the investor should acquire the capital providers' consent [12].

Conventional banking advocates and investors alike, far from appreciating mudaraba, disregard the “beauty” of PLS because their mentality is merely on “profit maximization”. In fact, it is sadistic to admit that Islamic investors too are confused with the “beauty” of PLS. This is evident from the percentage of mudaraba investment for the year 2004 which represents 0.1% of the overall financing in IB in Malaysia. Meanwhile, those who favour Musyarakah are 0.4%. Most of investors (50%) are favouring the Bai' muajjal which deferred payment sale [1]. Rationally, the “losses” which is borne by investors is paramount. Implicitly, he or she has lost the job and it is well understood that he or she will be demoralised (which is much better than being declared bankrupt, if they vote for the conventional banking system) [13].

The most pertinent issue raised in most of the literature is related to the practice of mudaraba and other IB products is fundamentally based on three considerations [14] such as: 1) the avoidance of investors in association with business activities which are prohibited by syari'ah ruling such as alcohol, gambling, pornography, meat packing (pork) and liquor, naming a few, 2) avoidance of any business that constitutes interest bearing, 3) avoidance of any business that is gambling in nature and 4) avoidance of any transaction which involves activities in future options.

Notwithstanding, the above, there is much to be done. What is preached is evidently not being practiced by most IB operators [1]. It is evident that in [10] study emphasizes that the Islamic Credit Cooperation Association (ICCA) in Indonesia though claim that their organisation is interest free but solely depend on loans for consumption goods at 9.6% interest rate.

Another study by [1] who base their arguments on whether Islamic investment rate has changes or vice versa. There is a change in conventional investment rates based on monthly bulletin issues by Bank Negara Malaysia on Bank Islam Malaysia Berhad (BIMB) pertaining to Islamic investment rates and conventional investment rates from April 1995 till April 2004. The Granger causality test which is carried out to determine the consequences,

significantly ascertains that Islamic investment rates change when there are changes in conventional investment rates. Conversely, conventional investment rates are unaffected when Islamic investment rates change.

In short, it portrays the dependency of Islamic investment on conventional investment. Nevertheless, the profile of mudaraba has becoming increasingly visibly and pragmatic and is base on the underlying legislation promulgated by the Government of Jordan. Article 18 stipulates that all mudaraba financing is recorded in separate accounts. Upon consultation between the Religious Committee Members, government representatives and the founder of Jordanian Islamic Bank (JIB), the concept of tandid as revenue measurement and recognition is found applicable to mudaraba transactions [13] i.e. revenue is recognised on the final liquidation of specific projects or investments. JIB as a financial intermediary is required to maintain separate profit and expenses accounts, which are distinct from investors' accounts.

Ironically, a study by [15] who distributed 52 self-developed questionnaires throughout the Malaysian region, depicts that religious motivation is not the priority for Malaysians patronising IB. Knowledgeable and competent personnel is ranked first followed by other criteria such as friendliness, ample parking space and efficient customer service quality. It should be concluded that though the inception of IB is inspired by the need of Muslims to conduct their business activities in an "interest-free" environment, but the sacred intention is distorted due to the unethical conduct of IB as financial intermediaries who remain tacit pertaining to exercising interest based transactions.

IS THERE A NEED FOR ISLAMIC REGULATORY FRAMEWORK?

From the economics viewpoint, where there is a demand, there is a supply. The demand for Islamic regulatory framework for IB is mainly because of the incompatibility of western accounting. The lingua franca of accounting practices as well as accounting standards promulgated by western accounting practices "dismiss without enquiry" [5] the prohibition of riba and zakat calculation. Owing to this argument, Accounting and Auditing Organisations for Islamic Financial Institutions (AAIOIFI), initially addressed the issues and published various financial accounting standards for IBs. Currently, AAIOIFI has issued forty one (41) Financial Accounting Standards inclusive of eleven (11) new standards.

The need for a lingua franca of Islamic accounting standard is imperative, so as to embark upon the challenges of globalisation and to be competitive with conventional banks as well as have a mechanism for social responsibility [16]. Despite the effort by AAIOIFI, the practicality of accounting standards issues by AAIOIFI is not fully utilised by other Muslim countries such as Malaysia, Indonesia and Brunei. For example, Indonesia, though consisting of the largest Muslim population in the world, are still dependent on International Accounting Standards (IAS) in preparing financial reporting and disclosure for IB.

