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The Rise of Islamic Banking System

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Abstract:

The Islamic Bank is seen as an alternative to Western banking models. It is a system that provides services - mainly based on the operations of Murabaha, speculation and participation, and prohibits all types of usury - as it is the backbone of the widely accepted Islamic banking system and an attractive sector for Muslim and non - Muslim investors.

In theory, Islamic finance is resilient to shocks because of its focus on risk-sharing, risk reduction and strong engagement with real activities. However, empirical evidence of the stability of Islamic banks has so far varied. Although these banks face risks similar to those faced by traditional banks, they are also exposed to their own qualitative risks.

Keywords: Islamic Banking- The challenges - The prospects.

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Introduction:

The current economic challenges are leading Algeria to think seriously about an alternative finance model, including the Islamic Banking, which is directly inspired by the religious principles and values of Islam.

In 2020, Algeria adopted a new bill in which the government has established the basic rules of Islamic Banking (IB)[(1)].

The aim of this paper is to shed light on the growth of Islamic Banking through the study of the challenges of this new system in our area (The first topic), Then, we will try to track the prospects of the Islamic Banking (The Second topic).

THE FIRST TOPIC : The Challenges of Islamic Banking

Despite the rapid expansion of Islamic finance and its appearance as the alternative system of traditional finance, in practice it still faces a range of challenges that can be classified into two types: General and qualitative challenges.

FIRST REQUIREMENT: General Challenges for Islamic Banking

The establishment of Islamic Banking has created many opportunities of investment, especially between Muslims. It encouraged them to participate with their wealth to develop their countries and make profits without a violation of Islamic rules[(2)].

However, despite all these perspectives, the Islamic Bank continues to face internal and external challenges that make this banking governance system weak in the face of the lack of a clear legal framework for the IB, and the general public's ignorance of the basics that govern it. The main challenges facing the Islamic Bank are as follows:

Firstly: The withered of Islamic practices:

Because of the weakling of Islamic states, the Islamic financial practices withered gradually and was rapidly replaced by the western financial model at the beginning of the 20th century[(3)]. This withering is due to the ignorance of the importance of the basics of Islam in the matter of economy.

Furthermore, most of the Muslim communities know less about the Islamic Banking because of the modest knowledge of public in Muslim society[(4)].

In addition, it is also observed that in the late 80s, there was a rise of Islamic trends in Algeria, a real enemy of the ideology of Nationalism, socialism and any kind of economic prosperity[(5)]. During this period, Algeria has been forced to get into a civil war to face a dark side of Islamic Salvation Front (ISF) which was created in 1989[(6)].

Secondly: The competition of Western financial Banks:

The western model banking system is one of the systems that the Islamic countries inherited from western colonialism, like Algeria, from which most of its districts were not extradited. It is based on mediation between savers of money « owners » and investors, by collecting funds from savers and making the mat available to investors against a profit « Riba », in addition to some services and facilities that facilitate the dealer transactions who deal with it[7].

There were many obstacles facing Islamic Banking that have allowed the western system to be replaced. Among these obstacles, we notice the social boundaries within a Muslim community that let the western bank take a chance and push over and over to gain places in Muslim society[8].

SECOND REQUIREMENT: Challenge of risk management in Islamic banks as opposed to traditional finances

In addition to facing common risks with conventional financial institutions, Islamic banks also face their own unique risks. The Shari'ah-compliant nature of assets and liabilities distinguishes them from conventional banks, while at the same time exposing them to similar market, credit, liquidity, operational, and legal risks. Notably, the differences in opinion among religious scholars regarding the Shari'ah compliance of specific financial arrangements can expose Islamic banks to the risk of noncompliance with Shari'ah principles. Furthermore, operational differences across countries result in different permissible financial products, thereby raising legal uncertainty in the area of cross-border Islamic financial activities. Islamic financing is also subject to high judicial risk, as clients may turn to Shari'ah courts that rule on a case-by-case basis, as well as seek redress in regular courts.

