ISLAMIC BANKING AND ITS PROBLEMS
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INSTITUTE OF
ISLAMIC BANKING & INSURANCE
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INTRODUCTION

MOST Muslim countries gained political independence within a decade or so of the end of the second world war. In the economic field, they adopted one or the other of the two models prevailing in the world: the capitalist model and the socialist model. However, it was not long before they began to realize that both these models had features which were inconsistent with the teachings of Islam. Both were fiercely materialistic in their approach and had little spiritual or religious content.

The increasing awareness about the drawbacks of the capitalist and socialist systems, and the mounting aspiration of the Muslim peoples to assert their Islamic identity and organise their affairs – political, legal, economic and cultural – in accordance with the teachings of their Islamic faith, moved some Muslim thinkers and intellectuals to act. In the economic field they laid and put into action plans to establish Islamic financial institutions. The efforts of these pioneers were rewarding. There can be no greater tribute to the success of their efforts than the fact that today more than 100 Islamic financial institutions are functioning in different parts of the world, employing thousands of people and managing vast funds. In addition, responding to aspirations of their peoples, the governments in Pakistan, Iran and Sudan decided to Islamise their banking operations.

However, the creation of Islamic financial institutions has not been smooth and trouble-free. The institutions had to be created from scratch, with no past experience to draw upon. Inevitably, the organisers faced numerous problems. Some were resolved but a great many remain.

Also, it is certain that more issues and hurdles will arise as the Islamic banking operations expand in order to meet the increasingly exacting demands of clients and to narrow the gap with the highly developed conventional banking sector. As pointed out by His Royal Highness Prince Muhammad al-Faisal al-Saud in his address to a seminar on Islamic banking, the situation demands a great deal of research and development on a continuing basis.
Responding to this need, the Institute of Islamic Banking and Insurance decided as a first step to invite Islamic banks to identify issues that in their opinion were hindering progress and needed to be resolved. The response of the banks was quite encouraging. The issues reported by them were collated and classified by the Institute and are presented in this booklet under the following headings:

1. Theoretical questions
2. Relations with government
3. Relations between Islamic banks
4. Internal structure and organisations
5. Relations with depositors
6. Relations with entrepreneurs
7. Relations with public
8. Relations with foreign countries

Needless to say that each issue merits careful consideration by Islamic bankers, ulema, jurists and economists to find optimum solutions. The Institute feels that the following steps can make a significant contribution to the ability of Islamic banks to meet the challenges of modern times:

1. Organisation of research by Islamic banks to develop new financial instruments and methodologies.
2. Organisation of workshops with the participation of Ulema, Islamic bankers, economists and jurists to resolve issues facing Islamic banks.
3. Organisation of conferences at national and international levels to discuss Islamic banking in all its aspects. These should attract people from all walks of life. This will result in public participation in Islamic banking and help to promote it.
4. Establishment of institutes to train and educate people for work in Islamic financial institutions.
5. Establishment of public relations departments by Islamic banks to project ethical Islamic banking as a viable alternative to the conventional banking.

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CHAPTER I

THEORETICAL QUESTIONS

This Chapter summarises a number of theoretical questions concerning the principles relating to the prohibition of interest.

The problems in the rest of the Chapters are classified according to the practical sphere to which they relate.

1. Definitions.

There is a need to define and explain all Islamic banking terms, especially where they differ from the meaning used in conventional banks. To do so would remove the ambiguity and confusion which arises from different definitions being followed by different Islamic countries and institutions, often without their realising it until mistakes have been made.

If a panel of Islamic scholars at the highest level compiled such a list of definitions of Islamic banking terms for distribution to the staff of all Islamic banks, it would enable their discussions to proceed with greater mutual understanding and their operations in consequence to be accomplished with greater efficiency.

2. Purpose of Prohibiting Interest.

What is the basic purpose of prohibiting interest? This question needs to be answered satisfactorily before any further questions as to what is, and is not, Islamic can be raised.

One answer often put forward is that the purpose is to protect the poor from exploitation. If this is true, cannot the same purpose be served by establishing a social security/income transfer system which would guarantee a minimum
standard of living for all? If that were done could interest then be charged on loans?

3. Answering Justifications for Interest.
It is generally admitted that there are real costs associated with lending money, such as loss of purchasing power because of inflation during the period of the loan, administrative costs and losses incurred by the borrower defaulting on his repayments.

Justice demands that a lender not be forced to bear these costs and supporters of the interest system use them to defend it. We urgently need an Islamic answer to this argument.

