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Issues in Transformation from Conventional Banking to Islamic Banking

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ABSTRACT

The present era has witnessed intensive changes in last few decades. The transformation of conventional financial system to Islamic financial system is one of these drastic changes the world has faced. Islamic banking is the major constituent of the Islamic finance. In line with these transformations, Islamic banks and financial institutions are facing several problems due to non-existence of comprehensive framework. However, some prominent issues are convergence issues, stability and regulatory issues, existence of different schools of thought and sensitivity towards role of religion in commercial and financial sector. A careful analysis of these issues can lead to sort out the solutions. The approach to overcome these challenges will determine the future success or failure of the industry. Therefore, this study shed a light on some major challenges that can hinder the progress and benefits of Islamic finance promises.

Keywords: Islamic Banks, Regulatory Framework, Financial Regulation, Governance, Financial Stability, Risk Management
JEL Classifications: G21, G28, G32, O16, P15

1. INTRODUCTION

Islam propounds the guiding principles and prescribes a set of rules for all aspects of human life, including economic aspect. The dealing of conventional and Islamic system is different regarding allocation of resources, production, exchange, and distribution of resources. In last few decades, efforts have been made to explain the Islamic financial system but it still needs to be studied further. Simple description of such terms is not only inaccurate but also causing more confusion (Rafay and Sadiq, 2015). The researcher, having complete grip on Islamic principles and economic system, can describe and clarify the issues. The Islamic finance industry is in the middle of the evolution era showing tremendous growth in the recent years (Askari et al., 2011).

The legal structure of financial intuitions is based on both legislative and regulatory structure. Both the aspects are equally important for the functioning of a practically operational system. While applying Islamic principles to existing banking and financial institutions, Shari'ah law is essential because its foundations are based on it. In addition, it can also be applied to any aspect of life. Shari'ah framework was further given a challenge of excluding interest: The base of conventional financial system. It is evident that development of a system depends on the solid legal foundation but the significance of evolutionary economy is also important, that is converting from conventional to fully Islamic financial system.

From last couple of decades, the convergence of Islamic financial system from conventional financial system depends on culture, social norms, and political philosophies of the country. Some countries have 100% Islamic banks like Iran while, others have dual banking system as they are running Islamic financial institutions (IFIs) along with the conventional financial institutions. During partial implications, it should be cleared that full rules of Shari'ah should be implemented on the selected segment.

It is inevitable for an emerging market like Islamic finance to grow without facing several challenges (Abduh and Omarov, 2013). The nature of these challenges is diversified depending on the prevailing circumstances. Islamic finance is also facing challenges regarding its theoretical foundation, systematic operations, and infrastructural development, augmenting the efficiency and fostering the growth. All these challenges need a careful analysis before operationalization of the strategies to cope up with these challenges because the success or failure of the industry depends on them.

Islamic banking is increasing 15% annually on average. This rapid growth is fueled by not only the Muslim investors and financers but also investors around the globe. Currently, more than $1.3 trillion are invested in Islamic banking, Islamic microfinance, mutual funds, Sukuk, Qard-e-hasna and Islamic insurance called Takaful (Sultan et al., 2012). Although, all areas of Islamic finance are growing but there is tremendous growth in Islamic banking and Islamic bonds called sukuk. The future of Islamic finance lies in addressing the below mentioned challenges along with other challenges. If due attention is not paid in sorting out the solutions of these challenges Islamic finance would not deliver the benefits that it promises. The risks are very high and demand serious attention and discussion on these issues. An ample reporting of all the issues and challenges that Islamic finance is facing is very difficult to summarize in a single study. However, this study will highlight a few major challenges.

2. LITERATURE REVIEW

In reviewing the IFIs following key issues are highlighted:

2.1. Development of Theoretical Foundation

Conventional economics is the result of research over the years that have gone through much iteration of analytical arguments. This has resulted in several time tested models and theories. While, the research in the Islamic finance is mostly driven by the business needs to set Islamic banking and financial system and very less attention has been paid to establish a framework of economic system based on the principles of economics and finance (Askari et al., 2011). So, it is the need of the hour to establish an Islamic financial system based on the foundation of rigorous analytic work so that, it can provide solutions of current economic and social problems.

