

Progress and Challenges of Islamic Banking

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Three decades have passed since the first Islamic bank, Mit Ghamr, began its operations in Egypt, and more than a decade has passed since the Islamic Republics of Iran and Pakistan adopted a non-interest-based financial system¹. The growth of financial institutions, instruments and transactions operating without interest has been impressive considering that until the early 1980s the concept of transactions that did not rely on the use of interest rate as the central balancing mechanism between the supply of and demand for financial resources was virtually unknown in the West. In terms of size, Islamic financial markets have exhibited remarkable growth from meager 5 billion in 1985 to current level of approximately \$100 billion. Today, Islamic banking is not confined to boundaries of Muslim countries anymore but is spreading and gaining acceptance in non-Muslim countries as well. Equally important has been the growth of scholarly interest in the subject. The viability and feasibility of non-interest-based financial transactions, instruments, institutions and systems as well as the legitimacy of academic

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research in this area are not longer questioned.

Objective of this paper is to (i) review the progress of Islamic banking and Islamic financial markets; (ii) present the fundamental principles of Islamic financial system in light of developments in modern financial theory; and (iii) identify the challenges ahead for the development and further growth of a non-interest based financial system. The paper is organized into five sections. Section I discusses progress of Islamic banks and financial markets, Section II summarizes development in Islamic financial theory, Section III discusses the relevance of principles of Islamic financial system with reference to modern financial theory, Section IV addresses issues and challenges, and finally Section V concludes the discussion.

Section I: Progress of Islamic Banking:

The last three decades of developments in the theory and practice of Islamic banking can be divided roughly in three periods of (i) development of conceptual framework, (ii) experimentation and (iii) recognition. In the first period, the efforts of Muslim scholars were concentrated basically on raising the consciousness of Muslims regarding the issue of riba.¹ Thus, considerable emphasis was placed on moral, philosophical and religious arguments against the institution of riba; economic-theoretic arguments were given less prominence. the exception was the writings of Sheikh Mahmud Ahmad (1985) who meticulously combed through nearly all theories of interest developed since the time of Adam Smith to show that there had been no satisfactory explanation of existence of a fixed and predetermined rate of return to financial assets.² He went further; analyzing the writings of economists such as Keynes, Bohm Bowerk, Cassels, and Samuelson, he argued that an objective assessment would lead one to believe that all of these writers held a

1 - Prohibition of 'Riba', a term literally meaning 'an excess' and interpreted as any unjustifiable increase of capital whether in loans or 'sales' is the central tenet of Islamic financial system.

2 - Sheikh Mahmud Ahmad (1985)

reasonably strong conviction that the existence of a fixed and predetermined rate of interest was an impediment to the process of economic growth and development. Khan (1986) noted that the abolition of interest-based transactions is not a subject alien to western economic thought. Fisher (1945), Simons (1948), Friedman (1969), among others, have argued that the current (one-sided liability) interest-based financial system is fundamentally unstable.

The ongoing research in the area of finance and contract theory was of considerable importance to the understanding of how financial markets work. A very simple but crucial insight of Muslim scholars made it possible to tie-in the developments in modern theory of finance and Islamic banking, i.e., the notion that prohibition against *riba* meant elimination of all fixed-fee debt contracts and that an Islamic financial system would have to be primarily equity based. This led to the development of a model for an Islamic bank conduction business on profit/loss-sharing principle.

The immediate intuitive response to elimination of *riba* (fixed interest rate) was that without this mechanism there would be a financial market failure; demand for loanable funds would be infinite while its supply zero, so that a financial system without an interest rate would be neither viable nor feasible. The challenge for Muslim scholars was to demonstrate that such would not be the case by building on the works of earlier Muslim scholars on profit-sharing-based banking. While the concept of profit-sharing-based Islamic banking emerged clearly as the dominant substitute for interest-based banking by the end of 1970s, much of its analytic underpinnings and theoretical Justifications were developed in the 1980s.