4. Should Prohibition of Interest be Absolute?
Should prohibition of interest be absolute or are there cases where it would be legitimate to use it? For instance,

a) Does the prohibition against interest apply only to compound interest or to simple interest also?

b) Can there be interest on business loans but not on consumer loans?

c) May there be interest involvement between Muslim and non-Muslim countries where it is impossible otherwise to do business?

d) May Muslims resident in non-Muslim countries be considered exempt from the prohibition against taking or receiving interest, in view of the fact that in those countries it is impossible to do business or buy a house without doing so?

5. Deficit Financing by Governments and Central Banks.
Is deficit financing by governments and Central Banks a form of unlegislated tax and therefore unconstitutional from an Islamic point of view? Or, if it is acceptable, should it take the form of:

a) Note printing by the Central Bank or Treasury

b) Floating of fixed-interest bonds by the Government for purchase by banks.
c) Floating of fixed-interest bonds by the Government for purchase by the public. But how would b) and c) be different from paying regular interest?

6. Possible Dangers of Prohibiting Interest.

a) To Sovereignty.
Where only PLS financing is permitted, foreign capital can only flow into a Muslim country by purchases in equity or direct capital investment. This will tend to increase foreign ownership until at some point it threatens national sovereignty.

b) To Mobilising Investment Funds
Basing loans on PLS contracts introduces extra costs to the lender as well as risks of loss if the entrepreneur fails in his project. These facts could well discourage depositors from putting their money into investment schemes and thus reduce the total amount of funds available for investment into trade and industry.

c) To International Trade
Risk also arises in international trade. Where PLS is used instead of conventional interest, a knowledge of the business concerned is essential if the lender is to be assured of fair play and this knowledge might be impractical to obtain in the case of foreign markets, in which case the risk of being cheated would be high and this would discourage international trade by the PLS method.

7. Documentary Credit.
At present no commissions are allowed on Letters of Credit and Letters of Guarantee in Turkey because it has been ruled that guaranteeship cannot be used as a justification for any charges being made. However, on Letters of Credit (whose legal status constitutes a kind of guarantee), a commission can be charged in the name of transfer commission. This can be done by blocking a certain percentage of the amount of the Letter of Credit or Guarantee (say, 10%) and this amount can be used by the lender until the expiry date of the Letter of Credit or Guarantee and then paid back to the beneficiary when he returns the Letter.

A ruling is needed on this matter for use by all Islamic banks and institutions.

The criteria used to determine the amount added to the price on mark-up financing, or to determine the bank’s share of the profits in the case of PLS financing, need to be standardised. Most Islamic banks having no other guide, tend to use conventional interest rates as indicators, but it would be better for a truly Islamic method to be found which would be independent of conventional market conditions.

Such questions as what factors must be taken into account in the determination, whether it can vary over time and whether it can vary between banks and between different customers all need to be considered. Also can it be determined as a percentage of the amount borrowed rather than as a percentage of the profits or would that be considered tantamount to interest?

9. Replacing Interest Functions.

In conventional banking, interest performs two functions:

a) It brings borrowers and lenders together and creates equilibrium in the loanable funds market. A shortage of funds is erased by the tendency of interest rates to rise, while a surplus causes it to fall;

b) It serves as a yardstick by which to decide which projects are economic and which should be rejected.

How can these two functions be performed in the context of PLS?

10. Stock Exchange Investment.

In Turkey, Islamic scholars have, in principle, permitted dealing in stocks. However, they do not allow speculation. Also, it is not permitted to deal in the stock of any company involved in interest dealings or in businesses prohibited by Islam.

But as it is very difficult to find businesses which do not come into the above prohibited classifications, Islamic banks and institutions in Turkey have not so far been able to deal on the Stock Exchange. It would seem important to find a solution to this problem, as banks’ customers frequently ask about making investments in equity.
11. Spread.
In conventional banking, banks may charge a higher amount of interest to their customers than the current bank rate at which they get their own funds. This is known as spread. Is this practice permissible in the Islamic view?

12. Calculation of “Present Value”.
In conventional banking, the discount rate enables an owner to calculate the present value of a property according to the income it can generate over a given number of years. For instance, a fair sale price for an apartment which can generate a certain net amount of income over the next twenty years can be calculated.

According to what formula could this calculation be made under PLS?

Short- and medium-term international financing is normally done with Bills of Exchange. In the absence of interest, how would the lender differentiate between different periods of maturity of loans? Is it a matter of adding a mark-up and, if so, how would this differ in theory from charging interest?

