# Future of Islamic Banking

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Islamic banking and financing has gained a foothold both nationally in Muslim countries and internationally in the financial world. Regular degree programs are also being offered at the university level in both the East and the West. Now Islamic banking industry faces issues of a different sort. That is, how to (1) consolidate the gains made so far and sustain itself, (2) ward against any meltdown and (3) grow. These issues determine the scope for our discussion.

The topic involves some futurology. Its nature requires interactive dialogue. We propose the following list of questions for deliberation:

1. Will Islamic banking survive or not?
2. What shape might the Islamic banking industry take in the future?
3. What, or what type of, challenges might Islamic banking face in the coming years?
4. What changes might Islamic financing bring about in the way people live, businesses work and governments run public affairs?
5. How might development of Islamic financing affect the disciplines of Fiqh, Accounting, Business Administration (in particular, Finance and Marketing and Business Management), Economics and Public Policy?

We make here some submissions for further dialogue. It is pertinent to mention that there are some similarities between this topic and the one on **Current Issues in Islamic Banking**. This is because present determines the future, and future considerations influence the present. Notwithstanding this, however, the future concerns merit their own discussion.

## 1. Survival of Islamic Banking & Finance

Survival of Islamic banking depends on the following: (1) its economic viability, (2) its stability, (3) its response to challenges to its identity, and (4) confidence of depositors and savers. We discuss these four things in turn.

### 1.1 Economic Viability:

Economic viability of Islamic banking/financing is not an issue for two reasons:

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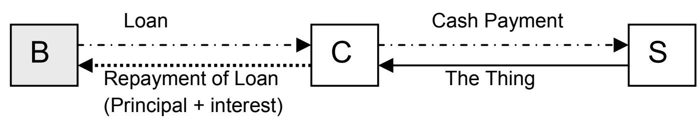
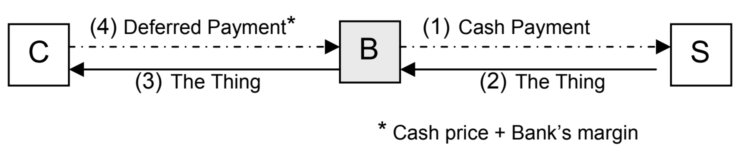
(1) Islamic banking is just another way of banking.
(2) Islamic banking offers a better financial architecture, on economic grounds.

Let us take the case of a bank client (C) who actually needs to buy something for which he does not have funds to meet the seller (S)'s demand for payment. Currently a bank (B) comes in the picture as follows:




**Interest-based Solution: Bank as Lender**

The prohibition of riba makes the loan option economically infeasible for the bank. It can, however, still play a meaningful role and help the client to tide over his liquidity problems as follows:




**Islamic Solution: Bank as Trader**

The above picture will remain by and large the same if the client needs something on lease basis.[1] However, if usage of funds involves several transactions at the client's end, Islamic bank can share its resources with the client under partnership arrangements—modarabah or musharakah—to do the needful.

The above analysis implies that Islamic banks will always be able to address financing concerns of their clients. And, in fact, they will have more than one distinct option to do so.[2] Note that financial tag for Islamic financial instruments need not be an issue because numbers can always be worked out to show that cost of Islamic financing remains the same as that associated with interest-based financing.

It is also noteworthy that Islamic financing implies direct linkage between financial flows and real flows in the economy. That is, funds will flow from Islamic banks only against real economic activity. Thus, investors will approach Islamic banks only

[1] Of course, in that case lease agreement will replace sale agreement between the bank and the client. And, if sub-leasing is involved, purchase agreement of the bank with supplier shall be substituted by a lease agreement.

[2] Interest-based banks use different variants of loan transaction. These instruments differ only in their degree of complexity stemming from the nature of financing request.

when they have genuine needs. End in dichotomy between financing and the use of funds will lead to integration of real and financial sectors in the economy. In this sense, Islamic financial architecture will be superior to the existing interest-based financing architecture.