Additionally, Islamic financial institutions may confront commercial pressure to pay competitive rates of return that exceed returns on the assets that are actually being financed, with the result being that shareholders may have to forgo part, or all, of their share in profits to minimize the risk of funds withdrawal. Such exposure to rate of return risk (resulting from unexpected changes in rates of return) engenders a risk that is unique to Islamic banks known as displaced commercial risk. Finally, equity risk arises when Islamic banks enter into musharakah and mudârabah partnerships as providers of funds and they share in the business risk of the activity being financed.

Mark-up risk tends to rank highly for Islamic banks. The 2001 Islamic Development Bank (IsDB) report contends that Islamic banks face more severe mark-up (interest rate) risk in fixed-income instruments like istisna' and murahabah. The report argues that operational risk, liquidity risk, credit risk, and market risk are next to mark-up risk for these institutions. All in all, profit-sharing

investment accounts (PSIA), diminishing musharakah, mudârabah, salam, and istisna’ tend to be considered riskier than murahabah and ijarah.

To mitigate risks, Islamic banks use a variety of prudential reserves. PER are intended to smooth profits for investment account holders (IAH). These reserves are funded by setting aside a portion of gross income before the bank’s profit share is deducted and are not part of equity capital. The Islamic bank can also use Investment risk reserve (IRR), which are funded by a portion of the income to investors after allocating the PER, to cover future investment losses of account holders. Since IRR belong to the equity of Investment account holders (IAHs), they are also not included under the bank’s equity capital. Finally, fiduciary risk reserves (FRR), which are much less frequent and less popular than PER and IRR, are funded by a portion of the income to the bank before the payment of dividends to shareholders(9).

Islamic banks use conventional risk management measures, but there is a need for additional risk mitigating tools to address their unique risk exposures. Conventional tools in use by Islamic banks that do not conflict with Shari’ah include internal rating systems, risk reports, internal control systems, external audits, maturity matching, and GAP analysis. However, the unique nature of Islamic financing, with a diverse set of instruments used as sources and uses of funds, calls for the development of new techniques, processes, institutional setup, and procedures to further enhance risk management practices and tackle Islamic finance–specific risks.

Corporate governance concerns are associated with these prudential reserves. While Islamic Financial Services Board (IFSB) standards set rules on disclosure requirements on displaced commercial risks and smoothing practices, investment account holders generally have no control over the PER and IRR usage and, in some cases, are not informed of the Islamic bank’s practices of maintaining these reserves. Also, an investment account holder with a short-term horizon may be negatively affected by the constitution of reserves that will most likely benefit someone else in the future. In addition, IRR may give rise to moral hazard akin to that arising from deposit insurance, as bank management may be encouraged to engage in excessive risk taking.

Further standardization for Shari’ah compliance would benefit Islamic financial institutions. Unlike conventional banking where a unified set of international standards help agents to identify risks associated with the bank’s activities, Islamic financial institutions often face difficulties presenting internationally accepted Islamic instruments to their customers. While it seems challenging to standardize different interpretations of certain religious matters across jurisdictions and Shari’ah scholars, harmonizing differences in the Shari’ah

compliance of different instruments would reduce uncertainty and foster industry growth. In this vein, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and IFSB have provided some Shari'ah standards and governance guidelines[10].

THE SECOND TOPIC: The prospects of Islamic Banking

There are several ways to view the Islamic Banking, but we cannot deny the role of this new system in economic Growth, especially because of the number of domains where this system can be involved.

The following points are some of the prospects of the Islamic Banking.

FIRST REQUIREMENT: The ban of Riba

It is obviously clear that the Islamic Religion has prohibited the Riba[11], as a fundamental principle that govern the Islamic financing as it is mentioned and stated in the Qur'an: « Those who consume interest cannot stand (on the Day of Resurrection) except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is (just) like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to (dealing in interest or usury) - those are the companions of the Fire; they will abide eternally therein »[12].

Moreover, Riba also connotes a loan in which the borrower makes a return to the lender that is more or better than what was borrowed[13].

However, the Islamic Finance system gives a various modes of financing of the Interest –free Banking, which are funded on the Qur'an dispositions[14], below are these types :

Firstly: Profit-and-loss sharing (PLS) Financing Products:

There are two types of PLS financing: musharakah and mudârabah.