Which of the following types of transactions are to be considered unIslamic?
   a) Insurance on deposits. Since it guarantees in advance the lower limit of losses that can be suffered by depositors, is such insurance unIslamic?
   b) Are fixed-rate mortgages for owner-occupied houses unIslamic?
   c) Is forward buying and selling of foreign exchange to protect against adverse exchange rate movement unIslamic? If so, what alternatives exist?
   d) Are passive capital gains, for instance, those acquired by inflation, such as can be made by buying a plot of land and keeping it until prices go up, any different, in the Islamic view, from getting interest on capital?
e) Should banks engaged in PLS agreements require collateral from borrowers and, if so, for what reason? (See also ch. 6, point 3)

f) Central Banks usually regulate money supply by altering reserve ratios, discount rates and open-market operations. Which of these instruments, if any, are to be considered un-Islamic?
CHAPTER II

RELATIONS WITH GOVERNMENTS

Governments often impose the laws governing the practices of conventional banks on Islamic banks, monetary control regulations and credit controls, even though Islamic banks do not deal in loans or credits. They also tend to hamper innovation and encourage running the banking system on a routine basis. Many of those in power have sympathy with the conventional banking system than with the Islamic.

Thus a great many of the problems of Islamic banks stem from the attitudes of governments towards them. Some ways in which government laws cause problems for Islamic banks are as follows.

1. Imposition of Interest-Based Laws on Islamic Banks.

One of the important constraining factors on the growth of Islamic banks is the absence of a suitable legal framework for them, that is, one not based on interest. All the existing financial and commercial laws in most countries are interest-oriented. The tax structure is also biased towards loan financing, as the cost of interest on borrowed funds is exempt from taxes, whereas dividends paid on funds mobilised as equity are subject to tax at varying rates.

Under the Shari'a, loan systems are required to be replaced by partnerships. Yet, at present, it is difficult to do this because, in default of an Islamic framework, Islamic banks are forced to have recourse to the existing interest-based laws for their legal remedies.

There is thus an urgent need for a special legal framework for Islamic banks. One problem which would need to be settled would be whether it would be subject to the judicial system, the civil law or the Shari'a.
2. Lack of a Lender of Last Resort.

One of the major issues for Islamic banks which operate in a dual economy is the lack of a lender of last resort. The Central Bank regulates the financial institutions of the country, thereby giving the public confidence in the banking system. The liquidity management of traditional banks is assisted through the Central Bank’s lending and borrowing scheme.

However, this assistance is not available to Islamic banks, although they have to operate alongside traditional banks. In order to solve this problem, it would be appropriate to negotiate with the Central Banks of, at least, the Islamic countries in regard to the following matters:

a) Providing financial assistance to Islamic banks in the form of PLS deposits.

b) Providing refinancing facilities to Islamic banks on the basis of PLS.

c) Allowing Islamic banks to open current accounts with the Central Banks, having occasional overdrawing facilities free of charge.

d) With regard to the use of the reserve ratio, the Central Bank might be asked to develop new instruments with no element of interest, so that Islamic banks can use them as liquid assets without either infringing the Shari’ah or impairing their profitability.

e) In some countries, a 25% reserve ratio is applied to Islamic banks so that they have to operate on 75% of their resources, the other 25% thus earning no income. Central Banks might be persuaded to lower the reserve ratios for Islamic Banks.

3. The Regulation of Islamic Financial Institutions by Non-Muslim Governments.

Having to work by the regulations of a non-Muslim government has a serious hampering effect on the growth of Islamic banks. For example some countries have taken the position that a bank is an institution that accepts deposits and guarantees a stated return on those deposits, except on current accounts. Therefore, an Islamic financial institution, since it does not guarantee a stated return, cannot, by definition, be recognised as a bank in those countries.
In the USA, the position has not been stated so clearly and those who have looked into the many regulations of financial institutions in the States feel that there is room to manoeuver. However, the establishment of Islamic banks has not yet been facilitated there.

4. Tax Laws in Europe and the USA.

The highly sophisticated taxation system in North America and Europe grew up well before the move towards Islamic finance began and therefore we face some serious questions with regard to the determination of taxable income. In these countries, interest is a deductible expense in determining taxable income, whereas dividends or profit are not. Islamic banks are therefore at a disadvantage in these countries, as their investments are generally equity based. The entrepreneurs (fund users) in these countries are also discouraged from using Islamic bank funds on their project for the same reason.