## 1.2 Stability:

According to Dr. Mohsin Khan, in his 1985 article in IMF Working Papers, when there is downswing in an interest-based economy depositors' existing claims remain a liability of the banking system. This forces the banks into debt management. That is, creation of new and more costly debt against the banks—in the form of new deposits and borrowings from other sources—in order to retire existing debt to the depositors. This action reinforces the process of downswing, and hampers the pace of recovery in the economy. As against this, Islamic banking has advantage that bank obligations to depositors automatically adjust, both in downswing and recovery phases, due to the principle of profit-and-loss sharing.

More recently, in an article on the web Dr Tariqullah Khan of the IDB has stated the same point as follows. "A banking system would be unstable if it concentrates asset risks on bank capital. Since Islamic banking principle is based on risk sharing and it spreads risks between bank depositors and bank capital, it is inherently more stable. If this inherent quality is coupled with prudential regulations and supervision and with implementation of internationally acceptable standards of risk management, transparency and corporate governance, Islamic banking can practically become an ideal alternative to the traditional banking system in achieving equity, stability and efficiency".

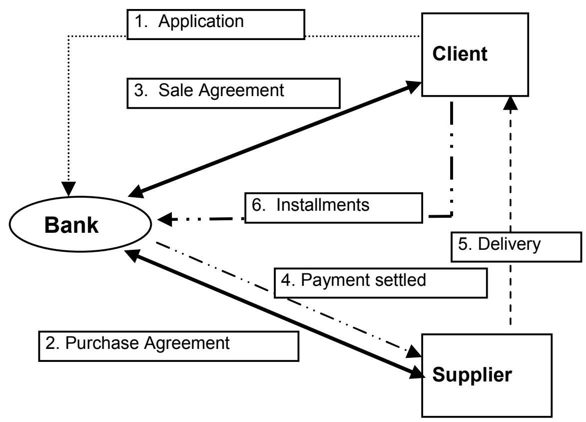
It is also well-known in traditional finance literature that interest-based debt finance is an important source of economic instability, as compared with equity finance. Relevance of this point for our purpose needs no further comment.

Last but not the least, direct linkage between financing and application of funds under Islamic banking will mean an end to credit or untied cash, as found in the existing interest-based economies.[3] Thus, an important cause of mismatch between aggregate demand and aggregate supply in the economy will be removed. This will mean less demand-pull inflation. On the other hand, linkage of financing to economic activity will help in easing supply constraints in the economy. This will result in, among other things, employment generation. These considerations lead us to conclude that frequency, intensity and duration of business cycles will be less with Islamic banking.

[3] Note that there may be debt in an Islamic economy in lieu of transactions involving deferred settlements. But there will be no credit, as commonly understood.

## 1.3 Challenges to Identity:

Let us take the case of Murabahah financing, i.e., financing via sale on deferred payment basis. A reference to the diagram on **Islamic Solution: Bank as a Trader** in section 1.2 above, clarifies how bank enters into the transaction process as a trader. That is, it comes in the picture between the seller and the bank client: it first buys the thing and then sells the same to the client. A simple way to do so is as follows:




The numerals in the diagram show the sequence of events in the transaction process. It is possible to define a financial instrument such that (i) there is little or no time lag between creation of bank's obligations to the supplier and its claims against the client and (ii) physical commitments on the bank's part are negligible.

As against the above, at present most of the murabahah financing work as follows:

1. There is a promise/agreement between a bank and its client. This binds the client to purchase thing(s) in question from the bank, creates a financing facility in the name of the client, and authorizes the client to directly purchase from the suppliers (though at the behest of the bank).
2. The client makes necessary purchase(s), and payment advices are sent to the bank that the bank honors.
3. The client directly takes delivery of the good(s) from the supplier.
4. Once the thing(s) is (are) with the client, a sale-purchase agreement is made between the bank and the client as follows. The client offers to buy (what is already with him) and the bank agrees to sell the same thing!
5. The client discharges his payment obligations to the bank.