During the second period of experimentation, private commercial institutions based on principles of profit/loss-sharing as conceptualized by earlier Islamic scholars started to appear. Islamic banking received further endorsement in mid-80s when Islamic Republics of Iran and Pakistan adopted a banking system that eliminated interest and provided constitutionally legal recognition. As demand for Islamic instruments grew and Islamic institutions

started to hold ground, several reputed western financial institutions realized the potential and entered the market by playing the role of financial intermediaries for Islamic banks who lacked technical-know-how. Western institutions helped Islamic bank funds placement and expansion of their deposit base while accessing wider capital markets. By the end of this period, Islamic financial institutions were successful in building a solid deposit base and maintaining relatively sound track record in such a way that the concept of interest-free banking became a practical alternative. It is important to note that much of the growth during this period was led by the initiatives of private sector institutions and was not state-sponsored. In fact, the performance of banks in countries where banking system is officially non-interest basis has been rather disappointing.¹

During the third period of 'recognition', Islamic financial institutions have gained confidence and relative credibility in domestic and international capital markets. Islamic banks are in a process of standardizing instruments and accounting procedures. Moreover, they have begun offering services directly to the investors and have realized the significance of introducing innovative products.

Section II. Developments in Islamic Financial Theory:

There is now a general consensus among Muslim religious scholars (fuqaha) and economists that the prohibition against riba extends to interest. At least four characteristics define the prohibited interest rate: (a) it is fixed ex ante; (b) it is tied to the time period and the amount of the principal; (c) its payment is guaranteed by the borrower regardless of the outcome of the transaction for which the money was borrowed; and (d) the state apparatus sanctions and enforces its collection.

One implication of prohibition of riba is that it virtually eliminates all debt financing and debt instruments as they exist in conventional banking; to

1 - Section IV discusses the reasons for such poor performance.

replace them, the shariah holds the view that individuals have a wide freedom of contract. Therefore the contracting parties are free to engage in any transaction not prohibited by the Shariat, this flexibility makes possible a virtually open-ended menu of various modes of financial transactions, instruments and contractual forms so long as contracts do not contain any element of *riba* and/or *gharar*.¹ The latter can operationally be said to exist if one (or both) of the contracting parties is in possession of some information regarding the subject of the contract and withholds that information from the other party. Incidentally, this definition brings the concept of *gharar* close to the notions of asymmetric information and moral hazard of contract theory.

Historically, Muslim religious scholars (*fuqaha*) did not define a priori the various methods of *riba*-free transactions available today. The practice was that the contracting parties would decide on a particular mode, and the *fuqaha* would then rule on its permissibility. Muslim economists often insist that, in order to become Islamic, a financial system must replace the interest rate mechanism with a profit-sharing mechanism. This is, of course, only the economist's inference. The position of the shariah, as stated earlier, is that any transaction is permissible so long as it does not contain any element of *riba* and/ or *gharar*.

It thus follows that it may be possible to develop a variety of non-profit-sharing methods of financial transactions that meet the basic requirement of the shariah. A prime example is the method of *Qard al Hassan* (loans made without any expectations of financial rewards); other methods include, among others, *Morabaha* (cost-plus financing) and *salaf*

1 - *Gharar* can be defined as a situation when either party to a contract has information regarding some element of the subject of contract that is withheld from the other party and/or the subject of contract is something over which neither party has control. Classic examples include transactions involving birds in flight or fish not yet caught. More modern examples include transactions whose subject is not in the possession of one of the parties and there is uncertainty even about its future possession.

(forward sale) transactions.¹ Hence, from the perspective of Islamic law a financial system is not rendered un-Islamic if it operates primarily or even mostly with non-profit-sharing modes as long as these satisfy the requirements of the Shariah. This is a very critical and significant point as many critics of the current practices of Islamic banks contend that many of the transactions conducted by these banks, such as Morabaha, installment sales and the like, are not profit-sharing methods, and that these transactions resemble or are in effect the same as interest-based transactions. While the latter may be true (installment transactions, for instance, may indeed resemble interest-based transactions), the fact is that the former are sanctioned by the shariah, whereas interest-based transactions, which may produce identical results, are not.

