Challenges in Islamic Finance

Ahmet Sekreter[1]

[1] Faculty of Administrative Sciences and Economics, Ishik University, Erbil, Iraq
Correspondence: Ahmet Sekreter, Ishik University, Erbil, Iraq.
Email: ahmet.sekreter@ishik.edu.iq

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Abstract: The growth of Islamic finance has been observed for the last decades. However Islamic finance is still 1 percent of the whole financial system. It has to overcome some challenges as it grows since it is not growing only in Muslim countries; some questions rise around Islamic finance. Given that the market of Islamic finance is new and fast-growing it is important to understand the differences between conventional and Islamic finance. Are they complements? Are they competing forms of contracts? Will they shape the future (conventional) industry of finance and how? These questions require an integrated understanding of Islamic finance and in particular its relation to conventional products. This paper studies challenges that Islamic finance has to overcome.

Keywords: Islamic Finance, Regulations in Islamic Finance, Transparency in Islamic Finance

1. Introduction

Islamic finance simply means that financial activities are approved by Islamic law. One main characteristic is Islamic finance is prohibition of interest also known as riba. Earning money from money is strictly forbidden in Islamic finance. Return must be based on an asset and involving risk. Hence pre-determined returns are also not allowed in Islamic finance. Moreover, speculation, uncertainty, and gambling are other prohibitions according to Islamic law in financial activities. Investing and trading some products that Islamic law prohibits such as alcohol, porn, and pork cannot be in financial activities in Islamic finance.

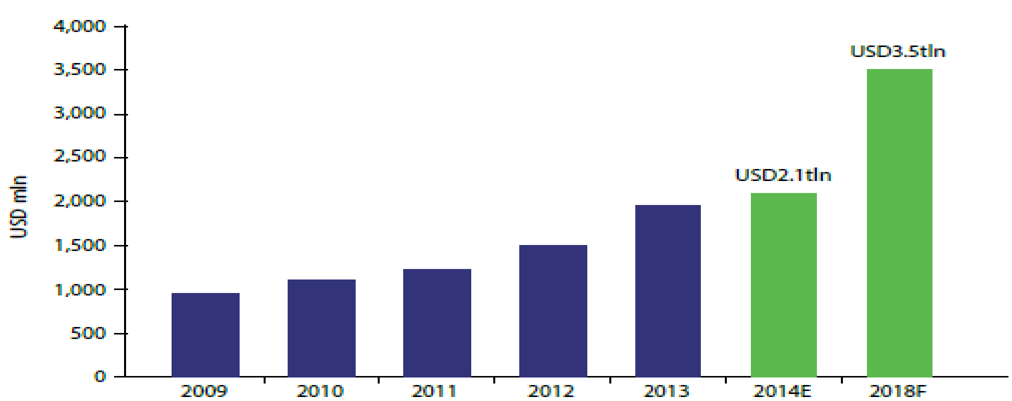


Figure 1: Growth of Islamic Financial Assets (Source: KFH Research Limited)

Islamic finance is growing with an increasing trend. It grows 10-12% percent annually during the last decade and total value of Islamic assets is approximately US $2 trillion according to the World Bank Group. However it was estimated that it is going to reach USD 3.5 trillion by the year 2018 by some research centers like KFH Research Limited. Globalization of Islamic finance and operating of Islamic financial products across countries arise some problems in Islamic finance that already existed. There is no doubt that Islamic finance has to deal with the challenge; preventing Islamic finance from occupying more portions in the global financial market. Islamic finance has expanded not only in Muslim countries but also in non-Muslim countries with many different Islamic financial products. However the share of Islamic finance in the financial system in non-Muslim countries is too small.