The above process is materially no different from that associated with Supplier's Credit currently in vogue in interest-based banking. Thus, if murabahah financing works as above, sooner or later questions may be raised about its claim to a separate identity. Change in labels and terms are unlikely to be a lasting defense.

As per the existing approaches as understood by us, there is little difference between hire-purchase practiced by Islamic banks and financial lease condemned by the fuqaha as a transaction of riba. Similar points may be raised about some other financial instruments adopted by Islamic banks. The line of distinction between Islamic financing and interest-based financing must always be above reproach in order to avoid identity crisis for Islamic banking.

### 1.4 Confidence of Depositors and Savers:

Dr. Tariqullah Khan recently raised this issue as follows. “A bank licensed as an Islamic bank may be running on a very sound financial footing. However, if the depositors came to know that the bank has violated its Shari’ah mandate, the depositors will lose confidence and the finding will trigger deposit withdrawal and probably collapse of the bank. By contagion effect this can lead to financial instability threatening economic development”.

One may add that success begets envy and, hence, scrutiny. Caution is, therefore, warranted against any thing that creates doubts about the Shari’ah credentials of Islamic banks’ transactions, especially on the financing side.

## 2. Likely Shape of Islamic Banking & Finance in Future

### 2.1 Islamic Banks as Pure Financial Institutions:

Islamic banks will become pure financial institutions that fill financial gaps standing in the way of real economic transactions at the grassroots level. The following economic factors will lead to this development.

Practitioners of Islamic banking will recognize that efficiency and gains lie in specialization. They will, therefore, delegate to third parties responsibility for field operations in lieu of a financing transaction, of course, in return for a charge. In some cases, such as taking physical possession of a thing in trade- or lease-based financing, this third party may be the bank’s client himself. This is likely to happen because economies of scales enjoyed by third-party specialized institutions will reduce operational costs for the banks. In the end, one expects Islamic banks institutions to touch the economic landscape only on the financial plane, i.e., become pure financial institutions—while acting as economic agents.

Notwithstanding the above, regulators also need to recognize the following danger. Islamic banks, as already seen, will provide financing by coming in the picture as traders, lessors or partners. This factor along with their ability to muster sizeable funds can have potentially damaging implications. For example, if there are no checks on the scope of trading operations of Islamic banks, mega traders will emerge as the expense of small traders and businesses. This monopoly problem can be addressed through limiting the role of Islamic banks to financing matters only.

That is, for example, they may be permitted to enter into a transaction as trader in order to facilitate a sale-and-purchase transaction at the grassroots level, they should not be allowed to buy and sell things for themselves.

## 2.2 Islamic Banks will primarily be Economic Institutions:

Islamic banking will be ethical banking for, among others, the following reasons:

(1) Islamic banks will stay away from financing Shari'ah-proscribed activities—producing alcohol or financing speculative activities, for example.

(2) There will be transparency in their transactions with the clients—depositors as well as fund-seekers—due to compliance with the Shari'ah Ahkam on gharar.

Islamic banks will also contribute to social welfare of the economy to the extent Ahkam on zakah would apply to them. But beyond this, generally they shall be pure economic institutions established by their owners for profit earning. Of course, individually some Islamic banks may specialize in participatory modes of financing modes due to some religious convictions of their owners. But there is no Shari'ah compulsion for this. Islam allows banks to exploit all halal ways to their advantage, of course, subject to willing consent of the all concerned in a given transaction.

As for Islamic banks doing charity, the thinking needs to be set straight. A bank's money (deposits plus bank capital) belongs to its depositors and shareholders. Prior permission of the ultimate owners is a must for any charity.[4] The same principle applies to profits earned through financing operations in which capital stakes of depositors, and may be the bank's shareholders, are involved. Technically speaking, bank management may exercise some discretion for charity with prior permission of the shareholders and the depositors. But getting such a mandate is practically not possible because both the group of bank shareholders and that of bank depositors continuously keep on changing.