By prohibiting interest, Islamic injunctions do not imply that the opportunity cost of capital represented by interest rate in a conventional system is zero. In an Islamic framework, the incentive for the firm to invest will solely depend on prospective profitability and therefore, a profit maximizing firm will continue investing until the marginal productivity of capital becomes equal to the opportunity cost of capital; therefore 'cost of capital' in Islamic system can be represented by the rate of return of alternate opportunities for investment of comparable risk.² It has also been demonstrated that there is a rate of return in Islamic capital markets serving opportunity cost of capital and driven by the rate of return in the real sector

1 - Qard al Hassan is an interest free loan given mainly to please Allah S.W.T. and, therefore, must not include expectations of any returns including the principal. The intention has to be assistance to those who need a loan but can not secure it and who may have no potential to return it. The Quran encourages these types of loans by saying that the loan is made to Allah S.W.T. and suggests enormous rewards directly from Allah S.W.P: see for example Quran 73.20. Morabaha is a contract sale between an Islamic bank and a client for the sale of goods at a price which includes a profit margin agreed by both parties. Salaf is a lending agreement in which the seller promises to deliver a specific product at a specified time in the future.

2 - See M. Khan (1985), Iqbal and Mirakhor (1987), and Fahim Khan (1991).

of the economy.¹

Theoretical models of a financial intermediary operating on the principles of Islamic financial system can be grouped into two broad categories: two-tier modaraba model and two-window model. Two-tier modaraba model is an arrangement where the Islamic bank enters into separate modaraba contracts, on assets (with the users of funds) and liabilities (depositors) side.² The entrepreneur agrees to share profits with the bank in return for the investment and the bank agrees to share (pass through) the profits with the depositors. In other words, the bank acts as a financial intermediary solely on the basis of profit-sharing both on the assets and on the liabilities side. Two-window model is also based on profit-sharing on assets side but recognizes the need of depositors on the liabilities side who wish to choose between transaction deposits and investment deposits.³ This model divides the liability side of the bank balance sheet into two windows, one for demand deposits (transaction balances backed by 100% reserves) and the other for investment balances with the choice of window left to the depositors. Since both models are based on profit-sharing, the losses incurred as a result of investment activities by the bank will be reflected in the depreciation of the value of the depositors wealth-thus eliminating any assets-liabilities mismatch. However, both models see the probability of loss minimized through portfolio diversification, careful project selection, monitoring and control.

Systems in which the assets and liabilities of banks are acquired on a profit-sharing basis have given rise to important propositions. First, the real values of assets and liabilities would be equal at all points in time.⁴ In addition, the prospect of instantaneous equilibrium between the asset side of

1 - Khan and Mirakhor (1988).

2 - See Siddique (1980, 1982), Chapra (1985), and Uzair (1980).

3 - Khan (1985).

4 - It is synonymous to continuous marking-to-market both asset and liability portfolios.

the banking system-driven mainly by the real sector of the economy - and the liability side means that there must necessarily be a close and direct relationship between investment and deposit yields. Also, since the return to liabilities of the banking system is a direct function of the return to the asset portfolio of the system, and since assets are created in response to investment opportunities in the real sector of the economy, it is the real sector that determines the rate of return to the financial sector rather than the reverse¹.

Furthermore, in an Islamic financial system the adjustment to shocks leading to banking crises and disruptions in the country's payment mechanisms is faster than in the conventional system. There will also be no disruption in the intermediation process of the banking system, nor is there any reason to believe that the savings and investment process will be impaired. Indeed, savings and investment need not decrease, and if the rules of the shariah regarding - contracts - including full disclosure requirements - are observed, both will increase².

Moreover, monetary policy can be effective in stabilizing - the economy, and this has been shown in both closed and open economy models³. In an open economy context, to the extent that external resources mobilized through profit-sharing models are channeled to productive investments, such investments can be expected to generate a stream of returns at least sufficient to repay the associated external liabilities. Also in an open economy context, there will be two-way capital flows; that is, there is no reason to expect only capital outflows, since net results will depend on the difference between domestic and external rates of return.

Section III. Integration with Modern Financial Theory.

Rapid growth and expansion in domestic and international capital markets since 1970 can be attributed to financial innovation as result of advancement

1 - Mirakhor (1989b).

2 - Haque and Mirakhor (1987).

3 - Mirakhor and Zaidi (1988)

in financial theory as well as in information technology.¹ Research in agency theory, capital asset pricing theory, portfolio theory, options pricing theory, and efficient market theory led to development of sophisticated instruments ranging from securitization to derivatives to complex structured instruments. Increased international trade and breakdown of Bretton-Woods system further contributed to high volatilities in exchange and interest rates and saw mushrooming of derivative products to combat market-based risk.

