*Readings in*

# Islamic Banking

## Theory & Practice


*Compiled, Classified & Edited By*

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Bangladesh Institute of Islamic Finance (BIIF)

বাংলাদেশ ইনস্টিটিউট অব ইসলামিক ফাইন্যান্স (বিআইআইএফ)

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*Readings in*

# Islamic Banking: Theory & Practice

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# PART III MANAGING ISLAMIC BANK

# INTRODUCTION

Need for developing a series of readings materials on Islamic economics and finance arises from the dearth of academic literature or textbooks meant for undergraduate and graduate students at universities particularly in Bangladesh. Islamic banking and finance, currently a $3 trillion industry in about 75 countries of the world, is a rapidly growing sector side by side with the conventional financial system worldwide. There is a growing interest on the concept, operational procedures of Islamic economics and finance in general and Islamic banking in particular. This is the 4th of the 10-series readings books meant for meeting the quest.

## A. Structure of the Readings Series-4

The series including this one are prepared following stylish standard syllabuses fit to the requirements of appropriate university level curricula adhering to object-oriented and outcome-based education (OBE) scheme. The 3-part book of the series-4 consists of 14 chapters. Contents placed under each part and chapter vividly reflect depth and breadth of the content and structure of the reading series.

Readings in Islamic Banking: Theory and Practice, like other ones in the series, is a compilation of judiciously selected professional articles published in journals of international repute. While selecting the articles for a chapter from among host of similar articles, due attentions have been paid to the authority of author as well as standard and reputation of the journals in which these are published. An overview on the structure of the book below may provide instant sense of what the book is all about.

The book is structured in four parts: Part I: Part I Evolution and Theorization of Islamic Banking; Part II: Functioning and Operation of an Islamic Bank; and Part III: Managing Islamic Bank.

## B. Contents Covered

### I. Evolution and Theorization of Islamic Banking

Part-I, comprised of chapter 1 & 2 of this readings series, illustrates the historical development of Islamic banking industry (Al-Harbi, 2015), Moniruzzaman examines insights into the growth and prospect of Islamic banking and finance in Bangladesh (Moniruzzaman, 2018).

In Chapter-2, investigation on the clarification of the concept, basic features and theorization attempts of Islamic banking have been made by Khaki et al (2011) (; Prabakaran et al (2019), Hanif (2011); and Iqbal, M. (2011).

Khaki mentions, an Islamic society is based upon righteousness and mutual help as laid down in the holy Quran: “Help ye one another unto righteousness and piety, but help ye not one another unto sin and transgression” is the call of *Qur’an*. He refers that an Islamic bank does not normally lend money except interest-free loans termed as *Qard Hasanah* (Benevolent Loans), while loans on service charge, not exceeding the actual administrative cost of such loans, have also been permitted by Muslim Scholars (Muslehuddin, 2008). To replace interest, the ideal mode of financing under the Islamic banking system is "Financing on Profit & Loss Sharing" (PLS) basis. *Qard Hasanah* are for the benefit of the individuals and the society at large, provided the institution of *Zakat* and the Islamic State treasury start functioning as preconditions for successful operation of *Qard Hasanah* (Khaki, 2011).

*Hasanah* (Benevolent Loans) while loans on service charge, not exceeding the actual administrative cost of such loans, have also been permitted by Muslim Scholars (Muslehuddin, 2008).

Prabakaran V, & Balaraman, P. (2019) refer definition of Islamic banking by Sundararajan (2011) that “consists of mobilizing funds through non-interest bearing deposits and through investment deposits based on“profit-sharing and loss-bearing” contracts and channeling these funds to finance permissible (under the Shari‟ah law) investment activities, using various forms of Islamic finance contracts.”

### II. Functioning and Operation of an Islamic Bank

**Part-II** Hanif (2011) attempts to address the perceptional issues by identifying the similarities and differences in Islamic and conventional banking. Iqbal (2015) identifies the relative importance of various Islamic financial products, in theory and in practice, by examining the financing records of the Bank Islam Malaysia (Berhad) and the Bahrain Islamic Bank.

(Chapters 3-11) deals with functioning and operation of an Islamic bank. In Chapter-3 Ahsan et al (2008) and Ausaf Ahmed (1994) discusses contemporary practices in terms of mobilizing sources of funds for an Islamic bank and these are invested through number modes of its own compared to its conventional counterparts having some similarities and dissimilarities among them.