1- Musharakah:

During the early years of Islamic civilization, there were some Banking activities which were similar to nowadays banking transactions, among these activities there were a famous Islamic framework which was the Profit and loss Sharing (PLS) basis. This system consists on the transformation of the pre-banking system which was based on debt based transactions, to investment based funding[15].

The Musharakah system or Equity-participation was a real alternative to interest on loans which was based on Riba's basics[16].

2- Mudârabah:

It is a social contract whereby one gives his property to another to carry on business therewith, and the profit to be shared between them according to their free- willing terms[17]. In addition, some authors[18] see the mudârabah system as a

partnership between the bank and the shareholders; Like the customers, holders, employers, so that the bank will receive from these parties deposits against a profit sharing.

Secondly: Non-PLS Financing Products:

Non-PLS contracts are most common in practice. They are generally used to finance consumer and corporate credit, as well as asset rental and manufacturing. Non-PLS financing instruments include murâbaḥah, ijarah, salam, and istisna'.

1- Murâbaḥah:

The Islamic Banking system is based mainly on the concept of social balance, which is realized through the fair distribution of wealth within members of society(19).

Among these models, we find murâbaḥah which is a sort of sale which was transformed into the Banking system(20), and it is based on the fact that the bank sells a particular good or commodity to its potential borrower on credit, and then buys it back for cash(21).

Furthermore, murâbaḥah refers to the sale of goods at a price and includes a mutually acceptable profit margin(22).

2- Ijarah:

It is a contract of sale of the right to use an asset for a period of time. It is essentially a lease contract, whereby the leaser must own the leased asset for the entire lease period. Since ownership remains with the leaser, the asset can be repossessed in case of nonpayment by the lessee. However, the leaser is also responsible for asset maintenance, unless damage to the leased asset results from the lessee negligence. This element of risk is required for making ijarah payments permissible. A variety of ijarah takes a hire-purchase form, whereby there is a promise by the leaser to sell the asset to the lessee at the end of the lease agreement, with the price of the residual asset being predetermined. A second independent contract gives the lessee the option to buy the leased asset at the conclusion of the contract or simply return it to the owner.

3- Salam:

It is a form of forward agreement where delivery occurs at a future date in exchange for spot payment. Such transactions were originally allowed to meet the financing needs of small farmers as they were unable to yield adequate returns until several periods after the initial investment. A vital condition for the validity of a Salam is payment of the price in full at the time of initiating the contract, or else the outcome is a debt-against-debt sale, which is strictly prohibited under Shari'ah. The subject matter, price, quantity, and date and place of delivery should be precisely specified in the contract. In the event that the seller can neither produce the goods nor obtain them elsewhere, the buyer can either take back the

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paid prices with no increase, or wait until the goods become available. Should one of the parties fail to fulfill their contract, the bank will get back its initial investment, but will have to accept the lost profit. To reduce exposure to credit risk, the bank may ask for a financial guarantee, mortgage, advance payment, or third-party guarantee.

4- Istisna':

It is a contract in which a commodity can be transacted before it comes into existence. The unique feature of istisna' (or manufacturing) is that nothing is exchanged on the spot or at the time of contracting. It is perhaps the only forward contract where the obligations of both parties are in the future. In theory, the istisna' contract could be directly between the end user and the manufacturer, but it is typically a three-party contract, with the bank acting as intermediary. Under the first istisna' contract, the bank agrees to receive payments from the client on a longer-term schedule, whereas under the second contract, the bank (as a buyer) makes progress installment payments to the producer over a shorter period of time(23).

Thirdly: Fee-Based Products:

Islamic banks offer a wide spectrum of fee-based services using three types of contracts, wakalah, kafalah, or ju'ala. They are usually auxiliary to the main murâbaḥah and mudârabah transactions, though they generate various types of fees and commissions. The fee-based services provided by Islamic banks include bank transfers, issuing letters of credit and guarantees, credit cards, and offering collection and safe-custody services, mostly used in trade financing. Wakalah results from the bank acting as the agent of a customer in a trade transaction or issuing a letter of credit facility. Kafalah is a financial guarantee whereby the bank gives a pledge to a creditor on behalf of the debtor to cover fines or any other personal liability. It is widely used in conjunction with other financing modes or documentary credits. Ju'ala is essentially an istisna' contract that is applicable for rendering a specified service as opposed to the manufacturing of a product.