Developments in modern financial theory offer enhanced understanding of motivations and factors behind why investors, intermediaries and users of funds tend to prefer fixed nominal contracts. These theories are of considerable significance in that they have yielded important results that can explain the persistence of fixed-return debt contracts and are highly relevant to Islamic banking.

Standard Modigliani-Miller theorem on irrelevance of capital structure showed that method of finance would be irrelevant to the capital structure of a firm under conditions of perfect capital market, implying that for debt financing to be preferred over equity finance other factors such as taxes or other capital market imperfections would have to play a role.² Existence of tax benefits to interest expenses provides an incentive for firms to enter into fixed debt contract and an opportunity to lower cost of capital.³

Modern portfolio theory was developed showing the importance of risk diversification and how efficient portfolios can be constructed by

1 - Jorian and Da Silva (1995).

2 - Modigliani and Miller (1958). Miller (1977) Miller (1988) re-examines the discussion on capital structures according to Modigliani-Miller proposition over past three decades. Miller (1995) discusses relevance of standard Modiglian-Miller theorem to banking institutions.

3 - Argentine Congress currently has a Tax Reform Bill under consideration that proposes withdrawal of tax deductibility of interest payments for corporations.

diversifying non-system risk.¹

- The concept of "capital market imperfection" was more precisely defined in terms of "information imperfection" or "failures". Concepts of asymmetric information, moral hazard, and adverse selection went a long way in explaining a large number of capital market phenomena as well as behavior of capital market participants.²
- Modern contract theory was developed which, inter alia, showed how contracts between principals and agents could be designed that would be compatible with desired results. Most importantly, this literature stressed the importance of providing incentives for agents and that any incentive structure must have managerial rewards depending significantly on firm performance, rather than on fixed payoffs.³
- Theory of financial intermediation attempts to answer two fundamental questions that had not been satisfactorily addressed. These were: (1) why did banks develop and (2) why were all their operations based on fixed fee contracts? These questions are importantly, albeit indirectly, relevant to the theory of Islamic banking.
- Arbitrage argument to price sophisticated financial instruments was extensively used to demonstrate that in an efficient market two instruments with identical risk-return characteristics can not have different prices. Also, implying that financial engineering can be applied to basic building blocks of a financial system to develop identical products, which are priced correctly and fairly and meet the specific requirements.

It is critical to understand why do banks exist and why do they prefer to enter into debt contracts and what kinds of disadvantages are associated with

1 - Markovitz (1959) and Tobin (1958) did pioneer work on portfolio diversification. It was extended to Islamic banking by Mirakhor (1987) who showed that it is possible to construct an efficient portfolio when there are no risk-free assets.

2 - Fama (1970) see application to Islamic Banking In Hague and Mirakhor (1987).

3 - See Haque and Mirakgor (1987) for application to Islamic contracts.

such contracts. Traditionally, the existence of banks in an economic system is considered to be justified because of their ability to intermediate between the preference of lenders (investors/depositors) for short-term liquid assets and the preference of borrowers (entrepreneurs) for long-term illiquid liabilities by transforming maturities and doing so at a reduced aggregate cost of gathering and monitoring information on borrowers. Furthermore, banks play the crucial role of a screening device for lending and allocation of credit. Asymmetric information literature suggested that not only banks, as intermediaries, save on duplicated monitoring costs, but also on indirect costs of transmitting information through signals. By diversifying risks across assets, banks are able to provide signals at lower costs.

Monitoring is costly, especially if duplicated by individual investors. Diamond (1984, 1996) concludes that the best way to delegate monitoring is for the delegated monitor, i.e. the bank, to issue unmonitored debt, which will be subject to liquidation costs. He demonstrates that the optimal unmonitored financial contract between a borrower and lenders is a debt contract that involves positive expected deadweight liquidation costs, which are necessary to provide incentives for repayment¹. This also implies that the laws governing bankruptcy provide incentives and protections to financial institutions to issue unmonitored debt.

Ascertaining that an entrepreneur is creditworthy requires resources, and standing by that judgement, providing or guaranteeing credit entails risk taking. When there are information imperfections and financial markets are incomplete, particularly when secondary markets for claims issued by individuals and small companies are lacking and transaction costs are non-zero, banks emerge as financial intermediaries that specialize in gathering of private information as well as the monitoring and enforcement of loan contracts,² these results have an important implication. The more incomplete

1 - Diamond (1996).