Chapter-4 takes care of liquidity management by Islamic banks with contribution from Muhammad Ayub (2017) looking into Malaysian experience in liquidity management, and Mobin et al (2017) and Dolgan and Mirakhor (2019) putting forward a proposal designed for calibrating liquidity coverage ratio.

In the Chapter-5 while dealing with investment financing issues brought into discussion by Hanif & Iqbal (2010) & Agarwall & Yousef (2000) on Islamic financing and business framework; and by Dar & Presley (2000) coining lacking in Profit-loss sharing practice in Islamic banking as management and control imbalance.

Chapter-6 devoted to project financing by Islamic banks and contributed by Zawawi, Ahmad, Umara, Khamidi & Idrus (2014), Alexander (2011) & Rarasati et al (2019) dealing with PF2 project financing, shifting title & risk in project financing, and allied implementation barriers therewith respectively.

Akbar & Akbar (2016), Aslam, Ijaz & Iqbal (2016), and Ullah, Jan & Khan (2017), and Shampa (2015) dealing respectively the working capital investment financing related to corporate performance, financing structure impact on profitability, working capital finance through murabahah, and assessment of relationship between working capital management and return on equity in Chapter-7.

Chapters 8, 9 & 10 discusses micro-financing, real estate financing, discounting techniques and their applications from Islamic perspective.

Chapter-11 presents a Shariah model for Foreign exchange operation by Masum Billah (2016), and challenges faced by Islamic banks in financing international trade by Muhammad, Amin, Amin, Anderson & Chong (2015).

**III. Managing Islamic Bank**

Part III (Chapter-12-14) analyses risk management, accounting and management information system, and governance of Islamic banking operation.

*Risk Management*

In Chapter-12 Ahmed & Khan (2007) examine the nature of risks in Islamic banks. After defining and identifying different risks, they report on the status of risk management processes in Islamic banks. Then specific issues related to risk measurement and mitigation in Islamic banks are discussed. Rahman et al (2014) explains the development of the Islamic banking environment in Malaysia and Jordan and summarizes the theoretical framework and empirical evidence that could be used to explain the importance of rigorous risk management practices in the industry. Ghenimi & Omri (2015) analyze the management of liquidity risk for Islamic banks and Conventional banks and add to the growing literature studying the determinants of liquidity risk.

*Accounting and Information Management System*

In Chapter-13 Haniffa & Hudaib (2011) review literature on IPA and find some weaknesses as reported by them including failure to recognize the political and economic constraints that exist in the development of IPA and the neglect of a comprehensive discussion on the aims, principles and role of accounting from the Islamic perspective at both the micro and macro levels. Hence, they argue that instead of adapting or modifying the current conventional accounting based on Western ideas, there is a need to build a theoretical framework for IPA if it is going to be accepted as a 'new' paradigm in accounting.

*Governance of Islamic Banking System*

While discussing governance issues relating Islamic banks under Chapter-14, Khan, M. M. (2019) provides (1) a brief literature review on *Shari'ah* standards and practices in Islamic banking practice; (2) explores the primary policy instruments of the Islamic banking model from *Shari'ah* perspectives; (3) analyses the market-based and *Shariah*-based features of Islamic banking products and services offered by Islamic banks worldwide; and (4) explores practical difficulties faced by Islamic banks in operating on Islamic lines, followed by (5) an objective study findings incorporated in the summary and conclusion, mentionable a few among these are:

a) Islamic banking substitutes the interest-based financial intermediation with a risk-sharing and interest-free intermediation. However, there are reservations on their blindly following the same conventional banking practices under the auspicious of their Islamic *Shari'ah* boards. Islamic banks almost ensure guaranteed and fixed returns on their lending and borrowing products and services. They have failed to take truly rigorous R&D to develop their own tools, systems and a wide spectrum of truly efficient and *Shari'ah*-compliant products for Muslim clientele and other market players.
b) Islamic banking leadership and *Shari'ah* governance are primarily responsible for gross *Shari'ah* violations at Islamic banks, lack a genuine interest in developing their own dynamic leadership and workforce with *Shari'ah*-cum-technical knowledge and skills. The majority of Muslim society and market players hold gross misgivings and doubts about the originality of worldwide Islamic banking practices. Islamic banks face the biggest challenge of establishing their religious and ethical legitimacy among Muslim businesses and communities. There is a pressing demand on Islamic banks to develop genuinely Islamic and innovative products and services to remain competitive and maintain ethical entities in the global business and finance.