SECOND REQUIREMENT: External Catalysts

There are several external factors predicting the development of Islamic banking, including: Muslims' need for a Shari'ah-compliant financial system, The international acceptance and the demographic explosion of Muslim community in the West.

Firstly: need for a Shari'ah -compliant financial system:

The growing need of Muslims for a Shari'ah-compliant financial system seems to drive the growth of Islamic finance. Early Muslims were not familiar with banking operations, and the concept of a bank as a modern institution is new to Islamic societies. Initially, many Muslims did not even understand the extent and

importance of banks in their everyday lives, even if living in non-Islamic countries. However, once they realized that interest payments from conventional banking were at odds with the prohibited riba, they naturally looked for alternative modes of financing. Early initiatives in the 1960s led to the establishment of Islamic financial institutions in Egypt, India, Malaysia, Pakistan, Saudi Arabia, and later in Iran and Sudan, where Islamic finance was adopted as the only financial system country-wide. It is, thus, not surprising to see that Muslims continue to look for Shari'ah-compliant financial institutions around the world, as these are becoming more mature and integrated in conventional financial systems, while offering a wider range of services.

Part of the industry growth is driven, naturally, by economic growth in the Middle East and North Africa region. Over the past decade, the Middle East and North Africa region has witnessed a solid growth path, which in turn has helped the Islamic finance industry, particularly banking assets. The average real Gross domestic product (GDP) growth in the Middle East and North Africa region has been about 4 percent, with the highest growth rate of 11 percent in Qatar and 5.2 percent in Saudi Arabia. Although some argue that rising oil revenues and the real estate boom in some Gulf Cooperation Council countries may have also helped the industry to grow, pointedly, real non-oil Gross domestic product of Gulf Cooperation Council countries has expanded, on average, by only 3 percent, while the Islamic finance industry has seen double-digit growth in the past 10 years. Many countries including some from Europe, Singapore, and the United States are joining the band wagon to capture capital flows from the Middle East.

Secondly: **The International Acceptance:**

Although it is based on Islamic principles, the Islamic Banking system gained the acceptance of the industrials states, like USA, Germany and Asia.

Many European financial banks perceive the Islamic Banking as a new tool that can provide them a profitable opportunity to create a new form of economy[(24)]. Luxembourg was the first area where this new system took place, and in 1970 the Islamic Finance Horse Universal Holding was established, and in 1981 the House of Islamic Fund was established in the Commonwealth of the Bahamas[(25)].

Furthermore, the University Bank lays claim to being the first bank devoted solely to Islamic Finance[(26)]. In the United States of America, Philadelphia – based Muslim Community Credit Union gained certain approvals; like a lot of credit union[(27)].

Thirdly: The demographic explosion of Muslim community in the West:

The growth of Muslim population in the west, and even non-resident population in this area, push the western government to think seriously to pave the way to the Islamic Banking[(28)].

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This population claims Islamic deposit facilities and fund management services which involve the Islamic regulations[29]. In addition, the Western bankers saw this fact as an opportunity for them to attract this community and to be involved more in this growing industry[30].

Conclusion:

There is no doubt that Islamic Banking (IB) is growing worldwide, though there are many obstacles that must be resolved in order to create a good atmosphere for this new system of governing a bank. Thus, The Muslim governors must react to generate new rules to favor this new system. Above all some issues must be taken into consideration:

- The obligation of making an Islamic literature on Islamic Banking available to make people's understanding of Islamic Banking much better.

- The resolution of all regulatory, legal, knowledge and social obstacles facing the growth of the Islamic Banking in the west, as well as in the East.

- The necessity of creating a new financial trick to reduce the costs of transaction mainly for those customers who wished to borrow cash for their investments, like what it had been created by the Gulf Cooperation Council (GCC) the "monetization".

- The creation of International Islamic Agencies to settle financial and commercial disputes that arise among Islamic Banking Systems.

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