Chapter 8
Moving Forward – Challenges of Islamic Banking and Takaful in Malaysia

8.1 Background

The Islamic banking and takaful industry in Malaysia has made steady progress since the establishment of the first Islamic bank in 1983 and the formation of the first Islamic Insurance company (takaful) in 1984. Twenty-six years ago, Islamic banking was considered a wishful thinking. However, serious research work of the past two and half decades has shown that Islamic banking is not only feasible and viable, it is an efficient and productive of financial intermediation (Iqbal, 2001). A number of Islamic banks have also been established during this period under heterogeneous social and economic milieu. The successful operation of these institutions and countrywide experiences in Pakistan, Iran, Sudan and partly in Malaysia are sufficient to show that Islamic banking offers an alternative method of commercial banking. The fact that many conventional banks, including some major multinational Western banks have also started using Islamic banking techniques is a further proof of the viability of Islamic banking. In fact, Khan (1986) noted that the abolition of interest-based transactions is not a subject alien to Western thought.

The commendable achievement during the last twenty years should not lead us to ignore the problems that Islamic banking is facing, and there is no dearth of these. While many of these are a result of the inappropriate environment in which Islamic banks are working, there are others which have arisen from the practices of Islamic banks themselves. They must have a critical look at their activities, correct their mistakes identify their long run comparative advantage and exploit it to the fullest possible extent. It must be realized that in the long run, for its viability and survival, Islamic banking has to rely on its strength as an
alternative model, rather than on the sympathies of its clients or government support.

8.2 Challenges Facing Islamic Banking and Takaful

Based on the spirit as we mentioned earlier, the followings are nine major challenges facing Islamic banking and takaful as it enters the twenty-first century.

8.2.1 Increased Competition as a Result of Globalisation and Financial Liberalisation

The emergence of global conventional players in Islamic banking business is clearly evident particularly in the area of structuring Shariah-compliant investment and financing deals. Initially, Islamic banks had a fairly large degree of "monopoly" over the financial resources of Islamically motivated clients (Iqbal, 2001). This situation is changing fast. Islamic banks are now facing ever increasing competition. An important development in Islamic banking in the last few years has been the entry of some conventional banks in that market. Although, it is difficult to know with certainty how many conventional banks around the globe practice Islamic banking techniques, even a randomly selected short may contain some of the giants of international banking business such as Hong Kong and Shanghai Banking corporation, Chase Manhattan Bank, Citibank, ANZ Grindlays, Klienworth Benson and Union Bank of Switzerland (Mirakhor, 2001). In addition to these, in many Muslim countries, several commercial banks are offering Islamic banking services. Bank Misr in Egypt and National Commercial Bank in Saudi Arabia have opened Islamic branches (Iqbal, 2001). In Malaysia, as at end-2000, 47 conventional banking institutions (17 domestic commercial banks, four foreign-owned banks, 14 finance companies, five merchant banks and seven discount houses) participating in the Islamic Banking Scheme (IBS), in addition to two Islamic banks, an Islamic money
market, two takaful companies and a broad range of financial products (Bank Negara Malaysia Annual Report, 2000).

This is a welcome development. On the one hand, it is recognition of the viability of Islamic banking (Ahmed, 1989) and on the other, it will force inefficient firms to either shape up or ship out. It will reduce the costs and improve services to customers. It will promote innovation and bring improvements in product quality. All of this will have important implications, both for resource mobilization and investment opportunities. The future of Islamic financial industry will depend on how well it adapts to this reality (Iqbal, 2001).

8.2.2 Changing Technology

Increasing role of technology is shaping the microstructure of business and financial markets, contributing to enhanced efficiency and competitiveness. Modern technology has allowed expansions of the financial services sector to the point where banks as traditionally defined are rapidly becoming obsolete. Electronic banking and widespread use of computers in banking has transformed the way banking was once done. Many banks and even non-bank entities are developing e-cash accounts, i.e. an on-line account that can be used in a manner similar to a debit card. A shopping mall-based ATM can now process loan applications. Instant loan facilities are also being offered on the Internet. A recent report on banking trends in one of the most important financial centers of the world, London, concludes that as many as one third of bank branches will disappear in the first five years of the new millennium (Iqbal, 2001).

The communication revolution through electronic correspondence has reduced the cost of international communication. Globalisation of financial markets has led to more and more integration of capital markets. Liberalisation of foreign exchange markets has further reinforced this trend. The paper currency is being replaced with plastic cards and electronic ledgers are replacing accounts books.
Now, the saving of one country can be invested in other countries by click of a mouse. Customers can now "navigate" on the Internet between competing banks, unit trusts, mutual funds and even business firms. The changing function of the bank branch from full-service to a multi-functional ATM machine seems to be the emerging shape of banking in the new millennium when most customers are able to reach their banks easily and happily via telephone or the Internet.

