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Islamic finance: more expectations and less disappointment

Abstract

Islamic finance has faced a two-fold criticism from scholars; viz. constructive criticism and destructive criticism. Majority of the scholars criticize it with the intention to improve its overall development, but some scholars are more negative in their criticism. This paper proposes that Islamic banks (a component of Islamic finance) are not charitable institutions, but are the intermediary institutions that take care of investors' expectations to keep the time value and return to their investments intact with the market fluctuations. The purpose of this paper is to provide better insight about Islamic finance so as to further improve this industry to achieve its long term goals and serve the society better. The paper also attempts to answer some of the common allegations imposed by scholars towards Islamic finance.

Keywords: expectations, Islamic banking, constructive criticism, destructive criticism, allegations banking.

JEL Classification: G2.

Introduction

In the last couple of decades, the progress of Islamic finance in the world has been satisfactory. After the establishment in the 1970s, the annual growth rate of modern Islamic banks for last 15 years is estimated to be around 14% (Sarif, 2011). However, a fair stream of research has also been conducted to disprove the escalating progress of Islamic banking. It is also evident that people have more expectations from Islamic finance and economists across the globe have eye on it. Some scholars have put some allegations towards Islamic finance which when observed keenly fail to prove the same. It also looks that many scholars fail to understand what Islamic finance is, and they label Islamic banking same as the Islamic finance. Many scholars write against Islamic finance with an intention to improve this system by criticizing it constructively, but some scholars are criticizing it for the sake of criticism and most of their allegations seem to be far from truth. While going through the literature on Islamic finance, the author has found many articles that criticize Islamic finance constructively and few

articles that have a destructive criticism approach. Therefore, we assume it to be necessary to first understand the basics of Islamic finance so as to answer the most common allegations based on the Islamic finance principles.

1. What is prohibited in Islamic finance?

In Islamic finance, many kinds of transactions are prohibited. These transactions are prohibited because they contradict with the economic and financial principles of Islam. As Islam is not just a religion but a 'Deen' which means a complete way of life. Therefore, all types of transactions, whether banking or non-banking, have to follow certain Islamic principles. Therefore, Islamic financial contracts have a strong potential to serve the Maqasid Al-Shariah (Gundogdu, 2016) which is the core area of Islamic finance. Maqasid Al-Shariah is the fundamental logic behind Islamic financial system and the operating guidelines of Islamic finance are drawn from the same. Islamic banking is based on some rules that are explained briefly in Figure 1.

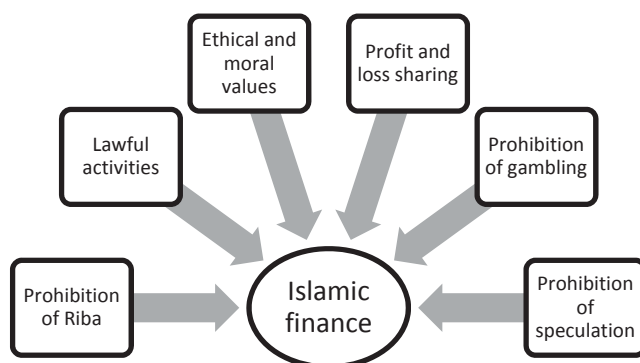


Fig. 1. Basic rules of Islamic finance

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- ◆ **Prohibition of Riba:** Riba is an Arabic word which means ‘interest’. It is the pre-determined rate of interest and is forbidden in Islam. To take care of Riba, an alternative system has been introduced, known as the Islamic economic system.
- ◆ **Lawful activities:** all activities which are unlawful are forbidden in Islam and, therefore, forbidden in Islamic finance as well.
- ◆ **Ethical and moral values:** Islamic ethical and moral values are the fundamental guidelines for the working of Islamic finance. Whatsoever is ethically and morally allowed in Islam is totally accepted by Islamic banks and financial institutions and vice-versa.
- ◆ **Profit and loss sharing:** there is no pre-determined rate of interest in Islamic finance. Rate of return depends upon the actual market condition in the particular market economy. In Islamic finance, risk is shared and not transferred on the borrower or entrepreneur.
- ◆ **Prohibition of gambling:** acquisition of wealth by chance is not allowed in Islam and, therefore, conventional insurance is treated same as gambling. Gambling is prohibited by Quran in many verses (like chapter 2: verse 219 and chapter 5: verse 93).