2 - Recent growth in equity markets of industrial countries has led to phenomenal

the financial markets and the greater the information imperfection, the larger the need for banking institutions¹. This makes banking institutions indispensable where capital markets do not exist or are very thin.

The question of why do banks operate on fixed-rate basis has been much harder to explain not only the fixed payoff but also related questions regarding financial repression, i.e. the necessity of interest rate ceilings on bank liabilities and other controls and regulations such as non-interest bearing required reserves, control on asset portfolios, entry controls, and finally, deposit insurance without adequate response of insurance premia to asset risks needed answers. Implicit understanding had been that without fixed payoff and all other related controls and regulations, a highly competitive banking environment would result in risky bank asset portfolios as well as risky deposits and this state of affairs was deemed undesirable. It has not been shown, however, why in the presence of deposit insurance and required reserves banks, investing in risky assets is inherently bad. Moreover, it is posited that since long-term investments are illiquid their presence in banks asset portfolios make bank runs more costly for every one. This, however, does not explain why should presence of risky assets precipitate bank runs.

Additionally, it has been shown that if preferences are risk-neutral and the choice of risk level is unbearable, it would be an inefficient choice to sacrifice higher-mean asset payoffs.² Consequently, if banks exist solely to

expansion of mutual funds industry which is providing efficient means of placing funds on profit/loss principle. This growth can be attributed to decreased informational asymmetry and therefore increased informational efficiency in capital markets. Technological advancements have further facilitated the dissemination of results of research and market sentiments to small investor.

1 - Markets are considered incomplete when the sources of uncertainty affecting the fundamental asset/security are not spanned by traded securities. In other words, full set of contingent claims on basic assets is not available in the market.

2 - Cho (1989).

save on transaction and monitoring costs in asset choice, there is no explanation of why their liability cannot or should not be all-equity. Asymmetric information literature, however, explains that since debt-type contracts are reinforced by threat of bankruptcy and since fixed pay out commitments diversify the risk of losses through early liquidation of illiquid assets, debt-type contracts dominant.

By mid 1980s, economic and financial theory had demonstrated that there were disadvantages in fixed-payoff contracts that dominated interest-based banking. First, these contracts create inefficient default or non-performance incentives. To overcome this risk, fixed-payoff contracts need additional stipulation of threat of bankruptcy and early liquidation of illiquid assets and/or collateral. Second, in the presence of asymmetric information, debt contracts suffer from adverse selection effects, (i.e., beyond a certain level of interest rates, lower quality borrowers are supplied credit) and moral hazard effect, (i.e., applicants undertake greater risks in reaction to the contract). These last two effects are sufficiently strong that the net return may be lowered as banks increase interest rates charged, therefore, market equilibrium may be characterized by credit rationing. Consequently, some groups may be excluded from the credit market although the expected returns of these groups, investment may be higher than those who receive credit. Equity finance, however, is free of adverse selection and moral hazard effects.¹

1 - Cho (1986). Suppose that the risk-neutral lenders (debt financiers) and potential shareholders (equity investors) have the same level of information of on groups of firms, i.e. about the characteristics of the firms, their industry, the record of payment, bank relations, etc. but do not have information about the risk characteristics of individual members within groups. They can sort out among groups of borrowers whose expected productivities are the same but can not sort them within groups according to their degrees of riskiness. Under these conditions, the lenders (debt financier/ banks) will ration out borrowers with lower payoff and high variations even though they are the most productive. Banks will avoid financing new, productive group

Third, fixed-fee contracts create a fundamental conflict between the interests of the borrowers and those of the lenders. The borrowers consider the upper tail of the distribution of investment payoffs while the lenders are concerned about the lower tail of the distribution. In case of equity finance the expected return to an equity investor would be exactly the same as the expected return to the project itself, thus avoiding the conflict of interest between lenders and borrowers that exists in debt-type contracts. Fourth, with fixed-fee contracts, the banks are primarily interested in safe and well-established borrowers, therefore, new borrowers will find it difficult and/or expensive to obtain credit in order to finance, their investment. Finally, in the down-phase of an economic cycle or as a result of unforeseen shocks, interest based banks may be forced into a liability-management mode where, in order to maintain their preset deposits and attract additional depositors, they increase their deposit rates while their earnings reduce, thus leading to banking crisis.