In an age where e-commerce and e-banking is the order of the day, most Islamic banks do not even have a web page. Those that have do not update it for months, whereas the dynamic financial institutions update them on an hourly basis (Abdul Rahman, 2001).

In addition, new generation of well-informed consumers demanding differentiated and sophisticated products. Against this backdrop, in order for the Islamic banking institutions (comprising of Islamic banks and IBS banks) and takaful operators to become leaders in the industry, compete effectively and at the same time preserve their niche, there is a need to strengthen their institutional and operational capacities and build their resilience to operate successfully in a highly competitive globalised environment. They also need to improve their efficiency and effectiveness to be at par with international best players, and intensify research and development efforts in Islamic financial product innovations. This will involve Islamic banking institutions and takaful operators to consider the possibility of forging strategic alliances to tap the research and development expertise developed outside the banking and insurance industry to create the range of Islamic financial products capable of meeting the customer requirements.

8.2.3 Need to Increase the Size of Islamic Banks

Size is an important variable to determine the efficiency of a bank. It determines the scale and scope efficiencies. In the wake of technological change and
globalization, Islamic banks must prepare themselves to handle a much larger size of operations and to deal with internationally minded and financially sophisticated customers. The required infrastructures as well as the larger and geographically wider scope of operations call for a larger bank size. There is a worldwide trend of mergers. In the last two years alone, more than twenty banks and financial companies, which were already big, have merged to form mega-banks (Iqbal, 2001). As against this, the available data shows that Islamic banks and financial institutions are much below the optimum size. According to Iqbal (2001), more than sixty percent of the Islamic banks are below the minimum size of a bank recommended by theoretical studies ($500 million in assets). Further, if assets of all 176 Islamic banks are pooled, they will still be less than those of any single bank in the top 60 banks in the world.

Considering that Islamic banks and financial institutions are generally very small in size, serious consideration should be given to mergers, syndicated finance, and creation and management of joint financial services companies. The Islamic Development Bank (IDB) has taken several steps to encourage that trend. The establishments of Islamic Banks' Portfolio, Unit Investment Fund and Infrastructure Fund all of which are meant to pool the resources are some of those. IDB is also sponsoring an annual meeting of all Islamic banks under its auspices to encourage cooperation and joint action.

Islamic banks also have to form strategic alliances with Western banks to cope with the implications of globalisation in the field of finance. Financial markets can no longer be restricted to national boundaries. Furthermore, there are large Muslim communities in several Western countries. Cooperation with Western banks is also needed to provide financial services to these communities in accordance with their faith.
8.2.4 Establishment of Secondary Markets and Inter-bank Market

Banking thrives on the existence of a secondary financial market. The commercial banks invest in very short-term financial papers, which they can convert into cash very quickly at negligible conversion cost. There are several ingredients of a secondary financial market: financial papers, dealers and financial institutions. Various kinds of financial papers such as securities, bonds, shares, debentures, and commercial papers are the financial instruments. Commercial banks, merchant banks, mutual funds, investment funds etc. are the financial institutions. Steps need to be taken for establishing and/or strengthening secondary markets.

Most of Islamic banks exist as single entities. The strength of commercial banking is derived not from individual institutions but by taking all banks together. Inter-bank transactions among Islamic banks are minimal because in most of the countries the number of Islamic banks is very small. The evolution of short-term financial assets which Islamic bank may hold and transact among them shall go a long way towards making an Islamic money market a reality.

Malaysia has proposed the idea of an international money and capital market that adopts the Shariah rules. Malaysia with a group of central banks of Islamic countries and the Islamic Development Bank are developing the International Islamic Financial Market, or IIFM (Abdul Kadir, 2001). It will address the liquidity needs of international Islamic banks, broaden the market of Islamic finance and investment internationally and expand the range of new Islamic financial products. For a start, Labuan has been designated as a focal center for IIFM for this region, and Bahrain, for the Middle East region. Both centres can complement each other in achieving and ensuring the smooth implementation and operation of the IIFM.
8.2.5 Need for Transparency and Control

Asymmetric information in financial markets exposes investors to many risks and hazards. It can also lead to widespread collapse of financial intermediaries, referred to as financial panic. Because, depositors may not be able to assess whether the institutions holding their funds are financially sound or not, if they have doubts about the overall health of the financial intermediaries, they may want to pull their funds out of both sound and unsound institutions. The possible outcome is a financial panic that produces large losses for the public and causes serious damage to the economy.