Prohibition of speculation: speculation means uncertainty. It is anything where end result is hidden or the risk is equally uncommon. An example of speculation is the purchase of the

unborn animal in the mother’s womb or the sale of the milk in the udder without measurement. Transactions involving speculation are also prohibited in Islamic finance.

2. Sources of Islamic financial product development

Islamic financial products are not developed on its own by taking profit and market return into consideration. A number of other issues are incorporated in case of Islamic financial product development process. So, Islamic banking products are not like conventional banking products, where only return is taken into consideration. Islamic products have to pass through different stages before they are issued in the market. The stages through which Islamic product passes are screened through *Ijma* (Consensus), *Qiyas* (anology), *Ijtehaad*, in addition to Quran and Sunnah. If the product does not violate the rules and principles laid down in these stages in a chronological order, then only that product is approved by *shariah* scholars and finally approved for Islamic banks. Products that pass the screening process at all stages are issued by Islamic banks to its customers, while as products that die in this screening process because those violate the rules and principles of Islamic finance are not approved by *shariah* scholars to be issued to customers. The screening process in a chronological order is shown in Figure 2.

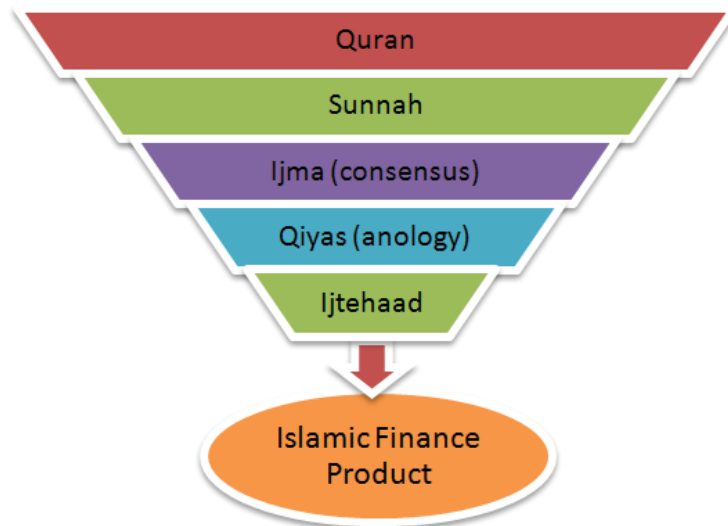


Fig. 2. Screening process of Islamic financial product development

3. Objectives of Islamic finance

The objectives of Islamic finance can be divided into four categories (as shown in Figure 3); which include economic, Islamic, ethical and social objectives (Lone, 2016). All these objectives are important for Islamic banks so as to serve the customers well. If any Islamic bank fails to achieve any of these objectives then that bank cannot survive in the

market from an Islamic as well as an economic perspective. It is, therefore, compulsory for banks to keep these objectives into consideration while offering different products to their customers. On the other hand, conventional banks do not have these all objectives. Their thrust is mostly to maximize the profit and provide better return to owners. Taking these things into consideration, it is evident that the

objectives of Islamic banks are broader than conventional banks. Also, Islamic finance functions under standard ethical and moral principles, which prohibits many kinds of business transactions from which more rate of return could be expected. But these moral principles make Islamic banking safe during fluctuations in the economy like global recession in 2008-10 (Chapra, 2011). In addition,

Islamic finance is based on risk sharing and not risking transferring, so as to avoid bulk loss or bulk profits in business. The doctrine of more risk and more return is replaced in Islamic finance with less risk and less return. Accomplishing these objectives may decrease the profit percentage of Islamic banks in the short run, but in the long run, it increases the stability and positive impact on the society.