5. Tax on Property Income.

It is difficult for Islamic banks to invest in real estate, especially in Europe and the USA. Fiscal policies in the West are designed to encourage investment in the real estate sector through tax incentives. Withholding tax on property income may reach 40%. In all countries, the cost of funds invested in real estate is considered an expense and is therefore deducted from taxable income. As all investments in this sector are usually leveraged up to 90% or more, the cost of this leverage (interest) can reduce the taxable income to almost zero. Islamic banks face reduced rate of return, or foregoing completely the investment opportunities in this sector.

Ways and means must be found to solve this problem and one possibility that Islamic scholars might consider would be to structure the investment to appear to the tax authorities as though it were a financing operation involving interest, while, in fact, it was not. To do this, the investor would establish two offshore companies: one to own the property and the other to lend money to the first. Both companies would be owned by the investor and therefore “interest” would appear only for book-keeping and tax purposes. In reality, the investor would not pay or receive any interest in this transaction and all proceeds would come from renting the property or from its appreciation in value.
6. Need for Banking Tribunals
The entire system of Islamic Banking rests on having a relation of mutual trust between the bank and the borrower. To ensure that this relationship is maintained at all times, an effective legal system is an important prerequisite. The present legal system is complicated and the procedures are slow and cumbersome. To counteract this Pakistan has established special banking tribunals.

7. Elimination of UnIslamic Financial Products.
The present structure of various government and other investment instruments is based on the principle of interest. Government securities such as Treasury Bills, Federal Investment Bonds and Deposit Certificates all carry an inherent factor of interest in the form of a fixed rate of return. There is a need for the government to set an example to the financial institutions by offering investment and saving schemes based on the Islamic principle of profit-and-loss-sharing.

8. Industrial Financing.
One area in which progress has been rather discouraging is longterm industrial financing based on PLS. In Pakistan, Bankers Equity Ltd pioneered financing in this mode in the early eighties, but they appear to have lost enthusiasm since then.

Wholehearted government support is essential to promote the PLS system in industrial financing. The changing financial environment caused by privatisation and economic liberalisation, however, poses a serious challenge in this regard. Moreover, low business morality, inadequate support from accountants and auditors and an inefficient legal process have inhibited the growth of a viable PLS system.

Saudi-Pak provides local and foreign currency financing to the corporate sector. Their local currency financing is based on mark-up, but they have also participated in financing by way of leasing and partnerships.

Different countries have different laws on this matter. For instance, in Iran, the system guarantees the repayment of principal and provides for the sharing of the profit at certain rates.
In Turkey, the system provided for the sharing of PLS profits but without guaranteeing the return of the principal.

It is clear that the first system has the best chance of competing with the conventional interest-based system and that this matter must be evaluated with a view to establishing a uniform system for Islamic banks in all countries.

10. Imposition of Government Budgets.

Where Islamic banks are not independent but are directly or indirectly under the government's influence, they are affected by the imposition of government budgets which are not always in line with their own policies or objectives. This can seriously affect the funds available for Islamic projects of all kinds.

11. Identification of Boundaries.

The identification of the boundaries between the public and private economic sectors, affecting as it does the limits of private ownership, is a matter which should be given high priority in discussions with governments on implementing the Islamic system.

12. Liquidity.

Western bank laws usually require a bank to secure ample liquidity at all times in relation to the composition of its balance sheet. For an Islamic bank operating in a western environment, the utilisation of zero-coupon debt instruments would be very useful. Would this instrument be approved by Islamic religious scholars?

13. Coordination of Government Bodies.

There is a need for more coordination and harmonisation among governmental bodies with regard to their various responsibilities and tasks in connection with the Islamic banking system. Lack of unity on these matters could adversely affect the smooth operation of the banking system and put obstacles in the way of its progress.

Studies are needed to pave the way for new Islamic financial instruments to be used:

a) To provide for the financial needs of Islamic governments;

b) To raise money on international financial and credit markets;

c) To provide suitable instruments for the effective implementation of monetary and credit policy—issuance of treasury bills, bonds, debentures, etc.


The question should be debated as to whether governments should come to the rescue of failing private banks and financial institutions and, if so, on what basis.
CHAPTER III

RELATIONS WITH ISLAMIC BANKS

1. Interbank Financial Markets.

Cooperation between Islamic banks is badly needed in the area of syndication, development of secondary markets and exchange of information. In the latter, the International Association of Islamic Banks can play an important role by providing a data base on the activities of all the Islamic banks.

There is a need for secondary markets where Islamic banks can trade financial instruments, raise funds, etc. At present these are almost non-existent.