Asymmetric information also leads to the problems of moral hazard and the adverse selection in financial markets. In this regard, there is need to make the activities of the banks as transparent as possible. The present situation of Islamic banks leaves a lot to be desired in this respect. In many cases the most essential information is not made public. More transparency in various aspects of the activities of the Islamic banks will increase the confidence of clients and will help avoiding panics (Usmani, 1999).

To protect the interests of the public and the economy form financial panics, most governments have created elaborate regulatory bodies. As a matter of fact, banking industry is one of the most heavily regulated industries all over the world. In the aftermath of the Asian financial crisis, the regulation and supervision of financial firms has assumed greater importance. New regulatory standard are being actively discussed. It is important at this stage that Islamic financial institutions are also integrated into the international financial system. It is pertinent to note in this regard that Islamic banking products are unique, and their operational modes are distinct. The regulatory and supervisory standards applied to conventional banking would therefore be insufficient to provide the necessary safeguards for Islamic banking. Ignoring such fact would leave the whole banking sector exposed, simply because a part of it is not supervised
properly. Countries that host Islamic banking and financial institutions have real interests in closing this hole. This could only be done through a coordinating body that would produce and enforce sound regulatory and supervisory standards, which would be tailored for the needs of Islamic banking and finance. In this regard the IDB is cooperating with other international financial institutions and member countries to establish an Islamic Financial Services Board or IFSB. Malaysia is one of the most active countries in this respect.

8.2.6 Need for Diversification in the Use of Islamic Modes of Finance

Islamic financial system has presented a number of financial instruments. Broadly speaking, they may be classified into fixed-return and variable return or profit sharing modes. Each of these categories has its merits and demerits. In practice, however, the use of profit-sharing modes has been very limited. Fixed-return modes account for more than three quarters of finance provided by Islamic banks (Gafoor, 2000).

There are several reasons why the fixed-return modes have become more popular in practice. They have a number of desirable features such as simplicity, convenience and safety. It should also be noted that the fixed-return modes of finance being used by Islamic banks are clearly distinguishable from interest-based modes. According to Gafoor (2000), transactions of the former modes are always done through real goods and services while in the latter they are carried through inter-temporal exchanges of money.

However, in order to have a more diversified portfolio, it would be desirable that the predominance of fixed-return modes such as murabahah and leasing on the asset side in moderate. It should also be noted that theoretical discussions on Islamic banking and finance have established that a system based on profit sharing is not only viable but also has a number of advantages over the interest-based systems (Mirakhor, 1997).
It may be mentioned here that even in conventional finance, there is an increasing trend towards use of equities as a source of business finance. All over the world, savers are deserting traditional bank accounts and low yielding government bonds by the thousands and moving en-masse into equities. Savers are now increasingly recognizing the benefits of profit-based instruments. The appeal of rate-based investment is waning. Although stock market investments have not become any less risky over the years, savers are beginning to accept the historical evidence that in any five year period since World War II, with one exception, stocks have produced higher returns than bank accounts, bonds or bullion. There is now a worldwide trend for establishing equity institutions such as mutual funds. Islamic financial markets have to take note of recent developments in international financial market.

However, it needs to be emphasized that under present circumstances, tools like murabahah are indispensable. They are serving a useful purpose: that of providing investors high liquidity with low risk. Until proper institutional set up is built and needed products, including those for managing risk, are developed, it may not be advisable to drastically increase the use of risky modes. However, several problems have been noted in the way it is being used. Serious attempts should be made to "cleanse" the "quasi" murabahah being practiced by some banks at present of the undesirable features, to make it "genuine" murabahah.

Nevertheless, an overwhelming use of these modes by Islamic banks in the absence of other Islamic financial institutions which could provide more profit sharing opportunities has led to some undesirable results for the Islamic finance scene. These include:

(i) Defaulters and the Issue of Penalties

By using fixed rate modes of financing, the Islamic banks have been able to minimize the impact of business risks on their cash flows. But precisely because
of the same reason, i.e. use of debt as compared to equity, they land themselves into a serious problem. Murabahah deals create debt obligations against buyer firms. Now, while it is permissible to charge a higher price in credit sales as compared to cash sales, the where-withal of murabahah mode of financing, once the deal has been entered, it creates a fixed liability. If the buyer defaults on his payment, banks cannot charge anything extra because that would mean taking riba. Thus, there is a built-in incentive for immoral buyers to default.