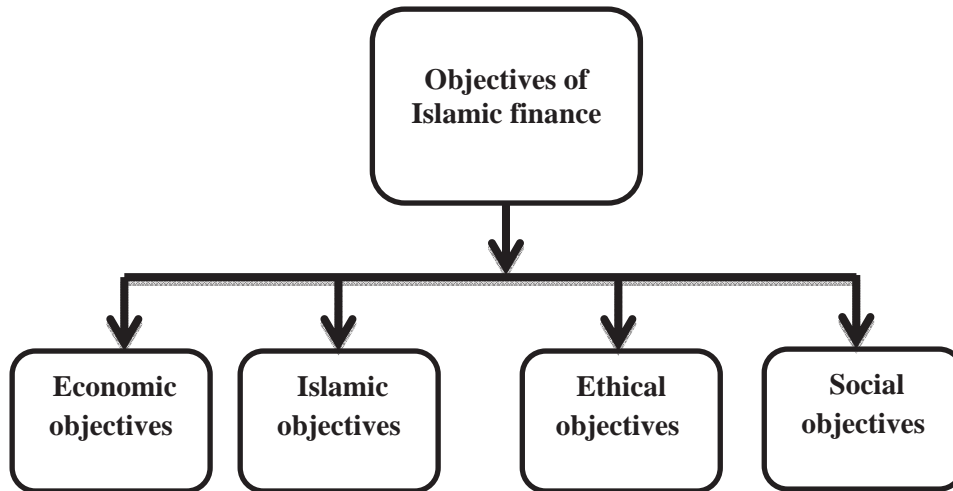
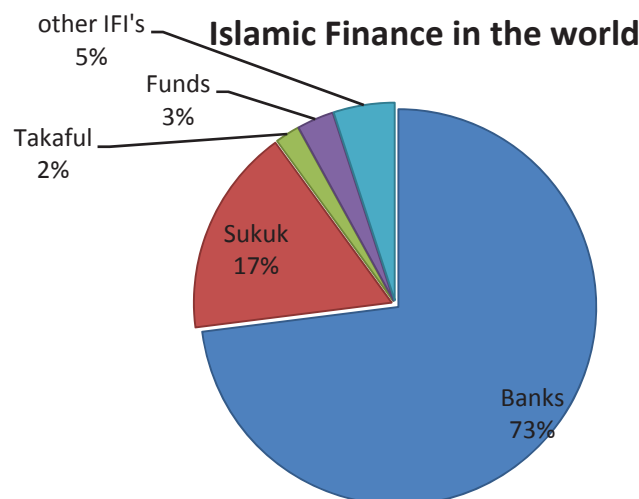


Fig. 3. Objectives of Islamic finance

4. Development of Islamic finance

Comparing Islamic finance with conventional finance in terms of its size is not justified. Comparing a financial system which is present in 196 countries with a system which is not fully present in a single country (but as a dual system in 20-30 countries with a small percentage on average) is not justifiable.

Besides, comparing a system that is prevailing for centuries with a system that is just few decades old and having more expectations from this in terms of growth and return is also inconceivable. While breaking the Islamic finance into different segments, 73 percent consist of banks, 17 percent *sukuk* and so on (Please see Figure 4).



Sources: Compiled from Thomson Reuters data of 2014.

Fig. 4. Breakdown of Islamic finance into different segments

The history of Islamic finance is new as its practical shape started in 1970s. It was a concept in books and giving it a practical shape was difficult because people were not sure of its success. But with the success of first modern Islamic bank, i.e., Dubai Islamic bank in 1975 (Lone et al., 2017), many Is-

lamic banks were started in different countries in the world (Islam and Rahman, 2017). Today maximum numbers of Islamic banks are operating in Malaysia which has become the hub of Islamic finance. Table 1 shows the name of bank and country with establishment year in a chronological order from 1975 to 2010.

