Islamic Banking : A Solution for Global Financial Challenges

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Abstract

This paper aims to assist those shaping the future financial architecture through a structured look at two important questions viz.; i) what are the global financial challenges? and; ii) how Islamic banking may be the solution to the challenges? Within the given time, resource, opportunity and single effort of the author, review of economic literature shows that there are eight global financial challenges and their Islamic banking solutions also. In order to make the Islamic banking, a more acceptable solution for the global financial challenges, four suggestions have been made. These scenarios will help stakeholders to the global financial architecture not only to address today's most pressing financial challenges, but also to prepare for and prevent the challenges of tomorrow with the Islamic banking solution.

Key words: *Islamic banking, solution, global, challanges*

I. Introduction

The Financial Challenge is a system to make changes gradually that will lay a solid finance foundation which will automatically lead to increasing wealth. Global financial challenges have been raised from the financial crisis of 2008 and the great recession of 2009. (Schwab, 2010, p.2) said, "The financial crisis of 2008 and the 'Great Recession of 2009' have shaken the very foundation of the financial architecture and raise challanging questions about the future of the global economy". He also said that over the past months governments and central banks have been forced to intervene in an unprecedented fashion to avoid a collapse in the global financial system. While it seems that the worst has been avoided, 'significant challenges' remain ahead. The complex set of stockholders to the financial system – most notably governments, central banks and financial institutions – are working individually and collectively to define the best path forward. Therefore an attempt has been made to undertake a study on the subject. The study aims to assist those

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shaping the future financial architecture through a structured look at two important questions:

1. What are the global financial challenges?
2. How Islamic banking may be the solution for the challenges?

Within the given time, resource, opportunity and single effort of the author, review of economic literature shows that there are eight global financial challenges and their Islamic banking solutions also. Therefore the study has been organised in three sections. After the introductory section, the global financial challenges have been identified *vis a vis* their Islamic banking solutions have been discussed in section II; and finally conclusion and suggestions have been made in section III. These scenarios will help stakeholders to the global financial architecture not only to address today's most pressing financial challenges, but also to prepare for and prevent the challenges of tomorrow with the Islamic banking solution.

While the global financial challenges are significant, "By the autumn of 2009, however, economists began to see light at the end of the tunnel.....Indeed, some emerging markets seemed to be back on the path of significant growth (Schwab, 2010, p.16)". But many[1] also pointed out that even if the recovery continued, GDP in most developed countries would not reach pre-crisis levels in the near future. It therefore justifies that the challenges, explored below, still prevails in global economy.

II. The Global Financial Challenges & The Islamic Banking Solutions

There are eight global financial challenges. Those have been identified below *vis a vis* their Islamic banking solutions have been discussed. The Islamic banking solution is on our basic philosophy of life.

1. Elimination of *riba*[2] from the economy:

Riba (Interest) is the tool of exploitation. According to (Chapra,1985, p.63) "*Riba* is essentially in conflict with the clear and unequivocal Islamic emphasis on socio-economic justice. Those who insist on charging *riba* in spite of its prohibition are

[1] The World Economic Forum Report is the result of a year-long multi – stakeholder collaboration of the World Economic Forum and Oliver Wyman with over 150 leaders in public policy, academia and business participating in interviews and workshops around the globe". *See, http://www.weforum.org/nfa*, p. 3.

[2] In the *Shariah*, *riba* technically refers to the 'premium' that must be paid by the borrower to the lender along with the principal as a condition for the loan or for an extension in its maturity". Given the definition 'Riba' and 'Interest' are to be the same. *See*, Chapra, M. Umer (1992), *Islam and the Economic Challenges*, The Islamic Foundation, UK and The International Institute of Islamic Thought, pp.56-57.

declared by the Qur'an to be at war with God and His Prophet, peace be upon him". All leading religions prhibited *riba.* Moreover, many arguments have been raised against *riba*.[3]

But as a global financial challenge, 'elimination of *riba'* still prevails. Because (Dusuki, 2011, p.857) mentioned, "While the ideal Islamic financial system promotes equity-based and risk-sharing instruments, the reality is quite different. Due to the heavy reliance on debt-based products and .....of conventional financial instruments, the Islamic finance industry is seen as a sub-set of the conventional financial system".