2. Short-term Transfer of Funds Between Islamic Banks.

Islamic banks should develop suitable instruments to enable them to place surplus funds with other Islamic banks on a short-term basis. This would not only provide liquidity when and where it was needed but would be useful where a project needed more funds than a bank on its own could raise. A bank supplying funds to another bank could arrange to benefit by a share in the profit on the project for which the receiving bank used the funds.

3. Inconsistencies in the Islamic Banking System in Different Countries.

Many of the laws, regulations, procedures and codes of conduct of the Islamic banking system prevailing in different countries have grown up haphazardly in response to various situations. We should now take an overall look at them with a view to reorganising and simplifying them, making them standard for all Islamic banks in all countries.

If all Islamic banks were operating under one agreed system as conventional banks do, much time at present spent on working out how to accomplish
various things and on putting right mistakes would be saved, cooperation would be speeded up and business would proceed much more efficiently.

4. Lack of Uniform Accounting Standards for Islamic Banking.

Among Islamic financial institutions, there is generally no uniformity in accounting policies and standards, hence a lack of consistency in the accounting treatment of various Islamic banking operations. Even the presentation of their financial statement differs, making it hard for the reader to relate the results of one bank to another.

There is clearly a need for Islamic banks to consult with each other and produce a standard accounting system acceptable to all.

The present system of accounting practices in Pakistan helps to create ambiguous and concealing financial statements. Only limited companies are required to prepare periodic financial statements and have them audited by a chartered accountant. Partnerships and sole proprietors are exempt from this requirement.

In order to create a viable financial environment for the establishment of a purely Islamic banking system, every medium-sized organisation, irrespective of the nature of its ownership, should be required to have its accounts audited by a qualified accountant.
CHAPTER IV

INTERNAL STRUCTURE AND ORGANISATION

1. Relationship Between Scholars and Bankers.
There is often a lack of understanding between the religious advisors and the bankers. The religious advisors do not fully understand the technical and day-to-day operational needs of the bankers and the bankers do not understand the constraints of the religious principles. There are no institutions at present for training the staffs of Islamic banks.

What is needed is the establishment of schools in all countries where there are Muslims, not only in Muslim states. In these schools, religious scholars and bankers would attend courses together for several years before being allowed to work in an Islamic bank.

In such schools, new instruments and methods would be created by the cooperation of the scholars and the bankers. From time to time, they would use existing Islamic banks as their classrooms to get practical experience and the bankers would also visit mosques in order to understand the orientation of the religious scholars. Some such training system is vitally and urgently needed for the success of the Islamic banking movement today.

Some banks do not have Shari'a panels to direct and guide their operations and others have but one person acting as a religious advisor.

3. Too Many Services.
Many Islamic banks try to compete with conventional ones by trying to provide more services than they can cope with. This results in a lack of
specialisation and inefficient operations. Each bank should consider which services it can best provide according to the skills and knowledge of its staff and concentrate on those, at least until it can expand its staff to deal with new services.

4. Need for Staff Training.
There is wide scope for establishing institutions which can provide Islamic banking training to bank employees and to customers of the bank. The existing professional institutions provide technical training mostly to the employees of financial institutions only and very little participation is invited from business and industrial circles. Similarly the financial institutions also provide in-house training to their employees but without any orientation to Islamic banking principles and procedures. In order to educate bank employees and customers about the delicacies of bank-customer relationships in Islamic banking and their rights and duties, it is necessary that various workshops and seminars should be held. In addition, other information media may be used to inform the general public.

Pakistan switched all its banks to a non-interest-based system on 1st July, 1985. Since then, all banks have come under the specific directives of the State Bank of Pakistan. The first problem to arise was how to train field staff to put the new system into operation. Elaborate arrangements were made for the extensive training of all levels of staff in every part of the country and eventually the new system was satisfactorily established. But these training activities must be seen as a constant necessity, as new developments in methods and instruments are arising continually.

5. Staff Shortage.
There is a shortage of skilled professional staff for Islamic banks because no career structure exists such as would offer a young man an assured future in Islamic banking such as he can now envisage in a conventional bank. It is necessary that steps be taken to remedy this situation.

There is a deficiency of by-laws to define the frameworks and govern the structure of internal relations in Islamic banks.
CHAPTER V

RELATIONS WITH DEPOSITORS

1. Mobilisation of Deposits.

Islamic financial institutions have done extensive research into how to utilise funds by Islamic means but very little into how to attract deposits. This needs to be done especially in countries where Islamic banks have to work side by side with non-Islamic banks and in competition with them.