Islamic jurists have been discussing this problem. It is generally agreed that penalties, both physical and financial, can be imposed against defaulters but the bank cannot get any benefit out of these penalties. Some contemporary scholars have argued that the banks can be compensated because the defaulter has caused damage and Islam permits, rather encourage, compensation for damages. However, this issue still remains unresolved due to lack of consensus among jurists. Furthermore, the award of compensation is not automatic. This has to be done by a judge. That makes this option both times consuming and uncertain.

(ii) Illiquidity of Assets

Another problem caused by the predominance of debt-based modes of financing is that it is difficult to transform these financial modes into negotiable financial instruments. Once a debt has been created, it cannot be transferred to anyone else except at par value. This renders the whole structure of Islamic financial market as highly illiquid. This is one of the major obstacles in the development of secondary markets in Islamic financial instruments. Unless equity-based modes become more popular or other negotiable instruments are developed, the Islamic financial markets will remain undeveloped. Some attempts are being made to develop negotiable instruments based on ijarah, salam and isticna’ (Al-Amine, 2001). However, these have not been used to any significant extent so far. The major hope for developing Islamic secondary markets lies in a wider application
of equity-based financial instruments and securitization some of the existing instrument.

(iii) **Short Term Asset Structure**

Banks everywhere prefer short-term investments. This is because they work on the basis of small reserves. They have to have the ability to liquidate their assets fairly quickly, if the need arises. In the case of Islamic banks, the short-term structure of their assets is even more pronounced. This also has to do with the predominance of murabahah among the modes of finance. Murabahah, a trading practice, by its very nature is a short-term contract. When turned into a financial instrument, it did not lose that character. Even though it is conceivable to design an installment sale murabahah contract spreading over many years, the needs for which the murabahah contract can “genuinely” be used are, by and large, short term. Therefore, murabahah deals entered into by the Islamic banks have been and are going to be largely short-term. Since murabahah comprises a very large percentage of Islamic bank’s investments, the structure of their assets has also become short-term.

8.2.7 **Financial Engineering**

Financial markets are becoming more and more sophisticated, and competitive. In order to exploit the fast changing market environment and face increasing competition, financial engineering and innovation is imperative. Financial experts have to keep an eye on the needs of various types of individuals and businesses on both the demand and supply sides. They also need to consider varying tastes for risk. Since the needs and tastes vary from person to person, a wide variety of products need to be developed to cater for all needs and tastes. In an Islamic framework, they must also observe Shariah rules and guidelines.
Until now, the Islamic financial tools have essentially been limited to conventional instruments developed centuries ago and their variants. The classical instruments were developed to meet the needs of those societies. While they may serve as useful guidelines for Islamic contracts, there is no reason to be restricted only to those. According to Al-Amine (2001), in Islamic Theory of Contracts, parties are free to agree on any terms as long as known Islamic rules and principles are not violated.

Islamic fiqh has laid down general guidelines for ijtihad, or dealing with new situations. In the light of the principles of ijtihad, a "needs approach" to financial engineering is desirable, of course within the known principles of Islamic finance. In this regard, the example of "bai salam" is very important to remember. In general, it is not allowed to sell anything which is not in one's possession. But in case of salam, Prophet (pbuh) allowed such a sale because of "need" of the people, but laid down clear rules to protect the interests of both the parties. Financial needs of both individuals and businesses have changed. Engineers in modern finance have designed several new instruments such as mortgage, options, derivatives, hedging, insurance pension plans, credit cards, etc. to meet these needs. We must examine what needs are being fulfilled by these instruments. If the needs are genuine (Islamically speaking), then we must either adapt them for our purposes or invent Islamic alternatives for them.

8.2.8 Shariah Aspects

Because of the religious dimension of Islamic banking and finance, no new product can be adopted until it is cleared by Shariah scholars. Even after a new product is put into use, Shariah auditing of the operations of financial institutions is very important to ensure that the actual practice complies with the requirements of Shariah. This is important not only for religious reasons but also for purely business considerations because the clients of Islamic banks will not have confidence in their operations unless Shariah scholars clear their activities.
In this background, the expertise of fiqh scholars in understanding the pre-requisites of modern financial products and in evaluating these products becomes very important.

Almost all Islamic banks have their own Shariah board or Shariah advisers. A survey of the members of these boards would reveal that hardly any of these scholars has a formal training in modern finance. This puts a serious constraint on the ability of Shariah scholars to issue well-informed rulings on financial products and activities. The Shariah scholars themselves are conscious of this difficulty. They are using a number of ways to acquire the necessary background information before issuing a fatwa. One was is to discuss an issue in meetings/workshops attended by both Shariah scholars and financial experts. Institutions such as the Islamic Research and Training Institute and Islamic universities are playing an active role in organizing such workshops. However, these workshops have no mandate to issue a fatwa. For that purpose, the meetings of the Fiqh Academies, the most prominent among which is the OIC Fiqh Academy in Jeddah play a more important role. These academies also commission a number of studies by specialized experts on specific issues before discussing them and taking a decision. In the absence of the required expertise in the field of finance among Shariah scholars, this approach of group ijtihad is playing an important role in safeguarding against serious mistakes in adopting doubtful instruments.