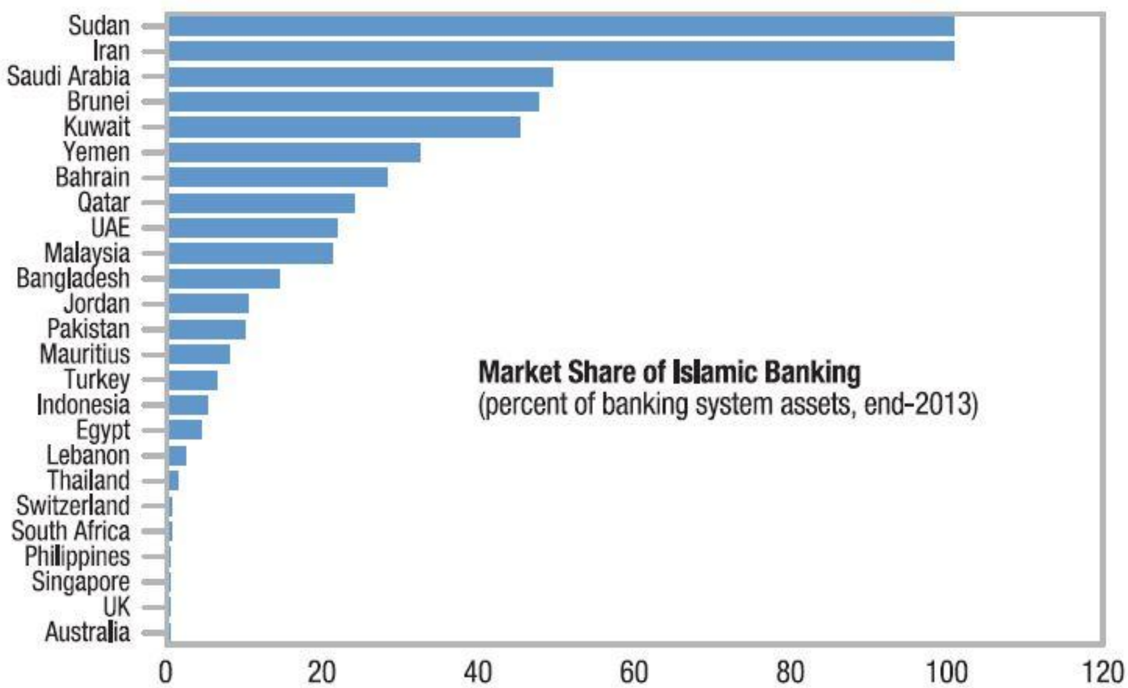


Figure 2: Market Share of Islamic Finance Banking Assets (Source: IMF Data)

2. Basic Products in Islamic Finance

Islamic finance offers plenty of financial products which allowed by Islamic law. However some basic Islamic products are going to be mentioned in this paper. Islamic financial products can be categorized as Profit-Loss Sharing, Advance Purchase, Deposit, Insurance products, and Islamic Bond which is known as Sukuk.

Musharakah is an Islamic financial product referring a partnership based on the profit-loss sharing principle. This partnership allows partners to share profit and loss according to a pre-determined ratio. All partners contribute to capital in Musharakah.

Mudarabah is another Islamic financial product which is very similar to Musharakah. However, one part contributes to capital and the other party supplies labor, effort, and expertise. The partnership is based on the profit and loss sharing. If there is a loss one party loses capital and the other one's labor, effort, and expertise would not be rewarded.

Murabahah is the most commonly used Islamic product. It can be defined simply as a credit sale. Islamic financial institution buys goods or asset then sells it client. The client buys the goods or asset in the form of deferred payments which based on the pre-determined agreement. So it is actually a sale of goods or asset for cash-deferred price.

Takaful is defined as type of insurance approved by Islamic law. The concept in Takaful is different than conventional insurance. Business organizations or individuals contribute money into a pool in order to use this fund against loss or damage.

Sukuk is mostly named as Islamic bond however it is very unlikely concept of conventional bonds. Owner of the bond is debt holder and get fixed-income by means of bond in conventional financial system. Sukuk makes the Sukuk holder as an investor who owns a share of an asset. Sukuk holder is granted by income like bond holder but it is not pre-defined and it is based on an identifiable asset.

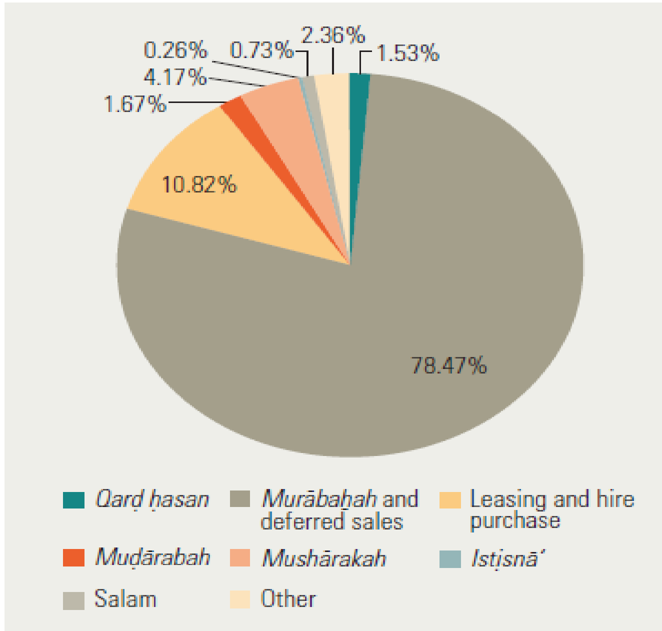
Qard Hasan is a loan without interest. Since interest is forbidden by Islamic law the lender can give money to the borrower and the lender cannot ask excess money from the original one. Repayments are done as installments by borrower and mostly money is given by lender as a charity.

Istisna is an Islamic financial product especially used for constructing real estates, machines or equipment. Islamic financial institution makes a contract with a manufacturer to manufacture goods or to build a real estate. Payments are done after production or property finished by the contract holder as installments.

Salam is a contract signed by Islamic bank and seller in order to undertake supplying some goods to the third party who is buyer at a future date. Salam creates an obligation for the seller to deliver the specific goods up to the agreed future date since it cannot be cancelled after parties sign the contract.

Leasing and hiring are financial products in Islamic finance. Ijara is known as the leasing in the form of Islamic finance. Ijara has different applications that can be in the form of hiring or leasing.