The Islamic current account, guaranteeing deposits but not paying any return, can attract only those people who have savings, do not want to take a risk and who do not mind earning no return on their money. The investment account, paying returns but not guaranteeing the deposit, since the depositor may also become liable to share in losses, can attract only those people who have savings and are willing to take some risk for a possible return.

In these cases, Islamic banks are in competition with interest-based banks and the stock market.

But there is another large section of the people who want a return on their savings but are not willing to take a risk. These people can have recourse to banks and building societies in the west, where they will get interest without taking any risk, but the Islamic banks, so far, have found no way of competing for this substantial section of depositors. Research is needed to solve this problem.

2. Providing Sufficient Guarantees for Depositors.

As is the case even with conventional banks, small depositors who put their savings into a bank are sometimes afraid that their money will be lost should
the bank encounter great losses leading to its collapse. Any sudden bad news in the financial world may cause many of them to withdraw their money all at once, which itself could cause the collapse of the bank. What can be done to provide a sufficient guarantee to avoid this?

Since deposit insurance schemes are non-existent in the current Islamic banking system, there is a need for an independent Islamic insurance company to introduce such a scheme in order to encourage people to have confidence in putting their savings into an Islamic bank.

Alternatively could Islamic governments be persuaded to set up a scheme to guarantee deposits in Islamic banks?

3. Credit Cards.

To compete with conventional banks, Islamic banks need to be able to offer their customers adequate modern services and possibly high-tech banking products as well, such as cash cards and credit cards. Since, in the conventional system, these cards are interest-based, the religious scholars will need to discuss how they can be amended so as to conform to Islamic principles.

There is no way as yet for Islamic banks to deal with personal, or non-productive, borrowing. PLS, as its name implies, can only be used for loans which produce a profit and consumer loans do not produce anything. Therefore there is no way as yet to determine or recoup the cost of such loans, given that interest, which the conventional banks rely on to finance consumer loans, is out of the question.

4. PLS Maturity Dates.

Legal restrictions in Turkey result in the following situation. Funds are mobilised on a basis of 90, 180 and 360 day call in PLS. A depositor cannot demand any profit if he wants to draw his Savings before the maturity date. His contract provides that he must participate in any incurred loss from his pool. As a result, his profit share remains in the institution with those of the other PLS depositors in his pool. This is likely to have a discouraging effect on deposits.
CHAPTER VI

RELATIONS WITH ENTREPRENEURS

1. Lack of Cooperation.

How can we deal with clients who do not understand the Islamic modes of investment or who want to manipulate them or take advantage of the gaps that exist under the present regulations?

In PLS partnerships, some banks find that there are entrepreneurs who always try to declare a loss or less profit than they have actually made. A way needs to be found by which banks can monitor the accounts of businesses with which they are in partnership in order to know how much profit they are actually making.

But there is no protection against businessmen cheating the bank on their accounts by using their expert knowledge of their business, a knowledge which the banking partner cannot match. Banks cannot have expertise in every commercial area and the more loans they are involved in the more their managerial capabilities are diluted, thus increasing their costs. Is the solution for every bank to choose certain lines of business to finance and to be obliged to keep within these limits? Or would this mean the neglect of small businesses, encouraging monopoly and creating unemployment? This is a widespread problem that will need to be discussed at the highest level.

One way round this problem would be to appoint a specified public agency to determine the “normal rate of return” for various industries. When a bank sets up a partnership with an entrepreneur, the latter would have to sign an assurance that the rate specified for the industry concerned would be payable
by him to the bank as a minimum amount. The agreement would also provide that if the actual profit on the project exceeded the specified amount, the difference would be voluntarily paid by the entrepreneur to the bank. If the actual profit turned out to be lower than the specified amount, or if there were a loss, the entrepreneur would have to prove this to the public agency concerned, in which case the bank would have to accept the lower rate of profit or loss so proven.

It might be considered, however, that a “specified rate of return” is the same as a “fixed rate of return agreed in advance”, which is one definition of interest.

However, in Pakistan, no PLS project is undertaken unless the bank, on preliminary scrutiny, is satisfied that it will be able to earn an annual profit of not less than 13% per annum.

2. Late Payments

Islamic bank funds are exposed to risk and reduction of income when invested in PLS schemes owing to the prohibition against charging any interest or penalty for late payment of instalments. The losses caused by late payments have made it necessary to ensure the timely recovery of loans under an effective recovery system.