The situation is, however, far from being ideal. As any participant of the workshops and meetings of the Fiqh Academies can be easily notice that the interaction between Fiqh scholars are experts of modern economics and finance does not proceed smoothly. They have so different backgrounds and speak such different technical languages that the communication between them is very difficult. It is, therefore quite understandable that the Shariah scholars are very cautious in giving their rulings. The result has been that the decisions making process has become extremely slow and tends to be over-conservative.
The past record shows that Shariah bodies have done a commendable job in evaluating the applications of traditional contracts and safeguarding against the use of some and the misuse of others. However, when it comes to evaluating modern financial contracts or Islamic substitutes for them, Shariah bodies have found it quite difficult to issue verdicts. This is basically due to an acute shortage of scholars with dual specialisation or at least working knowledge of modern finance and Shariah at the same time.

8.2.9 Research and Development

Research and development are the where-with-all for the development of any discipline. This is more so for a discipline like Islamic banking and insurance, which is still nascent. This is an unfortunate fact that neither the Islamic banks as a group nor any of the individual Islamic banks spend any sizeable amount on research. Some Islamic banks have small units for research but none of this research activity is designated for product development. It is, therefore, not surprising that the speed of development of new financial products within the Islamic banking industry is very slow. The Islamic universities and the few research institutions working here and there have not received any financial assistance from Islamic banks nor has there been any coordination between the Islamic banks and the seats of higher learning for any worthwhile research project. There is a need to establish strategic alliances between Islamic banks on the one hand and universities and research institutions in the Muslim world on the other.

An important component for useful and scientific research is the availability of authentic information. This has not received much attention from Islamic banks. Some attempts have been made in this regard but have not received active support, either financial or otherwise, from Islamic banks. As a result, there is no consistent data series on the activities of Islamic banks for a reasonable number
of years available anywhere. Whatever little information is available, is also subject to a number of qualifications.

Human resource development is another major challenge. Three aspects need special attention in this regard.

(a) As mentioned above, there is a serious shortage of scholars who possess even a working knowledge of both Islamic fiqh and modern economics and finance. Increasing the supply of such scholars is crucial for the development of Islamic banking and insurance in the right direction;

(b) Most the managers of Islamic banks and insurance are not very well trained in the use of Islamic modes of finance. The managers of Islamic banks may have been attending some short-term courses either on the job or elsewhere but there are not many formal training programs meant to prepare the employees of the Islamic banks and insurance for the needs of the system. Most of the employees of the Islamic banks and insurance, including the managers and financial experts come from traditional sources lacking necessary expertise in and commitment for Islamic banking and insurance. An institution is what its employees make it. Therefore, it is extremely important to have people with the right kind of skills and commitment to run Islamic bank and insurance; and

(c) The employees and management of Islamic banks and insurance also need to be trained in modern techniques of financial management, especially risk management, as well as information technology.
8.3 Issues to be Addressed in Preparing the Islamic Banking and Takaful for Challenges of the 21st Century.

On 1 March 2001, Bank Negara Malaysia (BNM) launched the Financial Sector Master Plan (FSMP) which outlines the road map and strategies to further develop the Islamic banking and takaful industry in a more systematic and orderly manner. The overall objective of the FSMP is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation (Bank Negara Malaysia, 2001). The specific recommendations are formulated with a view of building the capabilities of Islamic Banking Institutions (IBIs) and takaful operators to compete effectively and to increase the significance of their market share in the financial system. In addition, the underpinning financial infrastructure needs to be strengthened to support the expansion of Islamic banking and takaful operations envisaged.

It is envisioned that the Islamic banking and takaful industry landscape in 2010 would evolve in parallel with conventional banking and insurance to achieve the following:

(a) Constitute 20 percent of the banking and insurance market share with an effective contribution to the financial sector of the Malaysian economy;

(b) Represented by a number of strong and highly capitalized IBIs and takaful operators offering a comprehensive and complete range of Islamic financial products and services;
(c) Underpinned by a comprehensive and conducive Shariah and regulatory framework;

(d) Supported by a dedicated institution (Shariah commercial court) in the judiciary system that addresses legal issues related to Islamic banking and takaful;

(e) Supported by a sufficient number of well-trained, highly calibre individuals and management teams with the required expertise; and

(f) Epitomise Malaysia as a regional Islamic financial center.