Table 1. Name of Islamic bank with the date of establishment and country

Bank name with country	Year of commencement
Bank Al Jazira (Saudi Arabia), Dubai Islamic Bank (UAE), Sharjah Islamic Bank (UAE)	1975
Kuwait Finance House (Kuwait), Kuwait Finance House (Indonesia)	1977
Jordan Islamic Bank (Jordan), Faisal Islamic Bank (Sudan)	1978
Bahrain Islamic Bank (Bahrain), Faisal Islamic Bank of Egypt (Egypt), Bank Mellat (Iran)	1979
ABC Islamic Bank (Bahrain), Kararafin Bank (Iran)	1980
Qatar Islamic Bank (Qatar), Islamic Co-operative Development Bank (Sudan)	1982
Tadamon Islamic Bank (Sudan), Islami Bank Bangladesh Limited (Bangladesh), Bank Islam (Malaysia)	1983
Al Baraka Bank Bahrain (Bahrain), Al Baraka Bank Sudan (Sudan)	1984
AlBaraka Turk (Turkey)	1985
Bank Tejarat (Iran), ICB Islamic Bank Limited (Bangladesh)	1987
Al Rajhi Bank (Saudi Arabia)	1988
Kuveyt Turk Participation Bank (Turkey)	1989
Al Baraka Bank of Algeria (Algeria), Perbadanan Tabung Amanah Islam Brunei (Brunei), Bank Muamalat Indonesia (Indonesia), Al Baraka Islamic Bank (Pakistan)	1991
Iraqi Islamic Bank (Iraq), Al-Baraka Bank Lebanon (Lebanon), Qatar International Islamic Bank (Qatar)	1992
Takaful Indonesia (Indonesia)	1994
Palestine Islamic Bank (Palestine), Qatar Islamic Insurance Company (Qatar), Tadhamon international Islamic bank (Yemen), Al-Arafah Islami Bank (Bangladesh)	1995
Citi Islamic Investment Bank (Bahrain), Bank Asya (Turkey)	1996
Abu Dhabi Islamic Bank (UAE), Saba Islamic Bank (Yemen), Meezan Bank Limited (Pakistan)	1997
Islamic International Arab Bank (Jordan), HSBC Amanah (UAE)	1998
First Security Islami Bank Limited (Bangladesh), Bank Shariah Mandiri (Indonesia)	1999
Persian Bank (Iran), Islamic Finance and Investment Limited (Bangladesh), Shahjalal Islami Bank Limited (Bangladesh)	2001
Saman Bank (Iran), Dubai Bank (UAE)	2002
Ithmaar Bank B.S.C. (Bahrain), Arab Finance House (Lebanon), Export Development Bank (Sudan)	2003
Khaleeji Commercial Bank (Bahrain), Bank Albilad (Saudi Arabia), Emirates Islamic Bank (UAE), Bank Syariah Mega Indonesia (Indonesia), Bank Islami Pakistan Limited (Pakistan)	2004
Lebanese Islamic Bank (Lebanon), Türkiye Finans Katılım Bankası (Turkey), Bank Islam Brunei Darussalam (Brunei), Hong Leong Islamic Bank Berhad (Malaysia), Asian Finance Bank Berhad (Malaysia)	2005
Al Salam Bank Bahrain (Bahrain), Syria International Islamic Bank (Syria), Cham Bank (Syria), EONCAP Islamic Bank (Malaysia), Al Rajhi Bank (Malaysia)	2006
Jordan Dubai Islamic Bank (Jordan), International Bank of Kuwait (Kuwait), Alinma Bank (Saudi Arabia), Noor Islamic Bank (UAE), Ajman Bank (UAE), Emirates Global Islamic Bank Limited (Pakistan), Dawood Islamic Bank Limited (Pakistan)	2007
Al Hilal Bank (UAE), Bank Syariah Bukopin's (Indonesia), Maybank Islamic Berhad (Malaysia), Standard Chartered Saadiq Berhad (Malaysia), HSBC Amanah (Malaysia), Public Islamic Bank (Malaysia)	2008
Capinnova Investment Bank (Bahrain), Zaytuna Bank (Tunisia)	2009
Ahli United Bank Kuwait (Kuwait), CIMB Islamic Bank Berhad (Malaysia)	2010

Sources: compiled from websites of Islamic banks.