Under the mark-up system, there is no provision for any penalty for late payment by lessees. Where the lessee does not pay an instalment on the due date, he is not subjected to any penalty for the period of default. This clearly encourages late payments to the bank’s loss. The conventional bank can make compound interest charges over the period of default to discourage delays in payment, but this is not possible for Islamic banks. This is a disadvantage of the mark-up system for which a remedy needs to be found in keeping with Islamic principles.

There is no question of rescheduling overdue payments to include a penalty as this would constitute a “mark-up on mark-up”, a concept which has been disallowed, at least by the State Bank of Pakistan. The bank’s only recourse is to file suit in the tribunal within 90 days of the first default.

However, where long-term investments are concerned, it is not in the bank’s interest to go to a tribunal at the first default, as this requires recalling the
entire financing of the project. This is not practicable, since long-term commercial projects require a gestation period before they start making a profit. For this reason, the bank must avoid resorting to such extreme action early in the project period. Moreover, an entrepreneur, even with a profitable project, may go through a period of low cash generation and be genuinely unable to service his loan for a time, in which case the bank may feel he should be offered a rescheduling facility.

When payment recovery lags behind safe limits, a paucity of loanable funds and liquidity is experienced by the bank. The defaulter feels easy about non-repayment of his bank loans because he has not to pay any penalty for the period of default. One solution to counter this problem would be the establishment of special banking courts to hear cases of default and decide them quickly.

This problem is much increased in a time of inflation such as exists in Turkey at present. Inflation causes the currency to become devalued, encouraging unscrupulous borrowers to pay as late as possible, as the longer they wait the less, in real value, they will have to pay.

A means needs to be found for protecting the banks and the PLS depositors, who are the ones who eventually suffer through the erosion of the returns in this situation.


It is now generally agreed that the use of PLS partnership modes of financing needs to be increased, while mark-up, which is not truly Islamic in principle, needs to be decreased. The problem here is that Islamic banks see the latter instrument as a safe way of getting a return on their funds while partnerships with business are always risky.

One solution might be to introduce third party guarantees in order to reduce the business risks. Another might be for banks to require collateral from borrowers for the period of the loan.

4. Criteria to Determine Amount of Return

The criteria used to determine the mark-up, in the case of leasing, and the bank’s share in the profits, in the case of business partnerships, need to be
discussed and standardised. In the case of mark-up prices, most Islamic banks, having no other guide, tend to use western interest rates as indicators, but it would be desirable for a truly Islamic method to be found which would be independent of western market conditions.

5. Long-term Investment Problems

Islamic banks have a problem when investing in projects which have a long gestation period, that is, projects which will not show a profit in the first few years. Banks need to show a good return every year or they will not attract depositors. They therefore tend to invest in short-term projects, which will give them quick returns. This is the only way of competing with conventional banks in regard to offering their depositors steady returns.

But the result of this concentration on short-term projects is to reduce the efficiency of these banks as compared with conventional banks. Not only that, but developing countries needing long-term finance will be affected by the lack of funds.

6. Indexation

It would be useful to have a system to reflect the changes in the value of money, especially in times of inflation. This index could be used to measure changes during the period of borrowing by an entrepreneur and thus to adjust the amount of money owed to the bank at the end of the agreed period. The advantage of this is that it would enable the bank to assure their depositors that the value of their savings would be preserved and thus encourage the growth of savings deposits.


In leasing agreements, there is a need to determine Islamic criteria for deciding the extent of the lessor’s responsibility for maintenance of the item concerned.


There is a problem in how to find suitable short-term investments. These tend to be inefficient in terms of returns. Yet most depositors choose the short-term in order to be sure of a quick return on their money. Thus Islamic
banks tend to have a surplus of funds needing short-term investments and not enough funds for long-term investments. By what criteria can Islamic banks choose efficient short-term investments, or, alternatively, how can depositors be encouraged to put more of their money into long-term investment accounts?


Many Islamic banks find it advantageous to invest most of their mobilised funds in major companies and monopolies. But as their funds come mostly from the lower and middle classes, they are often criticised for this policy, since they are not giving a chance to small and medium sized enterprises. To do so, however, brings practical difficulties. A solution to this dilemma might be found by developing a model which can efficiently be applied to small and medium-sized businesses such as craftsmen, perhaps using collateral.