Although Islamic financial institutions are offering plenty of different financial products Murabahah or in another name deferred sales is taking the largest portion among the financial products. Murabahah is almost 79% of the all products offered by Islamic finance. Leasing and hire purchases are following Murabahah and they are only 11% although they are the most seen 2^{nd} product in Islamic finance. So the share of only two products occupies the 90% of the total products.



Source: Islamic Banks and Financial Institutions Information, Ibisonline.net/IRTI.

Figure 3: Portion of Islamic Financial Products

3. Challenges in Islamic Finance

Although Islamic finance has been showing a flourishing development in the last three decades it has been started to face challenges. There are several reasons why Islamic finance faced by challenges. The author categorizes these challenges into three main groups which are harmonization, safety nets, and transparency.

Hakim (2013) expresses the harmonization issue as the biggest challenge in Islamic finance. Nadir (2007) also criticizes Islamic finance because of the approach of Islamic jurists that cause doubts on compliance of financial products served by Islamic banks. Hawary, Grais, and Iqbal (2007) set the harmonization as a core issue in Islamic finance for strong standards that is a must for development of Islamic finance. Harmonization arises as a big problem as Islamic finance develops and operates across countries. As it is known that without standards managing, controlling, and auditing operations and regulations will be difficult and costly. Harmonization has been forced markets as Islamic financial institutions have introduced new financial products within the countries and across the countries. As the operations by Islamic financial institutions especially by Islamic banks globally then it is seen that one financial product is seen as Islamic in one country on the other hand another country does not accepted same financial product as Islamic financial product. Harmonization problem exists due to the nature of Islam. Islamic law known as Shariah is divided in different juristic schools of thought. Although there are many common applications among these there is no consensus on the all Islamic financial products that are really Islamic or not. Each juristic school of thought relies on their scholars and sometime the decisions taken by those scholars conflict to each other so it creates ambiguity that one financial product introduced by Islamic financial institution is conformity to Islamic law. These kinds of conflicts can also be seen in two different countries with same juristic school of thought. Sukuk is a very interesting example in terms of implications of Islamic scholars. Sukuk is getting popular in the last decade. Hakim (2013) says that there are some questions on Sukuk about conformity to Islamic law and it causes looming over them. The lack of harmonization in Islamic finance also causes an increase transaction cost to the industry and regulators. Another effect of absence of harmonization is prevention desired growth and confidence in the Islamic finance market.

Second challenge in the Islamic finance is the lack of safety nets and resolution frameworks. Most of the supervisors have not enough knowledge about Shariah and most of the scholars do not have education in finance. This creates problems in regulations to apply solutions for conflicts. Hassan and Dicle (2005) also mention that since supervisors mostly have experience based on conventional finance they can have struggle to find solutions in Islamic finance. One of the examples for the lack of regulation in Islamic finance is seen in Murabahah. As it is known that Islamic bank buys property and sell it with mark-up. However in conventional financial system that applied in most countries banks cannot own real property. This kind of conflicts creates challenges for Islamic finance.

Finally, one of the biggest challenges in Islamic finance is transparency. Transparency in Islamic finance can be defined as no difference between financial theories and operational practices, no hidden agendas, and the reliable information about the distributed profit by Islamic financial institutions, contracts, investments, and all financial activities for the clients and savers. Theoretically clients/depositors who save their money in Islamic banks will accept profit or loss on investments. However in practically since Islamic banks are wary of possible withdrawal of funds due to uncompetitive profit return rates, or even losses profit equalization reserve and investment risk reserve are used to smooth the return rates and cover the possible future losses. These reserves must be accounted and audited to confirm that whether these financial activities comply with Sharia or not. Transparency becomes very important to access all required documents for the clients'/depositors' confidence.

4. Conclusion and Suggestions

Islamic finance has been growing by about 10% in the last three decades. Although the growing trend is seen, there are several challenges that Islamic finance has to face. These challenges are categorized in three main groups by researcher. These challenges are harmonization, safety nets, and transparency. Harmonization exists in Islamic finance due to the nature of Islamic law. There are several juristic schools of thought in implementation of Islamic law. Another challenge is the lack of safety nets and resolution frameworks. The root of this problem is the lack of scholars with no finance knowledge and supervisors with no Islamic law knowledge. The resolution frameworks and regulations are all written for conventional finance. The main challenge in Islamic finance is transparency. The parallelism between interest rates in conventional banks and return rates in Islamic banks creates some doubts on Islamic finance. There are other discussions about Islamic financial products that are Islamic or not. The need to have Islamic commercial law that consists of diverse bodies of different juristic schools of thoughts to one standard will be entrusted to common regulations therefore harmonization. There are some attempts to establish Sharia standards; the most successful attempt according to some authorities is the publication of Sharia standards by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). AAOIFI is considered as a best attempt for establishing Sharia standards for the Islamic financial institutions all over the world. AAOIFI is criticized since they have disadvantaged at international level. However AAOIFI would render possible to establish transparency standards for the fully Sharia-compliant products. Education of clients is also very important apart from scholars and supervisors in Islamic finance. If Sharia standards are been seeking by clients then it helps institutions which offer Islamic products to improve their standards and it will force them more transparent activities. Education of clients can help to protect them from dishonest institutions that claim their selves as Islamic.

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