In addition, IBs are required to adhere to Indonesian Accounting Standards (PSAK) 38 by the Indonesian Central Bank [7]. By contrast, even though Malaysia practices the dual banking system, her Central Bank provides specific acts to govern IB inclusive of provisions for accounting practices for licensing, financial requirement, ownership, control and management, business restriction and supervision. Another feature of the lingua franca of financial reporting and accounting practices can be seen during the establishment of Jordanian Islamic Bank. Here, all the provisions of JIB are enacted through parliament inclusive of revenue measurement and recognition. It is important to appreciate the initiatives of AAIOIFI to various issues of Islamic accounting standards. There are alternatives for other IBs to adhere to the standards issued by AAIOIFI rather than applying the IAS that is incompatible to Islamic values.

DOES IB NEED ISLAMIC CORPORATE GOVERNANCE?

Contextually, governance comprises of legal obligations, organisational policy and record keeping and accountability. Rationally, the corporate governance framework of organisations', acts as a mechanism to review and monitor the directions of the organisation through the appointment of a Board of Directors (BOD). One of the functions of the BOD is to harmonize the relationship between managers and shareholders [17]. Accordingly, he argues that conventional corporate governance (CCG) is based on the rationalism and rationality paradigm.

Theoretically, this paradigm is a supposition that human beings will make decisions to the best of their ability i.e. by fully utilising his knowledge and expertise for the benefit of the society. By contrast, the economists admit that this will never happen [18]. On the other hand, Islamic Corporate Governance (ICG) is fundamentally rooted from the tawhidic paradigm [9, 17]. Tawhidic paradigm incorporates three axioms i.e. 1) the divine unity (tawhid uluhiyyah), 2) oneness in Lord (tawhid rububiyah) and 3) believing in His holy names (tawhid asma and sifat) [19].

Drawing from the argument built by [19], the divine unity is having faith that God is the Oneness of Allah; there is no real God to be worshiped except Him. The divine unity is portrayed in man's actions and inactions of creed (aqidah), worship (ibadah) and morality and ethics (akhlak) [15]. Consequently, in order to sustain the tawhidic paradigm, Allah has appointed man as His vicegerent (see Al Dhariyah: 56). In doing so, man is positioned as the administrator of the universe. In fulfilling his duties and responsibilities as administrator, Allah has provided him

with Allah's bounties and resources and guided him with the knowledge of how to perform his duty rewardingly. In addition, the concept of Oneness of Allah (tawhid rububiyah) requires man to be aware that although appointed as His vicegerent, is in fact servant to Allah. The absolute sovereignty belongs to Him.

Both CCG and ICG share the commonality regarding to their objectives. The primary intention of CCG and ICG is to safeguard the rights and interests of the shareholder. To date, the former even expanded further by taking into account the interest of the community. In doing so, the later observed that it adheres to syari'ah ruling which is based on tawhidic paradigm. Notwithstanding, CCG and ICG divert in terms of their nature in management, management board and capital ownership and capital related matters [17].

Management is dominant for organizations' which advocate the Anglo-Saxon model, while shareholders are more dominant as compared to management in organisations' which follow the European style of CCG. In ICG, the concept of shura or consultative board and Syari'ah Supervisory Board (SSB) is prevalent. It is worth to note that, theoretically, the existence of IB is mainly as an alternative for a Muslim society to adhere to Islamic calls for prohibition of riba. Thus, there is a need for IB to have ICG embedded in their corporate governance framework.

THE CHALLENGES

Though "Rome was not built in a day", and thirty years have passed, but still IB is shadowed by conventional bank images. One of the criteria to qualify as an accountant in an Islamic state as well as in Islamic organisations' (the word is emphasized) is the person should have an Islamic identity [20]. The rational of this characteristic is not mainly due to the nature of the occupation but more on the religious and political criteria. A Muslim should be dutiful and protect his religious interest. And if this is reflected in IB, then it is the obligation of Muslim accountants who are engaged in IB to make certain that riba is not practiced. Simultaneously, the SSB is not merely a rubber stamp to endorse any "Islamic product" but participate actively in attesting that religious interest of prohibition of riba is executed [13].

"O ye who believe! Devour not usury, doubled and multiplied; but fear God; that ye may (really) prosper".

Al Baqarah: 130

In view of the tawhidic paradigm, BOD, management and SSB far from viewing that their duties and responsibilities are stated in the policies of the organisation also go further by executing their duties as the servant to his Master. Thus, as servants, they must abide by the rules of their Master that is spelled out in the revelation. With relation to IB, they must, with their expertise, authority, power and wisdom demonstrate their abilities so as to ensure all the business activities in IB are "interest- free". This is in line with the revelation commandment:

"Those who devour usury will not stand, except as stand one whom the Evil one by his touch hath driven to madness".

Al Baqarah: 275

The essence of upholding the Master's command is invisible and to some extent ambiguous in Non-Muslim accountants. Their belief and worldview is distinct from that which is suggested by Islamic worldviews. The benefit of symbiosis can to some extent be shared with them as illustrated from the following comment. "If Islam can be shown to be capable of providing fruitful vision to illuminate the modern conscience, then all mankind, and not only Muslims, have a stake in the outcome" [20].