We have identified eight critical issues that need to be addressed in preparing the global Islamic financial system for challenges of the 21st century.

8.3.1 Common Standard for Islamic Banking

The absence of an internationally acceptable minimum standard/principles including regulations and supervision standards has created discrepancies in the standards of each country. As a result, cross-border supervision of Islamic banks is relatively impossible.

The Islamic Development Bank (IDB) is instrumental in introducing the Accounting and Audit Organisation for Islamic Financial Institutions (AAOIFI), which undertakes the responsibility of codifying accounting principles for Islamic banking activities throughout the world (Akauntan Nasional, 2000). However, other aspects of Islamic banking practices have yet to have a set of standard guideline by which Islamic banks worldwide can base on.

Currently, while there are many new initiative planned for further develop and reinforce existing infrastructures of the Islamic financial system in many
countries, there is also a need for various countries to form a comprehensive consultative council to work towards developing a compatible and internationally acceptable framework for the Islamic banking and takaful sector.

One such initiative, the setting up of the Financial Services Board (FSB) is a step in the right direction for the future of Islamic banking and takaful. The objectives of this board, set up for the purpose of issuing a standard in Islamic banking, will have to encompass the whole spectrum of Islamic financial services, and taking into account Muslims world-wide.

8.3.2 Harmonising Shariah Interpretations

While differences in the interpretation of Shariah in Islamic banking is common among various nations, variance and inconsistency in the interpretation of Shariah within a single nation may hinder the progress of Islamic banking and takaful in a particular country.

Hence, there is a need for a specific national body at individual nations that is responsible for harmonising issues relating to Shariah, and to avoid public confusion. This national Shariah body can then collaborate with Shariah bodies of other countries to find solutions to common problems and share experiences and deliberate on Shariah issues impacting other nations.

Currently, the Fiqh Academy in Jeddah undertakes this responsibility at the international level. However, its activities are wide-ranging and not focused on financial services per se.

Shariah scholars of each nation must also be more open to discussion, especially on novel Shariah issues. Pre-judgment and the discounting on new issues and products by basing on previous predisposition may result in
undermining the "creativity" process of developing and introducing new financial products and instruments.

On the Malaysian experience, in 1997, a National Shariah Advisory Council (NSAC) was set-up, taking over the role of the Bank Islam's Shariah Supervisory Council. The council is the highest authority to decide Shariah issues pertaining to Islamic banking and takaful operations, and plays a key role in harmonizing Shariah differences in the Islamic system. The primary objectives of the NSAC are as follows:

(a) To act as the sole authoritative body to advise BNM on Islamic banking and takaful operations;

(b) To coordinate Shariah issues with respect to Islamic banking, finance and tafakul; and

(c) To analyse and evaluate Shariah aspects of new products / schemes submitted by the banking institutions and takaful companies.

8.3.3 Wider-Ranging Legal Framework

The lack of legal frameworks and supervision to support further growth of Islamic banking continue to be among the major stumbling block for the Islamic banking sector worldwide. Islamic banks continue to confront numerous challenges in terms of regulatory frameworks and their relationship with central banks of each nation.

In many countries, Islamic banking is still viewed as secondary at best, and as such is treated as peripheral to mainstream conventional banking activities. In other countries such as Malaysia, although there exists regulatory arrangements
to supervise the activities of Islamic banks, there is still a speed for a wider ranging regulatory framework to assist in the future expansion of Islamic banking.

With the imminent future challenges brought about by globalisation facing many countries, it is all the more important for Islamic banking to have a set of regulatory framework so as to stay competitive and relevant in the financial sector of the future.

In this respect, regulatory and supervisory authorities play a major role in ensuring that Islamic banking continue to gain national and international acceptance by way of having a first-rate framework governing the Islamic financing system.

8.3.4 Introduction of an Islamic Money Market

The non-existent of an Islamic Money Market at many countries (domestic) and international level has dampened the growth process of Islamic banking in many countries. The development of an Islamic Money Market is crucial as an essential avenue to provide a ready source of short-term investment outlets based on Shariah principles. In the case of temporary shortage of funds, Islamic banks can borrow from the Islamic Money Market. Likewise, in the case of surplus of fund, Islamic banks can also channel its funds into the Islamic Money Market as a form of investment in other institutions offering Islamic banking.