## 2.3 Standardization of Islamic Financial Products:

Standardization is necessary, and it is bound to happen. This is because the world is a global village. Costumers' consciousness and competition among Islamic banks will lead to standardization of Islamic financial products. Ultimately, barring exceptional circumstances when large and long-term fund commitments and/or a lot of financial engineering is involved, only price competition will rule in the Islamic banking industry.

In passing, one may note that in the long run standardization in the financial instruments will require consensus of fundamental Shari'ah principles for designing

[4] This automatically happens in the case of charity by an individual out of his personal wealth.

financial contracts. Unless this happens, Islamic banking may become a clash of dogmas.

### 2.4 Structure of Islamic Finance Industry:

Islamic finance industry is likely to be divided into (1) normal banking institutions, (2) development finance institutions, (3) microfinance institutions, (4) mutual funds and (5) life insurance companies and their other equivalents.

Development finance institutions will specialize in financing based on divisible and tradable financial instruments to address sizable financing needs with long maturity periods.

Microfinance institutions shall emerge not only for economic considerations but also as part to government strategy to exploit the potential of micro-financing for poverty alleviation.

There will always be return-conscious depositors who want maximum flexibility in investment and withdrawal of funds. Accounting and, may be, other costs considerations at the level of the normal banks will give rise to institutions like mutual funds or unit trusts. The quest for maximum responsiveness to their clients will force these institutions to operate only in the secondary markets, such as Islamic stock market (for Islamic shares) and Islamic money market (for divisible and tradable Shari'ah-compliant financial instruments).

Life insurance companies and their other equivalents, such as Employees Provident Funds and Private Pension Plans, are likely to emerge on the Islamic financial scene in order to provide avenues for long-term capital accumulation to the people. The existing Islamic Takaful model is expected to be working model for these financial institutions. It is expected that Shari'ah considerations will force development of separate institutions for other forms of insurance. For example, fire insurance companies may also be required to take remedial measures for avoiding the occurrence of fire. Accident insurance scene may be characterized by separate Aaqila (عاقلة) for car, bus and truck insurance. And, so on.

## 3. Future Challenges for Islamic Banking & Finance

Some of these challenges are noted below.

### 3.1 Financial Innovation in Critical Areas:

Progress of Islamic banking will depend on its ability to innovate in the following areas:

- Financial instruments yielding stable income flows for orphans, widows, pensioners and other weaker segments of the society
- Financial instruments for meeting government's financing needs
- Cover or security for financing, in particular Shari'ah-compliant alternatives for penalty on payment defaults

- Formulas for pricing of Islamic financial products

## 3.2 Competition:

Islamic banks should be ready to brace not only intra-industry competition but also inter-industry competition from interest-based banks. The latter are already offering Islamic financial products. The competition is likely to grow.

### 3.3 Misuse of Islamic Banking

Unless there are effective checks and monitoring, vested interests may use Islamic banking to bypass the Ahkam on riba. For example, in the existing murabahah financing banks do not directly come into the picture as buyers from the would-be suppliers. This gives dishonest fund-seekers a window for getting credit from the bank through fictitious purchases. Moreover, without effective checks and monitoring, some bankers under financial pressures may be tempted to provide funds through dummy transactions. For example, a person might get $1000 from a bank by the bank first buying a bread—or something dirt cheap, not worth $ 1000—from the client's close relative and then selling the same to the client at a higher price.