The development of theoretical foundation based on the Islamic principles is the needs much more attention. For example the behavior of widely accepted capital asset pricing model based on the risk free rate of return which practically does not exist. Similarly Black's zero beta models can't explain the behavior of short selling. Similarly, the relative worth of the risk is also acknowledged by Islam. The study of finance in Islam is based on the foundation that there is no risk free asset and while doing contracts risk should be shared by the parties rather than pushing it to single party only. Moreover, as Islam prohibits the economic gain without assuming the risk so validating the theory of random walks in financial assets. In short, there is need to divert more research towards developing and testing of analytical models and theoretical foundation of economics and finance.

2.2. Globalization of Islamic Finance: A Convergence

Globalization is a multidimensional process and its dimensions included social, political, cultural and economic. The economic dimension includes the free trade, unhindered financial flow, investment and production, regulations, standardization of processes all facilitated by the free flow of ideas and information. The world is becoming global village because more and more economies are liberalizing and integrating to the global economy, so new finance is mounting up so as the risk of asset based securities. Both are the core of Islamic finance. Due to unequal distribution of risks and rewards globalization is considered to be an unfair process (Chapra and Khan, 2000).

As the globalization process precedes, the advances in finance and technology, will shift the process of trading, production, investment and financing by spreading and sharing the risk rather than older conventional ways (Askari et al., 2011). These developments will lead to the financial innovation which will result in minimizing the risk combined with the efficient available information increasing the standards of accountability, transparency and good governance. All this will pave the path of risk sharing in the light of Islamic finance. This will lead to the construction of financial architecture composed of traditional as well as Islamic financial products that would augment the economic development of the economy.

2.3. Financial System and Infrastructure

There are several studies supporting financial sector development promoting economic development of an economy. The development of financial system infrastructure leads to the development of financial market that ultimately grounds financial system stability. Robust financial system is required for rapid growth of an economy. The challenge of rapid growth of the financial institutions offering Shari'ah compliance products, is putting on the policy makers to mold their policies and strategies towards this sector. Increasing globalization, risk based regulations and severe competition, are the factors influencing the Islamic finance product development. Finally, return on the basis of perceived risk must be incorporated on the structure of the financial product.

The financial infrastructure has three components including liquidity infrastructure, information and governance infrastructure and safety net infrastructure (Askari et al., 2011; Alamer et al., 2015). First, is the systematic liquidity infrastructure which includes the payments transfer systems, liquidity management systems and foreign exchange market operations. Second, is the informational and governance infrastructure in which regulations and accounting standards are set and corporate governance structure is finalized. In third type of safety infrastructure, governing framework, loan recovery, bank insolvency and insurance methods are defined to set a smooth infrastructure. So, overall, the infrastructure provides a sound and efficient platform for providing financial services with effective governance and supervision of different sectors.

2.4. Financial Stability Issues

Islamic banks are growing at greater pace as compared to the conventional banks. So, it is important to acknowledge whether Islamic banks are more stable than conventional banks or vice versa. Some researcher (Van Greuning and Iqbal, 2008) posed that Islamic banks are exposed to different set of risks because

Islamic banks face the unique direct risks arising from the specific features of Islamic contracts, along with the other indirect risks arising from the other dimensions like interest rate, economic conditions, liquidity, governance and legal issues. The profit-and-loss-sharing (PLS) account is the best example of risk sharing. In this account, the bank has shared the risk with the creditor. These types of transactions make the balance sheet of the bank more vulnerable because these types of risks mostly lie in the equity investments rather than by debt investments (Mejia et al., 2014).

Furthermore, due to the absence of viable Islamic money markets the risks of Islamic banks are exacerbated. In addition, according to Cihak and Hesse (2008) the Islamic banks cannot use the traditional derivatives limit to hedge the risks so, they have to face some additional risks in this regard. Most of the Islamic banks are operating in less developed or non-existed money markets and government securities and in most of the cases the lender of the last resort facility is not available to them. However, these risks are reduced by developing the Islamic money market instruments and Islamic lender-of-the resort modes. Also the regulatory authorities also committed to provide liquidity during exceptional circumstances so that financial stability risk can be minimized.