This is proven in the case of Malaysia, whereby the country introduced its own Islamic Money Market (Inter-bank Mudharabah) in 1993 – then believed to be one of the first Islamic Money Market in the world. The development of this Islamic Money Market has helped expanded the Malaysian Islamic banking practitioners’ source of funds, through investment and borrowing activities. Initially five banking institutions made up the Islamic money Market. Currently 52 banking institutions participate in the Malaysian Islamic Money Market.
In the case of the Malaysian Islamic Money Market, Islamic banking institutions will be able to request from participating banks in the Islamic Money Market the Islamic banking Mudharabah deposit (Interbank Mudharabah), and in the case of surplus of fund, Islamic banking institutions can also invest in the Islamic Money Market as Mudharabah interbank investment. Those placement or investment are at a nominal return which is normally equivalent to the return in the conventional money market.

Currently, work is in progress for the setting up of an International Islamic Money Market to be based in Labuan, Malaysia. This initiative, once accomplished, will facilitate the growth of Islamic banking institutions throughout the world.

8.3.5 Widening of Operations Scope

The Islamic banking system in Malaysia is relatively still in its infancy. In Malaysia it started off with Islamic commercial banking, and progressed to include different components within a wider Islamic financial landscape such as takaful, capital market, and so on.

While it started out concentrating on debt instruments, as most commercial banking tend to do, Islamic banking in Malaysia has progressed to include equity instruments (e.g. Mudharabah and Musyarakah). With each instrument having its own inherent risk profile, it is imperative that Islamic bankers identify these risks and act accordingly.

Depending on how advanced a particular market is, all instruments can be capitalised, in no particular order. In Malaysia, debt instruments were developed first because of the market needs and available infrastructure. As the demands and needs of the nation became more sophisticated and advanced, the need to develop equity instruments increases.
Following from this development, it is anticipated that the Malaysian Islamic banking system will witness a convergence between debt and equity markets, as both components continue to develop at a rapid pace. Modes of financing utilised by Islamic banks should also depend on the policy of individual nations – based on their priorities and means.

Bank Islam Malaysia Berhad for instance was set up as a commercial bank dealing mostly in debt financing (which has a totally different risk profile as Mudharabah and Musyarakah modes of financing). However, the Bank does not discount these forms equity financing as apart of its business activity in line with its expansion.

Islamic banks should consider the following factors in dealing with forms of financing:

(a) Risk profile; and

(b) Regulatory framework.

8.3.6 Increase in Capital Base

With the imminent globalisation and liberalization of the global financial market, Islamic banks would have to continue to strengthen and enhance their capital base so as to prepare themselves in facing greater challenges in the future.

One obvious challenge facing Islamic banks when the financial boundary of nations is opened up is the foreign competition brought about with the entering of foreign banks, which are normally bigger in size and more advanced in terms of financial capabilities.
Currently in many countries, Islamic banking still has a niche market. Thus, Islamic banks in these countries are relatively secured and would only have to compete with other local conventional banks in each country. These Islamic banks, then, are at liberty to develop and progress at their own pace, and in a protected financial environment, without too much competition from their conventional counterparts.

With the coming of foreign banks, many of which expertise and offer Islamic banking facilities within their conventional set-up, local Islamic banks, which in general are small in size, are confronted with a new challenge, - one which requires them to increase their competitiveness through the strengthening of their capital and asset base. Only then can Islamic banks hope to measure up to and equally compete with the bigger and more established foreign banks.

8.3.7 Upgrading of Information Technology Systems

The importance of information technology (IT) in banking cannot be stressed more. As more and more banking institutions rely on IT in enhancing their business capabilities, IT has become a necessity in the banking sector. Hence, Islamic banks will have to equip themselves with state-of-the-art Islamic banking IT systems if Islamic banking is to stay competitive and progress in the 21st century.

Being the backbone for future fully computerised banking operations, IT infrastructure includes hardware, systems software, applications software, communications network facilities and support services. In addition, to facilitating the upgrade of services, work processes, communication and decision-making efficiency, the Islamic banking IT infrastructure will also accommodate new and future advancement in electronic banking- a vast area with high potential which many Islamic banks has yet to explore extensively. Again, sufficient capital is a
pre-requisite for Islamic banks to invest in IT. Therefore, Islamic banks should be equipped with adequate capital to be able to invest seriously in IT.

8.3.8 Cooperation Between Islamic Banks

Cooperation between Islamic banks at an international level especially in areas of mutual benefit could be improved. This is important because due to the small nature of many Islamic banks, such consolidation will facilitate in international business dealings or operations that usually require wider-scope of expertise and financial capacity. For example, in the case of syndication at the international level, there is a lacking of syndicated financing organized by Islamic banks (acting as Arranger). At best, Islamic banks participate in these syndications.