5. Common allegations and their genuineness

There are many allegations imposed by scholars on Islamic finance. Among them some allegations are genuine and need attention. But most of the allegations imposed are either due to little knowledge about Islamic finance or just for criticism. While going through many papers written on the similar issues of Islamic finance, as discussed earlier, it is important to first provide a general understand of Islamic finance.

The operating structure of Islamic banking includes windows model, branches, subsidiaries and full-fledged banks. Among these, windows system in conventional banks is not considered a viable option of Islamic banking in many countries. But practically many conventional banks have Islamic banking windows to offer Islamic banking options to its customers. An example of such a case is mostly found in Malaysia, where 4 conventional banks have 1335 branches where Islamic banking products are

issued. In the same country, Islamic banks have only 122 branches (Ariff & Rosly, 2011). There are many advantages of having Islamic windows in conventional banks, such as extensive branch network and trust of customers. Usually windows system is preferred in a country, where Islamic banking is expected to attract the maximum market and also as a pilot program in a country, where Islamic banking has just started. The condition for conventional banks to offer Islamic products and services through windows system is the separation of accounts for a distinction between Islamic and conventional transactions. Additionally, if a conventional bank offers Islamic window system, there is a trust among customers that their money is safe as compared to the bank, which is new to commence operations in an Islamic way.

Many scholars consider Islamic banks as charitable institutions and expect them to do more social work than commercial activities (Asutay, 2007). However, Islamic banks are not charitable institutions, but are working as an intermediary between the depositor and lender. Islamic banks receive deposits from customers and invest the same amount through different ways to generate return, as well as take into consideration the time value of money. In Islamic banking, profit is earned through trade (*al-bay*) by properly managing risk taking (*ghorm*), work and effort (*kasb*), and responsibility (*daman*). Therefore, In Islamic banking, a contract is based on exchange of money with an underlying asset, while as in conventional banking, contract is based on exchange of money with money (interest) (Ariff & Rosly, 2011). Besides, Islamic finance is a broader concept and includes banks, equity and capital market, *waqf* and *zakat*, and *takaful*. Islamic banking is one component of Islamic finance. The charity work is done usually through 'waqf and zakat' component of Islamic finance. Banks have different objectives, while as 'waqf and zakat' has different objectives. The best model for poverty eradication or charity model in Islam is given by Kaleem and Ahmed (2010), which is based on *Zakat* (compulsory charity), *Sadaqat* (optional charity) and *Qard Hasan* (interest free deposit). In accordance with the Islamic principles, these three sources are received from rich people and are used for different purposes to eradicate poverty from society. In the real sense, Islamic banks have to do other functions and not to become charitable institutions. To understand Islamic banking well, Islamic banks and financial institutions (IBFIs) are not charitable institutions, where customers can take the loan and not return on time or as per the agreement. The IBFIs are the institutions like conventional institutions with the only difference of *shariah* compliance. The IBFIs also have to pay rate of return and bear the daily opera-

tional expenses like conventional institutions. Islamic banks are also required to monitor the investment of borrowers so as to report actual profit and loss of the businesses. Islamic banks are also required to monitor the borrowers' business activities (Chong & Liu, 2009). This banking has to adopt such a system that helps it avoid sanctioning of loans to such people, whose loyalty and trust is doubtful.