Solution: Islamic banking is the only solution to this challenge because OIC defined Islamic Bank 'as a financial institution whose statutes, rules and procedures expressly state its committment to the principles of Islamic *Shariah* and to the banning of the receipt and payment of interest on any of its operations'.[4] Besides, (Dusuki, 2011, p.857) believes that there is a need for an *riba*-free alternative system. An Islamic financial system could be a viable alternative, he mentioned. It should be remebered that Islamic banking is a part of the Islamic financial system. But a number of objections have been raised against the *riba*-free economy alleging that such a system will face difficulties and would not be practicable. Therefore, (Chapra, 1985, pp.107-145) evaluated the nature and significance of these objections which help indicate the rationale behind the prohibition of *riba.* Accordingly, *(*Akkas, 2008, p.34) wrote that the economic rationale for eliminating *riba* is based on values of justice, efficiency, stability and growth. The arguments for distributive justice are:

a) The industrial and/ or commercial risk is shared more equitably between entrepreneur and the capital owner.
b) Replacing a fixed return by a proportionate share in actual profits would ensure equitable returns to capital regardless of whether profits are high or low, or whether prices are inflationary, stable or deflationary.
c) Wealth would generate more wealth of its owners only when its employment in economic activities results in creation of value added.

The arguments for efficient allocations of capital are:

a) Loan finance in contrast to the provision of risk capital, tends to serve the most creditworthy borrowers and not necessarily the most productive and profitable projects.

[3] Hamid, M.A. (2009), *ISLAMIC ECONOMICS: An Introductory Analysis*, Rajshai, Bangladesh, pp. 186-189.
[4] *ibid.*, p.192.

b) Profit-sharing arrangements harmonize the interests of the suppliers and users of capital, resulting in a joint focus on productivity.

c) The approach also provides for social cohesion between different classes, the motivations of which are often conflicting and opposed in the conventional system.

On the subject of stability, the argument is put forward that an interest-based economy has a built-in tendency toward inflation, because the creation of money is not related to productive investments, either at the level of the central banks or at the level of commercial banks.

2. Instability of the economy:

Economic instability was addressed about four decades ago. (Schmidt, 1974, p.437) worte, "The world economy has entered a phase of extraordinary instability and ..... its future course is absolutely uncertain". (Chapra, 1985, pp.19 & 17) also wrote that after going through the throes of painfully high levels of inflation, the world economy has experienced a deep recession and unprecedented rates of unemployment, complicated further by high levels of real interest rates and unhealthy exchange rates fluctuations. Although the recovery is now underway, the uncertainty still prevails. It may in fact be asserted that interest is one of the important destabilising factors in the capitalist economies. Sometimes, interest rate contributes to create 'financial economy' bigger than 'real economy' leading to crisis. (Dusuki, 2011, p.836) also made same observations. He wrote that easy money, uncontrolled growth of credit and debt, lax regulation and supervision, innovation of complex and opaque financial products, mismanagement and mispricing of risk involved, lack of disclouser and transparency, predatory landing and high leverage, among others, are thought to be the main culprits of the global financial crisis. A Report (Schwab, 2010, pp.10-14) mentioned that easy access to financing in terms of relaxed lending standards and low interest rates, supported by upward drifting asset prices and a stable macro-environment, fuelled an increase in debt as a percentage of GDP, notably in the United States and Western Europe in mid-2007. During this period, indicators of financial risk remained unusually subdued. The 'easy' with which money could be borrowed and what is now understood to have been a mispricing of the risk attached to debt drove asset prices up around the globe. Moreover, households, corporations and governments allowed savings ratios to fall substantially and expanded their spending comfortable in the mistaken belief that assets would continue to appreciate. While these trends were largely global, differences in policies and behaviour between East and West allowed for the development of a highly significant global geo-economic imbalances. Many western economies, particularly

the United States, ran significant current account deficits that were financed by current account surpluses in emerging Asian economic powers, particularly China. As the world's emerging economies transformed themselves from debtor to creditor economies, geo-economic power began to shift towards them.

With hindsight, the apparent prosperity and growth of the past two decades leading into the crisis were never sustainable. The cycle of falling rates, increasing debt, decreased savings, increased spending and increasing gap between East and West simply ran out of runway.

Solution: Why Islamic banks could be a solution for economic instability? It has been found (Rahim and Roza,.2013, pp.192-93) that Islamic banks are unique or different from their conventional counterparts in terms of their underlying modus operandi. Guarded with the belief that interest or riba is totally unacceptable, Islamic banks' operation is based on *Shariah* compliance principles such as profit sharing basis, real asset transactions and strict adherence to no speculative element. With these differences on the three basic principles, Islamic banks portray different response during the recent financial meltdown. According to them, a review of past studies related to the issue of banking sector stability show that there are at least three explanations on the relative stability. Those are given below:

Firstly, banks operated under Islamic principles possess greater liquidity holdings relative to conventional ones. Partly, this is due to the relatively limited availability of investment avenues that are *Shariah* compliance. This is, in accordance with (Loghod, 2010, p.193) who found attractiveness of Islamic banks products such as *Mudaraba, Musharakah, Murabahah, Ijarah*, and profit and loss based investment was the main reason behind the greater liquidity holdings.