10. Other Matters.

a) Islamic financial instruments which take into consideration the need for zakat payments need to be found. This is an important factor in identifying investment fields.

b) What is the Islamic position regarding preferred stock, options and futures.

c) There do not seem to be any Islamic models for investing in real estate. (See also Ch.II No.5)

d) A form of Islamic arbitration for disputes arising in partnerships needs to be set up. (See also Ch. II No.6)
CHAPTER VII

RELATIONS WITH THE PUBLIC

1. Public Awareness.

The use of the media needs to be looked into by Islamic financial institutions. So far, they have tended to ignore them, even Muslims are not very aware of the fact that Islamic banking is being practised. The public needs to be informed about the nature, objectives and working of Islamic economics and banks. A few spasmodic reports have appeared in British and US newspapers but there have not been enough to bring an awareness of the new system to the general public, much less any encouragement to use it.
CHAPTER VIII

RELATIONS WITH NON-ISLAMIC BANKS

1. Introduction of Islamic Products by Conventional Banks.

Many conventional banks have now started offering what they call Islamic products. These products may appear at first glance to be Islamic but, as the conventional banks are not subject to Islamic regulations, many of them may not meet the requirements of the Shari'a. This makes for unfair competition, and, because the ordinary purchaser is unable to tell the difference, Muslims who buy these products may be duped into thinking they are acting in accordance with Islamic principles when they are not.

A possible solution to this problem is for Central Banks to examine all financial products claiming to be Islamic and inform the public which of them really are so and which are not.

2. Need for Compatibility.

There is a need to create harmony and compatibility between the rules, regulations, instruments, code of conduct, etc. of Islamic banks and financial systems and those of other banking and financial systems. Doing so at an early stage would help enormously in facilitating business between the two systems and would go a long way towards precluding possible friction and disputes in the future.
CHAPTER IX

RELATIONS WITH FOREIGN COUNTRIES

1. International Trade Financing.

In the conventional banking system, foreign trade is financed by Bills of Exchange and interest is charged according to maturity dates. How does an Islamic institution charge, since interest is prohibited here as elsewhere? If it is done on a PLS basis, there is the problem that the lender may not know much about the foreign market concerned and could easily be cheated.

There is a need for some central body which would have enough information to set realistic criteria for dealing with various countries and to whom Islamic banks could turn for advice. Otherwise, this problem is likely to discourage foreign trade.

2. World Bank Funds.

Many developing countries are forced to borrow money for their projects from the World Bank, but the latter only makes loans on interest. Suitable Islamic instruments need to be developed which would enable Islamic financial institutions to channel their funds through the World Bank. This would not only provide more investment possibilities for Islamic banks but would enable developing Islamic countries to borrow without violating Islamic principles by paying interest.

2. Disputes over Contracts.

The admissibility in foreign courts of contracts made under the Shari'a has many problematical implications. Even where an Islamic contract is
acceptable by the court in question, should any of the Islamic provisions in the contract violate the local law, the provisions of the latter will obviously prevail. On the other hand, if a provision of the local law should violate any of the Islamic provisions in the contract, this will not be acceptable to the Islamic financial institution involved. This leaves the latter in a quandary, as it may not, in that case, be able to obtain full recompense against its client.


Currency conversion methods such as arbitrage, PPSC, cash and carry, etc., often carry elements of interest. There is a need for Islamic scholars to examine these things so that interest-free forms can be established.

5. Need for International Islamic Insurance.

Islamic insurance does not exist in Turkey, yet insurance of imports and exports is compulsory. There is a need for Islamic validation of current applications and for ways to be found of getting reinsurance support in foreign countries on an Islamic basis.

6. Threat to Sovereignty.

An important aspect of international trade is that if only PLS financing is allowed, then foreign capital can only flow inwards as direct investment in equity in the businesses of the receiving country. This would increase foreign ownership and eventually threaten the sovereignty of the Islamic countries.

7. Muslims Living Abroad.

For the peace of mind of Muslims everywhere, a ruling is needed on whether, and in what circumstances, it is permissible for Muslims working or setting up in business abroad to pay or receive interest. In non-Islamic countries, it is usually impossible to set up a business or buy a house without getting involved with an element of interest.
The Institute of Islamic Banking and Insurance is an independent, non-profit trust. Its aims and objectives include:

Promotion of knowledge and understanding of Islamic banking and insurance.

Education of personnel in Islamic banking and insurance to fill the rapidly growing demand for qualified personnel by financial institutions. For this purpose, the Institute runs a Diploma Course in Islamic Banking and Insurance on the distance learning method.

Conducting research and development to develop new Islamic financial instruments and to tackle issues and problems relating to Islamic banking and insurance.

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