# 4. Effect of Islamic Banking on Economy and Economic Life

The following effects are anticipated:

- The real and financial sectors in the economy will be better integrated, as compared to what one finds in interest-based economies.
- Both what the governments do and the way in which they work, will change. This will mainly stem from the fact that without tax revenues, governments may address only those needs for which an economic transaction—other than pure loan transaction—can be defined between the government and the financiers. Economic considerations will in the long run lead to development of "Fiqh for Government" that would regulate economic activity at the government level.[5]
- Inter-bank money market and central banking will take new form. New matrix of Shari'ah-compliant divisible and tradable financial instruments and the Shari'ah parameters for contracts will give shape to this development.[6]

  While the above happens, the regulators will also have to ensure compliance with Basel requirements for international acceptability of Islamic banking. In cases of no conflict between the Shari'ah parameters and the

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[5] Note that Ahkam in the Qur'an and Sunnah are primarily at the individual level. In the past, Fuqaha did draft rules for governance. But those are of a recommendatory, rather than mandatory, nature. A modest attempt at developing fiqh for government is made in Chapter 5 of *IIIE's Blueprint of Islamic Financial System* (Islamabad: International Institute of Islamic Economics, 1999).

[6] See, for example, Chapter 7 of *IIIE's Blueprint*, *op. cit.* There is need for comparative study of the developments in Iran, Sudan and Malaysia.

Basel requirements, there would be no problem. However, where conflict arises, there will be need (1) to design Shari'ah-compatible ways for compliance with the Basel requirements and (2) to sell the same to the international regulators.

- Accounting and financial management may undergo major changes. This would happen because Islam has different position on ownership, rules for transactions and the financial instruments.
- Islamic banking will lead to better business ethics because banks will entertain only economically viable financing requests. Note that the said transformation shall take place even without prior moral uplift of the society for Islamic banking. Careful design of Islamic financial instruments will discourage unscrupulous behavior by fund-seekers.

## 5. Effect of Islamic Banking on Various Disciplines

**Fiqh:** A change is already taking place. Instead of thinking within the narrow domains of Hanafi, Maliki, Shafie, Hanbali and Ja'fari fiqhi schools, contemporary fuqaha are joining hands and looking for common ground that best suits contemporary needs.

OIC Fiqh Academy and AAOIFI provide formal international platforms. Individual Islamic banks have either international representation on their Shari'ah Boards or they are open to international influences.

**Accounting, Financial Management, Marketing and Bank Management:** When full significance of the Shari'ah is recognized, these areas will change. The impetus will come from, among other factors, Islamic concept of "rights" (based on Islamic view of ownership) and permissible forms of transactions.

**Economics:** New economics will emerge for the new economic setup. Changes will be more noticeable in the areas of macro and monetary economics.

**Public Policy:** A paradigm shift will take place due to changes in what governments may do and the ways in which they would work.

## 6. Some Other Relevant Points

6.1 With Islamic banking gaining ground, new challenges are already emerging for redrafting the rules for international trade and accommodating Shari'ah-compliant foreign trade financing. A good deal of work has been done, but a lot more is needed.

If Islamic financing is adopted at the state level, inter-governmental financial flows will change, in both form and size.

6.2 Forces of the status quo will always resist change. Hence, every now and then issues would be raised about what riba is or what it is not.

6.3 Government finances will remain a problem in the way of Islamic banking until sufficient new financing tools are developed and a consensus develops on the economic and social role of government.

6.4 While the thrust of the present efforts in Islamic banking is on the financing side, matters related to liability side of Islamic banks will become an issue in future. The way in which Islamic banks look after interests of various groups of depositors and what they actually do, both are likely to become an issue.[7]

## CONCLUDING OBSERVATIONS:

"Highly ethical, well-regulated and beneficial Islamic financial architecture is possible. Indeed, working in this field with more transparency, with effective corporate governance and with better interaction with relevant international, regional and national institutions, will definitely help all [those] who want to contribute to the welfare of their community as well as to the welfare of the world as a whole.[8]

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[7] Chapter 4 of *IIIE's Blueprint*, *op. cit.*, throws light on some of the relevant issues.

[8] The author owes these observations to Dr. Tahir Memmi of the IDB, Jeddah.