Discussion in preceding section leads to the inference that based on the research in modern financial theory, in a world of perfect information, *ceteris paribus*, there can be no reason why debt-type contracts should dominate equity-type contracts. In the presence of imperfect information when the need for monitoring arises, to demonstrate the superiority of debt-type contract on needs additional assumptions, at least, regarding the risk preferences of lenders and borrowers, institutional setups and the incentive structure imbedded in the relationship of principals and agents. Generally though, it has been shown that efficient contracts require incentive-compatibility in order to induce agents to deliver in accordance with the terms of the contract. It has been demonstrated that efficient contracts are possible with Islamic

of borrowers who may be perceived to be risky even though the banks are risk neutral. The dynamic effect of this on economic growth would be even more since it can reduce opportunities to innovate and make the adjustment of industrial structure difficult in developing countries.

principles.¹

In summary, from a theoretical standpoint, there is no reason to suggest that an Islamic bank or an Islamic financial system cannot fulfill the basic tasks required of any financial intermediary or a system. Indeed, it is possible to argue that, under certain circumstances, they can do better.

Section IV. Issues and Challenges:

Whereas theoretical developments have demonstrated the viability and practicality of Islamic financial system, implementation of the system faces several challenges. It is critical to identify and meet the challenges in order to maintain current momentum in growth and to achieve long-term sustainable growth. The long-term sustainability will largely depend on how effectively and successfully these challenges are overcome. The major and the most immediate challenges are (a) development of liquid secondary and money markets, (b) development of supervisory and regulatory framework for Islamic banks; (c) development of instruments for effective monetary and fiscal policy; and (d) standardization of accounting and auditing standards as well as the process of religious approval of new instruments and techniques. These challenges can be classified into two groups; (a) financial engineering challenges to apply principles of Islamic finance for further innovation and (b) challenges to make operation of the system more efficient, stable and well integrated with international capital markets.

A financial engineering challenge is to introduce new shariah compatible products to enhance liquidity in the market and to offer tools to manage risk and to diversify portfolios.² Generally, applications of financial engineering techniques to Islamic banking will require serious commitment of resources to

1 - Presley and Session (1994) demonstrate that a Modaraba contract between the manager of a project and a syndicate of investors may permit a more efficient revelation of any informational asymmetries between the two. See also Khan and Mirakhor (1987).

2 - Askari and Iqbal (1995).

understand risk-return characteristics of each building block of Islamic financial system and to offer new products with different risk-return profile to meet the demand of investors, financial intermediaries and entrepreneurs for liquidity and safety. The process of securitization to enhance marketability, negotiability, marketability and return of an asset is a prime candidate for application of innovation and financial engineering.¹ With increased globalization, degree of financial markets integration and linkages has become critical factor in success of any capital markets. Such integration becomes seamless and transparent when financial markets offer wide-array of instruments with varying maturity structures and opportunities for portfolio diversification and risk management. Financial engineering in Islamic finance will have to focus on development of products that foster market integration and attract investors and entrepreneurs to risk-return characteristics of the product instead of the product being Islamic or non-Islamic.

Another candidate for financial innovation is development of instruments to satisfy needs of the market on the two ends of maturity structure, i.e. extreme short-term money market or long-term. Money markets that are shariah compatible do not exist at present and there is no equivalent of an Islamic inter-bank market where banks could place, say, overnight funds, or where they could borrow to satisfy temporary liquidity needs. Currently, the markets are operating on limited traditional trade-related instruments and seriously lack instruments for long-term investment and economic development.

As impressive as the record of growth of individual Islamic banks in the west may be, the fact is that, at the present, these banks have mostly served as intermediaries between financial resources of Muslims and major commercial banks in the West. In this context, this has been a one-way relationship, so far. There is still no major Islamic bank that has been able to develop ways and means of intermediating between western financial resources and demand for

them in muslim countries. There is an urgent need to develop marketable shariah-based instruments by which asset portfolios generated in Muslim countries can be marketed in the west. It also appears that individual Islamic banks face difficulties in fund placement because they have had a major bias toward short-term, secured, low-return but liquid investments.