There are some positive aspects of Islamic bank contracts that make the Islamic banks less vulnerable than the conventional banks. Islamic banks have the ability to pass through negative shocks from the asset backed securities. The specific risk sharing arrangements of Islamic banks provide an extra lay of protection in addition to the capital. The liquidity risk and shareholder's negligence put pressure on Islamic bank to make their policies more conservative (Ahmed, 2010).

On the other hand Islamic banks are mostly not involved in the short term investments opportunities; they have to hold a large portion of their deposits in the reserve account with the central bank (Ahmad et al., 2011). If they do more risky investment the total risk is offset by the more reserve buffers indicating a stable condition of Islamic bank. So the overall financial stability depends on the relative risk and the buffer. The total relative stability depends on the geographical area in which Islamic bank is located and the size of the bank and it varies from country to country and bank to bank.

2.5. Regulatory and Governance Issues

Islamic banks have increased in the presence of conventional financial system. By viewing the growth of the Islamic banks the conventional banks converged in two ways, either opening Islamic window or offering Islamic products remaining the conventional status of banking intact (Sole, 2007). So, in this way Islamic banking emerged in the lap of conventional financial system, but how the existing supervisory and regulatory framework of conventional financial system can address the Shari'ah activities and products of Islamic banking.

First question regarding regulatory framework is that, whether there are enough regulations to regulate the Islamic banking products in a secular environment in the light of Shari'ah (Chapra and Khan, 2000). Second issue is that the Islamic institutions are also required the same prudential regulations to streamline their operation as the conventional banks require. Regarding first issue, Islamic contractual arrangements are not present in the secular jurisdictions and have not made under Shari'ah principles to govern the Islamic financial transactions. However, according to DeLorenzo and McMillen (2007) the conventional financial system is so much flexible that customized contractual arrangements can be made remaining within the limits of this system. Thus, while doing such contracts the concerned parties can add additional Shari'ah requirements after fulfilling the conventional regulatory requirements. In this way both the contractual parties can ensure to uphold the jurisdictions in the economy where the contract is imposed.

In comparison with the second issue there is a common misunderstanding that most of the Islamic financial contracts are based on PLS, so do not require any supervision of conventional regulations. In fact, some researcher such as, Errico and Farrahbaksh (1998), El-Hawary et al. (2004), Cihak and Hesse (2008) and Sole (2008) pointed out that there are certain features that applies on the contracts in the similar way as the conventional banks regulations. The conventional financial system needs some modifications in the regulatory framework to ensure the fulfillment of goals of supervising IFIs. These modifications vary geographically. Some countries like, United Kingdom, adopted minimal alteration and all the financial institution are required to fulfill the same set of minimum regulations and IFIs are additionally required to fulfill some extra regulations as well. However, in some countries (Bahrain), there are separate set of regulation for conventional and IFIs (Rafay and Sadiq, 2015).

Every country has different system for treating Islamic banking but there are certain risk associated with the Islamic banks that needs to be acknowledged by policy makers and regulators while prescribing the regulations (Alamer et al., 2015; Sundararajan, 2007). Taking this into account the central monetary authorities of different Islamic countries have inaugurated the Islamic Financial Services Board (IFSB) in Malaysia as international standard setting autonomous body. The responsibility of the IFSB is to create sound and stable environment under the international financial standards in the light of Shari'ah principles. In 2005, IFSB issued two regulatory frameworks for risk management and capital adequacy similar to the revision of Basel Capital Accord.

To conclude, the regulatory authorities should provide an environment that can foster the development of Islamic banking by offering Shari'ah compliance products to the investors and the financers. They should not provide the regulatory incentives but provide a room for the new entrants a space for operations. The authorities' behavior should be like British Financial Services Authority's stated policy of "no obstacles, no special favors." Cihak and Hesse (2008) empirically proved that the larger Islamic banks are more risky than the smaller ones and similarly the conventional banks. Their study also proved that the presence of Islamic banks have no significant effect on the soundness of the conventional banks. So, both banks can co-exist and operate side by side without "crowding out" each other.