With the cooperation and combined strength of Islamic banks from various nations, syndication of Islamic banks is now a viable financing avenue for Islamic banks across the globe. This is also true for other initiatives as well, and should be seriously discussed between Islamic banking practitioners at an international level conference.

8.4 Summary

By any standard, 26 years of Islamic banking is an extremely short period of time if we were to compare it with conventional banking, which has a history of more than 200 years. Islamic banking developed in earnest beginning in 1975 followed by the establishment of the Islamic Development Bank in the same year. In Malaysia, the first Islamic bank was established in 1983. Alhamdulillah, we have made great strides when Islamic financial institutions began to be set up in all parts of the world, and is continuously being established until this day. It is heartening that we have made remarkable progress, if not momentous, over the years. We have created the genesis of an alternative financial system that has begun to gain worldwide recognition.
Indeed the initial reaction of the West towards Islamic banking was great skepticism. However, the attitude of international financial community towards the system has since improved. Today it is received with significant interest. With about US$170 billion of fund managed by more than 50 Islamic institutions, in more than 50 countries including the US, the UK and the Far East Islamic banking has proven itself and survived. Islamic banking continues to grow because of its value-oriented ethos that enables it to draw finances from both Muslims and non-Muslims alike. Islamic bankers, keeping pace with sophisticated techniques and latest developments have evolved investment instruments that are not only profitable but also ethically motivated.

Islamic banking and takaful has over the past 26 years made impressive progress. However, there is still much planning and strategizing ahead – no Islamic banks are in the world’s top 100 banks. The young Islamic banking faces obvious limitations. Although Islamic countries are home to one-fifth of the World population, the total amount of funds accounts for only about 10 percent global funds. Large amount of prove assets belonging to Muslims are still nesting with the traditional bankers.

We have not kept pace with developments in banking. While we have progressed, others have achieved more. We must not live in isolation, or grow independently of each other. Islamic countries must foster greater cooperation. And, the noble form globalisation will spur growth and trade. Aspects of globalisation were evident during the great Islamic Empire. There were no boundaries to deter and stifle the spread of Islam and with it the movement of trade and knowledge. Resources were utilized and shared for the common good of the Ummah.

Unmistakably, globalisation has the potential to produce greater wealth for all. If properly managed, the poor nations will benefit. It presents exciting new
opportunities for the creation of wealth and economic growth. At the same time, the idea of bank consolidation is only catching on for the Islamic banks and financial institutions in the last few years. We must understand that to be even acknowledged in the global financial market, a bank must be of significant size and has substantial capital strength. As we mentioned earlier, up to now, no one Islamic bank has made the list of top 100 largest banks in the world by asset size or capital strength. Islamic banks should strive to be in the top 100. Merger is another alternative for we must not be marginalized.

Uniformity and standardization will increasingly shape the Islamic banking and takaful industry and leads it to a lucrative global customer base. This calls for harmonization of Shariah decisions, for which, the concerted efforts within the Islamic banking industry towards uniformity in Shariah interpretations is a right step. This uniformity is emerging partly as a result of the participation of several leading Islamic scholars on Shariah boards of various Islamic financial institutions. Central Banks from Islamic countries should work closely towards evolving a consensus on a uniform set of Shariah standards of least for the more universal products, if not all, to inject greater vitality in the Islamic financial sector.

We need to standardize the supervisory and prudential standards for the Islamic financial institutions. Recently, an international supervisory body known as the Islamic Financial Services Board, or the IFSB, was proposed. It will design and issue these standards. Malaysia looks forward to playing a key role in this initiative and gladly offers to be the host nation. Guided by the IFSB, managing the unique risk characteristics of Islamic financial institutions will become more structures, prudent and transparent. This will spur the growth of Islamic financial services industry throughout the World.

Malaysia has proposed the idea of an international money ad capital market that adopts the Shariah rules. Malaysia with a group of central banks of Islamic countries and the Islamic Development Bank are developing the International
Islamic Financial Market, or IIFM. It will address the liquidity needs of international Islamic banks, broaden the market of Islamic finance and investment internationally and expand the range of new Islamic financial products. For a start, Labuan has been designated as a focal center for IIFM for this region, and Bahrain, for the Middle East region. Both centers can complement each other in achieving and ensuring the smooth implementation and operation of the IIFM.

Islamic financial institutions also have to be active in the international financial market and take advantage of the networking opportunities that it offers. There has been some progress concerning Islamic bonds. It is inevitable that the creation of the secondary market arising from such issues would present active trading opportunities.

References