Operational challenges can be better understood when analyzed separately both at the micro level, i.e. setting-up the financial institution on a profit-loss sharing principle, and the macro level, i.e. economy-wide implementation of Islamic financial system. While it has been relatively easy to create an Islamic bank where deposits do not bear interest, in reality, the asset portfolios do not contain sufficiently strong components that are based on profit sharing. The main reasons for this can be attributed to informational asymmetry due to inefficient markets resulting in costly delegated monitoring and preference for short-term trade related transactions. Also, there is lack of legal and institutional frameworks that facilitate appropriate contracts as well as mechanisms to enforce them.

As operational difficulty facing Islamic finance is the availability of an equity-based benchmark or reference rate (reflecting the rate of return on the real sector) for pricing assets and evaluating portfolio performance or comparing various investment alternatives. In absence of such reference rate or benchmark, a questionable but common practice has been to use the London Inter-Bank offer Rate (LIBOR) as proxy. Recently, two models by Mirakhor (1997) and Haque and Mirakhor (1998) attempt to address this challenge which with further refinement can offer a workable solution, Mirakhor's model is based on the concept of Tobin's q theory of investment implying that a firm's cost of capital is a linear function of firm's q -the ratio of market to replacement value of capital. Haque-Mirakhor model, attempts to develop an economy-wide index based on major indicators of domestic and international equity market performance to serve as a benchmark for issuing government papers. Suggested index is designed as weighted average of

domestic stock market index, international equity returns, and return on government, s development projects. Inclusion of both domestic and international indices make it efficient in terms of its ability to eliminate any arbitrage opportunity and discourages speculative behavior.

Another operational challenge for Islamic banks is to standardize the process of introducing new product in the market. Currently, each Islamic bank has its own religious board examining and evaluating each new product without coordinating the efforts among other banks. Each religious board may have its preferences or adherence to a school of thought. This process should be streamlined and standardized to minimize time, effort and confusion.¹ There should be proper post-product audit by audit committees to make sure that institutions are complying with the shariah guidelines defined by the religious board. Some Islamic banks have already started using such audit committees.

The most important operational challenge of Islamic banking is in its system-wide implementation. At the present, many Islamic countries suffer from financial disequilibria that frustrate attempts at wholesale adoption of Islamic banking. Financial imbalances in fiscal, monetary and external sector of these economies cannot provide a fertile ground for efficient operation of Islamic banking. Major structural adjustments particularly in fiscal and monetary areas are needed to provide Islamic banking a level playing field. Additionally, adoption of legal framework of property ownership and contracts that would clearly specify the domain of private and public property rights as well as stipulation of legally enforceable rights of parties to contract that fully reflect the requirements of the shariah are necessary to allow an operational framework conducive to efficient operation of Islamic banking.

1 - Informal discussion with practioners reveals that reveals that religious boards sometimes become extremely rigid on minor technical matters that it makes the process of introducing new product difficult and lengthy and may result in missed business opportunities.

An Islamic financial system can be said to operate efficiently if, as a result of its adoption, rates of return in the financial sector correspond to those in the real sector. In many Islamic countries fiscal deficits are financed through the banking system. To lower the costs of this financing, the financial system is repressed by artificially maintaining limits on bank rates. Thus, financial repression is a form of taxation that provides governments with substantial revenues. To remove this burden, government expenditures have to be lowered and/or revenues raised. Efficiency can be promoted by requiring that governments compete with the private sector when accessing the credit market, i.e., allowing the unification of rates of return to borrow by government and the private sector.

Massive involvement of governments in the economy makes it difficult for them to reduce their expenditures. Raising taxes are politically difficult. Thus, imposing controls on domestic financial markets becomes a relatively easy form of raising revenues. Under these circumstances, it is understandable why governments would have to impose severe constraints on private financial institutions that can provide higher returns to their shareholders and/or depositors. However, these constraints make it very difficult for Islamic banks and other financial institutions to realize fully their potential. For example, modarabah companies that can provide higher returns than the banking system would end up in direct competition with the banking system for deposits that are used for bank financing of fiscal deficits, thus leading to sizable disintermediation from the, often nationalized, banking system.