The word "stake" should not interfere in the fundamental concepts of IB such as by the creation of new Islamic products, promulgating new standards for Islamic products, naming a few (which should be in theory, shouldered by SSB and Muslim accountants) but merely enjoying the benefits of Islamic products as investors and customers.

"Kind words and covering the faults are better than charity followed by injury. God is free of all wants, and he is Most Forbearing."

Al Baqarah: 263

In short, BOD, managers and SSB should be imbued with the appropriate characteristics to uphold the sacred intentions of IB. IB as well as Muslim investors have to look beyond the notion of "profit". Allah has granted that if Muslims adhere to His injunction i.e. prohibition of riba when dealing with business transactions and other prohibited activities, He will surely flourish them with better opportunities.

THE WAY FORWARD

In [20] argues that the human being is the key factor who plays a pivotal role in the decline or rise of any civilization. This principle also applies to organisations'. Therefore, in the context of IB, the key factors of

ensuring that IB is in line with its sacred intentions and goals, lies with the BOD, SSB and managers. As Allah has stated in the Qu'ran:

“God does not change the condition of people until they change their own inner selves”.

(13:11)

In the light of the above verse, BOD, SSB and managers alike, are responsible for the vision and direction of IB, whether IB is mimicking conventional banks [1] or vice versa in their daily business practice. They (BOD, managers and SSB) do not operate in a vacuum but through the guidance of Islamic universal ethical values derived from Qur'an [19]. These values such as justice (adalah), reformation (islah), care and cooperation (ta'awun) and true righteousness (al- birr) are the benchmarks of their intentions and motivations while performing their duties and responsibilities.

Justice could be demonstrated through fulfilling what should be done in the right way in the right manner to the right person. In doing so, the roles of managers and accountants are to ascertain that all business activities are in accordance to syari'ah rulings. Precautions are made to avoid illegal contracts arising from speculative trading, future options, gambling, window dressing, falsifications of accounts and on top of that free from riba, just to name a few [21].

In case of any discrepancy or deviation of business transactions, the management has to be transparent and communicate through financial disclosures. The need to meet the investors “profit maximization” desire cannot be overemphasized. Given the current emphasis on the “real” intention of business from the Islamic standpoint, i.e. for the welfare of mankind by prohibition of riba (just to name) a few, is not an option but an obligation for IB managers and accountants. It is the duty of SSB to ensure that current accounting practices do not take into accounts the notion of riba with the exception of few IB such as JIB [16].

The confounding issues of ownership specifically on the question of form over substance need meticulous attention from the SSB. It is equally important to note that the Muslim scholars should open the door to consensus (ijtihād) and be more pragmatic in their approaches with accounting issues. In light of the current accounting practice principles issued by AAOIFI, it serves as “an acid test” [6] of the practicality of the guidelines.

Reformation takes place when man (i.e. accountants, managers, BOD and SSB) acts is parallel to the syari'ah rulings. In [19] argues that as human beings deviate from complying with his Master's commandment, he perplexes his vision as the vicegerent. As man lost his goal and position as vicegerent and servant as well, he has a propensity to destroy and indulge in corruption in his daily life.

The inception of IB with sacred intention portrays the cooperation and care of the Muslim society. They (Muslims) give full cooperation in observing syari'ah ruling i.e. by avoiding interest activities which ended up with the establishment of IB (that is interest free). Some scholars' term this is as “Islamic resurgence” [1, 8]. The Muslim has no intention of recovering the “Golden Ages” as unfairly accused by western scholars [13]. Their ultimate goal is to avoid riba', as riba' is clearly prohibited in Islamic teaching.

True righteousness is portrayed during emergent discussions amongst Muslim scholars via intellectual discourse and internet [10]. Their discussion mainly focuses on a broad range of issues which covers the definition of Islamic accounting, accounting practices and accounting treatment of Islamic products i.e. murabaha, mudaraba etc., accounting concepts, accounting framework, just naming a few indicates their immense care in designing the “real Islamic banking products” which do not violate syari'ah rulings in any aspect.

CONCLUSION AND RECOMMENDATIONS

It is worth to note that man, as vicegerent is the key player in the success or fall of an organisation or institution. Their intention if not properly guided by universal Islamic ethical values will lead the organisation as well as the society to catastrophe. It is not the question of whether the establishment of IB which is “totally interest free” will lead to another “Golden Age” of the Muslim civilization. The most pertinent matter is that it is compulsory for IB to be distinct from conventional banking so as to cater to the needs of the Muslim society in general and others as well.

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