2.6. Shari'ah Governance Issues

Although there is tremendous development in the Islamic banking and finance but still people are skeptical due to some reasons related to governance such as, lack of innovation and credibility in operation and products are considered as the largest hindrance problems in growth of Islamic financial instructions (Remo-Listana, 2009). The general public is stuck in the conventional banking. They feel that there is no difference between the conventional and Islamic banking due to the huge similarities in their products. In line with this, Ahmad (2010) narrated a study on the attitude of customers and bankers arguing that 70% people consider no difference between Islamic and conventional interests and profits. In addition, Singh (2008) also highlighted some issues causing skepticism in trusting IFIs. So, the basic issues lies in the Shari'ah governance which needs to be rebuild between management and board of directors. The credibility of the Shari'ah scholars also matters while developing new operations and products (Siddiqui, 2010). The scholars having less experience and expertise in the IFIs are appointed as member of Shari'ah board around the world that results in some ambiguous policies.

Some Shari'ah scholars also don't spare sufficient time to tackle the new challenges with devotion that result in misleading implication of the policies (Wilson, 2009). Role of experience and devotion may vary demographically but plays role in translating the image of Shari'ah governance in IFIs. Azmi (2011) reported that there is insufficient staff for Shari'ah audit and the staff is inadequately trained. There are loopholes in the Shari'ah audit top cover all the aspects of a bank because Shari'ah scholars are not involved in the audit process. Shari'ah governance faces a lot of challenges like lack of trust in confidential information, independency and consistency in repeated decisions by the Shari'ah scholars (Aziz, 2013).

3. CONCLUSION

Islamic trade practices are on the move to make space in conventional financial system. It is in emerging phase because many Muslim nations get liberation in 20th century. Islamic finance is neither fully based on religious principles nor on some specific economy rules. Muslims started not only spreading Islam but also started implementing Islamic rules on prevailing economic and financial systems all over the globe. Now, Islamic finance is becoming prominent not only in Muslim countries but also in the rest of the world due to its long lasting effects. Transformation of conventional framework to fully Islamic framework is challenging task both theoretically and practically. Traditional models are verified over decades. In contrast, Islamic finance models need to be studies further to overcome all the recent challenges of the economic world. Therefore, Shari'ah scholars, having expertise in economics and finance should come forward for formulating new strategies and products in line with the prerequisites of today's environment. New regulations should be developed to make the financial and governance system more efficient. Furthermore, incorporating the electronic resources governance mechanism should be enhanced to gain the trust of stakeholders on IFIs. Similarly, regulations should be modified to settle the liquidity, stability and audit issues in IFIs. This may leads to economic stability and ultimately economic growth. Central banks and controlling authorities should also provide some financial cushion so that new IFI can handle liquidity issues and bear economic shocks. The less vulnerable aspects of the Islamic contracts should be adopted by the conventional banks to take advantage from these features. To change the general public perception, professionally trained employees should be hired that will remove the misconceptions in people. The future of Islamic finance lies in addressing these challenges and if due attention is not paid it would not deliver the benefits it promises.

Development of one business framework and then transformation to another is always done if previous model fails to satisfy the needs of the customers or the market. There is the dire need to develop comprehensive framework for IFIs smooth transformation backed by financial system based on Shari'ah rules and regulations (Askari et al., 2011). It can be concluded that the regulatory authorities should provide an environment for fostering the development of Islamic banking. This can be achieved by offering Shari'ah compliance products to the investors and the financers with modified framework having less risk. The development of such model will guide the future researchers by talking about current problems in the financial framework. The development of comprehensive frame work by cutting the loopholes will lead toward the betterment of the system. The problems would be solved and regulations would be tuned according to the changing environment with the passage of time. The future of IFIs could be bright with continuous development, which should make implementation and adaptation of Islamic principles much easier for individuals as well as institutions.

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