Efficient operation of system-wide Islamic banking is presently severely constrained by distortions in the economy. Factors that include pervasive government intervention and controls, inefficient and weak tax system, financial repression, lack of capital markets, unavailability of a well-targeted and efficient social safety net, lack of a strong supervisory and prudential regulatory framework in the financial system, and, finally the deficiency of legal and institutional framework that provide Shariah-based definitions of

property rights as well as the rights of the parties to contracts cannot allow the efficient operation of an Islamic financial system. These distortions need to be eliminated to minimize waste and promote efficient resource allocation in any case. Their removal prior to or in conjunction with adoption of Islamic banking can be expected to create the dynamics necessary for non-inflationary and sustainable economic growth.

These distortions not only enhance the risks to price stability but also strengthen the environment of risk and uncertainty for contracts that do not promise a fixed nominal contract. While Islamic modes of transaction shift more risks to the investor, the risk environment has to be such that the investor can count on credible policies of the government that would maintain stable prices. It has now become clear that the choice of a monetary and fiscal policy regime determines the types of risks and uncertainty that the society bears. Individuals reduce the costs of risks and uncertainty associated with a given monetary or fiscal regime by refusing to share in risks of projects and opt out for safe, rather than risky, assets with fixed nominal payoffs, rather than returns that are outcome-dependent.

It is unreasonable to assume that if provided with two instruments with similar risk characteristics but one with higher expected payoff, as is the case with Islamic instruments, investors would prefer the one with lower payoff. The problem is that in many Muslim countries participants have to be concerned not only with the risks of the financial transaction itself but with price stability affected by a plethora of government-induced distortions and inefficiencies. If in addition to risks of the investment projects, the investor has to be concerned with the creditability of government policies, or arbitrary government decisions or distortions that threaten long-term price stability in the economy, he/she would be reluctant to invest in contracts that do not provide fixed nominal payoffs.

While Muslim countries may, for legitimate reasons, opt for an Islamic financial system, for the economy as a whole to benefit fully from the

operations of such a system it is necessary that (a) government expenditures are fully rationalized, (b) revenues from taxation, and those derived from property legitimately placed within the government domain by the shariar, are raised to meet the expenditure needs of the government, (c) financial sector is liberalized to allow the returns to this sector reflect returns to the real economy, (d) equity markets are developed to allow financing of investment projects outside banking institutions, and, finally (e) the structure of the banking system should be such as to allow strong banking supervision and prudential regulation commensurate with the risks involved in various transactions, To accomplish the last objective, the banking structure can be tiered in accordance with principal Islamic financial transactions,¹

It can argued that risks involved in Musharakat (equity partnership) or Modaraba financing are different from those involved in trade-type financing; therefor prudential regulations of these transactions should be different. An appropriate regulatory framework for banking supervision in an Islamic banks are in place; (b) investment and other risks are adequately dealt with taking into account that financing through the profit/loss sharing modes adds and element of complexity to the already difficult task of investment banking; and (c) adequate information is disclosed to allow the supervisory authorities to exercise a more effective prudential supervision and to enable public to make reasonably informed investment decisions.² Similarly, it is important to note that due to different nature of instruments and structure of an Islamic bank. its capital adequacy ratio should be determined accordingly instead of treating it like any other conventional bank. Therefore, and appropriate regulatory

1 - It is not an accident that Islamic bankig is making its most promising progress in Malaysia. This country has of the least repressive financial systems, no fiscal deficits, low inflation, low interest rates, and a dynamic and vibrant equity market as well as a strong private sector. It is hoped that recent contagion-related financial crisis in Malaysia will soon subside so that greater dynamism can be invested in the process of growth of Islamic banking in the country.

2 - Errico and Farahbaksh (1998).

framework for an Islamic financial system should aim at reinforcing banks, operating environment, internal governance, and market discipline.

Section V. Conclusions:

Islamic banking has established itself as an emerging alternative to interest-based banking system and is gaining roots in both Muslim and non-Muslim countries. Research in Islamic economics and financial theory has further enhanced our understanding of Islam's vision of an economic and financial system. Developments in modern financial theory leads to the inference that, under certain conditions, existence of relatively efficient and distortion-free markets can be conducive to development of a financial system based on Islamic principles that has the potential to be more efficient and stable compared to a fixed interest-based system.

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