Another allegation is that Islamic banking is more based on *Murabahah* than *Musharakah* and *Mudharabah*. For this evidence, Iqbal and Molyneux (2005) have collected ten samples from the year 1994-1996. In these three years, it was calculated that *Murabahah* is 70% of the total finance. Most of the criticism is on *Murabahah* model and it is interpreted that they are similar to conventional banking (Kuran, 2004), which is not so actually. In the *Murabahah* model, the customers do not purchase the product directly from the company but from the bank (which purchases it on behalf of customer) and pays the amount in deferred instalment basis with a markup cost. The ownership of the asset remains with bank until the maturity of the contract (Shaban et al., 2014). If this principle is followed, then *Murabahah* product is Islamic as per the existing ruling of Islamic finance scholars. Some banks may not be following the principles of *Murabahah*, therefore, those banks can be blamed but not the system. The *Murabahah* contract reduces asymmetric information, which is associated with financing assets from banks. In *Murabahah* contract, decision making, management and control remains in the hands of the entrepreneur and not the bank (Dar & Presley, 2000). While calculating the country profile of Islamic banking products, Malaysia is the largest Islamic financial market in the world in terms of banking, capital and insurance (World Bank, 2006). But in Malaysia, only 0.5% of Islamic banks investment is based on profit and loss sharing basis and deposits in Islamic banks are similar to conventional deposits. Profit and loss sharing practice of Islamic banks is closely pegged to conventional banking deposit rate setting (Chong & Liu, 2009). Also, in Malaysia Islamic banks are not different from conventional banks and the alleged benefits of Islamic banking exist only in theory, but not in practice. The logic behind *Murabahah* contract in the world is that 90 percent of transactions relate to trade finance (*Murabahah*), and the remaining 10 percent are either project finance or *sukuk* in Islamic banks (Gundogdu, 2016).

Islamic banks should finance at individual level for minimizing risk and attracting investments. Financing a huge amount to any company is not possible to a bank, which is of recent origin and at the growing stage. With the passage of time, when Islamic banks

get financially sound, there will be a shift from *Murahabah* to *Mudarabah*. In *Mudarabah* contract, the entrepreneur takes more risky projects as he/she bears no losses at all (Chong & Liu, 2009). However, Islamic banks always provide finance to rational individuals, who can understand the market fluctuations and invest accordingly. Bank (*Rab-ul-Mal*) is the provider of finance to the entrepreneur (*mudarib*), who utilizes his/her specialized knowledge and starts the venture. In case of profit, it is shared as per pre-agreed ratio and in case of loss, bank bears the financial aspect, while as entrepreneur loses his time and expertise. For such type of transactions, it is necessary for banks to thoroughly examine the project of an entrepreneur before making the contract, so as to understand where, how, and for what purpose the bank makes a partnership with an entrepreneur. It is true that long term financing was missing in Islamic banks (Aggarwal & Yousef, 2000) before 2009, but with the establishment of many banks, Islamic banks are now providing every kind of finance. Additionally, before 2009, Islamic banking was a niche market, where concentration was mostly towards short term financing. It is because Islamic banking was new and the deposit rate was not as high as it is today.

Another allegation imposed is that Islamic banking does not encourage entrepreneurship in the world as does the conventional banking. This allegation is also not fair. Islamic banks in Turkey provide more finance for micro, small and medium-sized enterprises (MSMEs) than conventional banks (Aysan et al., 2016), therefore, contribute more to the development of business in Turkey as compared to conventional banks. Therefore this research argues that Islamic banks encourage entrepreneurship more than conventional banks. It is because Islamic banks have to strike a balance between their objectives, in which social objectives are prime.

Some scholars have considered Islamic banks to be the same as conventional banks. In support of this argument, Azmat et al. (2015) have quoted the balance sheet example of Islamic banks, where deposits are shown on liabilities side and debt contracts on assets side. The authors have suggested that Islamic banks should select such a model of finance wherein there is more return and less risk. However, considering the fact that Islamic banking is based on both profit and loss sharing and not loss transferring, therefore, this logic becomes non-functional in practical sense. Second argument presented by the same scholars is that Islamic banks have to report their financial statements in the same way as conventional banks, except for few changes. But the findings of Azmat et al. (2015) are in contradiction with the findings of Aysan et al. (2016), who argue that

Islamic banks have better competence than conventional banks in the management of non-performing loans. Therefore, it would be unfair to view these two banking systems as the same.