Bouheni (2015) reviews the theoretical and empirical research on the main mechanisms of banking corporate governance, the features of Islamic banks and their problems, and proposes recommendations such as: In theory, Islamic finance differs significantly from conventional finance. Specifically, Shari'ah-compliant finance does not allow the charging of interest payments (Riba), and it relies on profit-loss sharing (PLS) principle. There are clear differences in funding and activity structures of Islamic and conventional banks. In practice, however, Islamic scholars have developed products that match with conventional banking products, by replacing interest rate payments and discounting with fees and contingent payment structures (Beck *et al*. 2013). The goals of Islamic banks are: achievement of a pattern of growth; eradication of poverty; equitable distribution of income and wealth; and opportunities for gainful employment. In addition, the competitiveness of many of Islamic products and the PLS principle attract Muslim and non-Muslim investors. Unlike a conventional bank that is a borrower and lender of funds and it is guided by the "maximization of value", an Islamic bank is essentially a partner with its depositors, and also a partner with stakeholders.

Faruk & Hassan (2007) studied the banking system as well as the regulatory environment of Islamic banking in Bangladesh. They focus on the shortcomings of the regulatory framework and suggest how the deficiencies therewith can be overcome. They evaluate also how Islamic banking can be a viable alternative to conventional banking in Bangladesh. In this regard, they explain the main differences between a conventional interest-based banking system and an interest-free Islamic banking system. They observe that Islamic banks in Bangladesh came into existence with certain objectives, in line with the philosophy of Islamic banking, that imply a direct and specific responsibility on their part to play an effective role in the socioeconomic development of the country. It is apparent that Islamic banks have concentrated on short-term commercial activities to maintain their place in the market. However, achieving and maintaining high profit is also essential for the success of the system.

Although the existing *Shari'ah* principles of banking and finance are considered sufficient to facilitate all modern banking products and services, they should also include laws, practices, procedures, and instruments that help in the maintenance and special consideration of distributive justice and equity.

The spread of Islamic banking in the country would improve the interregional flows of funds, reduce the disparities in the cost of borrowing, and mobilize investment resources in the rural areas to improve the living standards of the small and marginal farmers. Issues of poverty and unemployment are major ones. Being one of the poorest countries in the world and with limited job opportunities, a large number of university graduates in Bangladesh are unemployed. Islamic banks could play an active role through their welfare-oriented activities to create job opportunities for the graduates.

*Bai' murabahah*, or markup-based financing, has gained a singular momentum in Islamic banking operations in Bangladesh. In order to contribute more for the economic development of the country and to encourage their customers to have investment accounts in the banks as well, Islamic banks in Bangladesh should put more of an emphasis on the long-term financing based on *mudarabah* and *musharakah*, which are considered as the chief alternative to *riba*. It is thus proposed that Islamic banks in Bangladesh try to incorporate the principles of the PLS mechanism in their current investment decision and increase the PLS ratio in total investment through implementing special clientele and project-development programs on an urgent basis.

Islamic banks depend to a great extent on religious commitments of depositors to maintain their market share rather than competitive and widespread services. Since the majority of depositors in Bangladesh are from low-income groups, Islamic banks should seek to attract more customers through extending a wide range of credit facilities and realizing high returns on investment deposit so as to avoid endangering their market share. In other words, Islamic banks should build their bank-customer relationship on economic rather than religious considerations.

To reach desired levels of efficiency, Islamic banks in Bangladesh should find more standardized financial instruments and innovations in accordance with the *Shari'ah* principles, which will enable them to deal with other interest-based conventional banks. Likewise, Islamic banks should have their own interbank money markets and develop a secondary financial market for Islamic financial products if they wish to achieve a true comparison with their conventional counterparts. They must also develop more transparency in financial reporting, auditing, and accounting.

Finally, Islamic banks still do not have the legal support of the central bank of the country, which exposes them to great risks. Therefore, it is suggested that Islamic banks in Bangladesh should have their own banking act that can provide legal support to the banks and their customers.

**The Editor**