One of the most common misunderstanding among non-Muslim customers is that Islamic banking is for Muslims only and, therefore, non-Muslims as well as non-Muslim countries will not prefer this banking. This allegation is against the Islamic banking objectives. Islamic bank of Britain is the first Islamic bank to get the license to commence its functions in a non-Muslim country (Chong & Liu, 2009). After the establishment of this bank, many more Islamic banks were established in non-Muslim countries in the world. It is true that this banking does not exist in many non-Muslim countries yet. However, practitioners are now focusing to expand this banking to the non-Muslim majority countries. For this purpose, it is suggested to change the tag Islamic from the name of banks but keeping the principles of banking as the same.

Many scholars have this perception that Islamic banking will not absorb the macro economic shocks in the world as this banking is new to the market. But, the same allegation was proved wrong during financial crisis. In financial crisis, Islamic funds performed better than conventional peers in Malaysia, especially in equities (which are more risky) and also Islamic funds performed better before and after financial crisis during the period 1996-2013 (Boo et al., 2014). Islamic banks were more immune to the 2008 financial crisis than conventional banks (Ebrahim et al., 2016). All these financial crises have proved that the Islamic banks absorb economic shocks better than the conventional banks both at micro and macro level.

Another highly criticized issue is that Islamic banks offer different products in different countries through different principles, and scholars question the lack of universalization in Islamic banking. Islamic finance should have single regulatory system so as to monitor the Islamism of its financial products (Cynthia Shawamreh, 2013). For this purpose, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has played an important role for preparing common laws for accounting, auditing, governance, ethics, and *Shariah* standards for Islamic banks and financial institutions. However, it is not possible to generalize it at a global level yet as different countries have different laws for both Islamic and secular orientations. Some countries strictly follow Islamic rules, whereas others partially do. For the countries which Islamic laws Islamic banking is easy to establish fully but on the other hand, countries where Islamic laws are followed partially; it is difficult to fully implement the Islamic banking. While comparing Islamic banking

with conventional banking (having a long history), there is still no universalization in conventional banking due to the diversity in laws across countries. For example, International Accounting Standards Board (IASB) has tried to universalize the accounting system, but failed to do so due to a multitude of reasons. Therefore, we cannot expect a quick universalization of the Islamic banking system which is still in its infancy stage.

Conclusion

Development of Islamic banking favors macroeconomic efficiency (Gheeraert & Weill, 2015) and, therefore, develops the infrastructure in the country, where it operates. Not only this, there are many other aspects which Islamic banking is taking care of. The development of Islamic banking provides many alternatives to the country for boosting the economic sectors, where there is risk and offers good returns if successful. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is taking the accounting, auditing, governance, ethics, and Shariah standards aspects and provides professional training and qualification programs for Islamic finance industry professionals (Cynthia Shawamreh, 2013). With the help of AAOIFI, Islamic banking has developed at par with conventional banking in addition to the compliance with the *shariah* and ethical aspects.

This paper concludes that the criticism on Islamic finance is both constructive as well as destructive.

There are some contradictory opinions about the operation of Islamic finance and its ideas and practices among scholars (e.g., Khan, 2010; Khan, 2015; Kuran, 2004; Kuran, 2012). But overall, majority of scholars have criticized it constructively. The reason for this constructive intention to improve this system is the extraordinary progress that Islamic banking system has shown from the last few decades and that Islamic finance in future is foreseen to flourish very quickly due to its unique ethical and moral principles, which every society expects from the financial system to solve their day to day financial problems in an efficient and effective manner.

The intention of many scholars is not clear while writing against the Islamic finance. It is necessary to read thoroughly the works done by such scholars. While trying to do the same, author has found one such, scholar who first criticized Islamic economics (Kuran, 2004) based on many points like Islamic economics is irrelevant to present economic challenges but later the same scholar criticized Islam (Kuran, 2012) itself. Therefore, it is clear that such scholars have problem with Islam and not the Islamic financial system. Their criticism has no value in academic literature except to please those who are against Islamic system. Another author has criticized Islamic finance from many angles and one such criticism is that there remain substantial divergences between IBF's ideals and its practices (Khan, 2010). Later the same scholar has suggested ways to making Islamic banking even more Islamic (Khan, 2015).

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