Secondly, Islamic banks focused on profit sharing investment and financing, in which there is mutual risk sharing. For instance, (Rahman, 2011, pp.37-62) details that Islamic banks in Bangladesh currently adopt sophisticated qualitative and quantitative techniques to overcome the credit risk problems. In addition to that, Islamic banks are different in their business model as well as financing or equity participation. This led them to channel their investment more in less risky investment sectors. For instance, (Hasan and Dridi, 2010, pp.36-37) reports that Islamic banks successfullly maintained stronger credit growth. His research proved Islamic asset growth and bank credit was double than those of conventional banks during 2007-2009.

Thirdly, Islamic banks are less affected with many conventional banks because Islamic banks were prohibited in any speculative practices and excessive leveraging, which were root causes of the recent global financial crisis.

(Dusuki, 2011, p.837) supported above explanations. He wrote that most of the Islamic economists asserted that a financial system working in accordance with Islamic financial teachings such as risk sharing, prohibition of interest, ban on trading in debts except at par and prohibition of contracts involving excessive *gharar* would never lead to such a crisis. He again mentioned that to extent Islamic finance remained shielded from the gravity of the crisis, the main reason, everybody agreed, was its closer ties with the real economy.

In recent years, the Islamic Financial Service Board (IFSB, 2009, p.1) has developed three Guiding Principles to help governing structures and processes in various sigments of the Islamic financial services industry (IFSI) in line with its mandate to promote soundness and stability of the Islamic financial system in an economy.

3. Lack of transperancy[5] and market discipline[6]:

As the crisis spread throughout the globally interconnected financial system, a major complication became apparent. It was not at all clear which investors and market participants were most exposed to the steep falls in asset values. Widespread ownership of complex and often opaque investment instruments, including collaterilised debt obligations and many other structured investment products, made contemporary risk expousers difficult to evaluate, specially when they were held off balance sheet. "Market participants soon realised that external ratings might not accurately represent the true quality of some of these instruments" (Schwab, 2010, p.13). Thus the crisis was facilitted by a lack of transparency and market discipline.

Solution: It is well-known that Islamic banking is *Shariah* compliant. The need for transparency is, above all, an important *Shariah* consideration. Any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in *Shariah* as mentioned in the *Qura'n* in, *inter alia*, Surah *An Nisa*' verse 135 and Surah *Al Mutaffifin* verses 1 to 3. Islamic banks follows the standards of (IFSB).[7] The IFSB disclouser to promote transparency and market discipline for institutions offering Islamic financial services (Excluding insurance institutions and Islamic mutual funds), December 2007, specified a set of key principles and parctices

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[5] The concept of transparency is wide-ranging and covers the notions of accountability as well as the legal and accounting infrastructure for economic decisions.

[6] "Market discipline" refers to those environmental features, which in response to the disclouser of material information, elicit prompt adjustments in either prices or quantities of financial positions in the financial institutions, and thereby provide incentives for financial institutions to limit excessive risk-taking and to pursue good governance.

[7] The IFSB is an international standard-setting organisation. It promotes and enhance the soundness and stability of the Islamic financial services industry by issuing global financial standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. For more information about the IFSB, available at *www.ifsb.org*

to be followed by institutions offering Islamic financial services (IIFS) in making disclousers with a view to achieving transparency and promoting market discipline in regard to these institutions.This Standards is addressed to IIFS and to their supervisory authorities and other relevant policy-makers. For this purpose, recommendations have been developed for a set of disclousers that are differentiated by the type of stakeholders and that focus on the risk profile and financial soundness of the IIFS. The disclouser framework for IIFS under this Standard takes into consideration, and does not conflict with, international accounting standards and relevant national standards, which are broader in scope.

4. Restoring trust[8]:

Trust in the global financial system, and the institutions and individuals that comprise that system has significantly eroded through the crisis. Banks were unwilling to lend to each other during a liquidity crunch, retail customers diversifying their bank exposure, and taxpayers insisting on resignations, compensation reduction and criminal procecutions of financial institution executives.

"Today, as bodies such as the G20, Financial Stability Board, and the European Commission work to restore trust in the global financial system as a whole. Individual financial institutions are working to restore contemporary trust necessary for competitive success and long-term durability (Schwab, 2010, p.18)".

Solution: The disclouser principles and practices of IFSB are designed to enable market participants generally to assess key information on: 1) the type of IIFS, and where applicable, the scope of the consolidation method used by members of an Islamic financial group; 2) capital structure and overview of capital adequacy; 3) the treatment of investment accounts; 4) the risk management process; 5) risk exposers by types of risks and indicators of risk-sharing with Investment Account Holders; 6) key aspects of general governance and *Shariah* governance; 7) the scope of consumer-friendly disclousers concerning such risks and returns, *Shariah* compliance and investment account products. "Such disclousers when combined with adequate market and legal infrastructures, can enable market forces and palyers to enhance the stability and soundness of Islamic finance and reinforce the trust in the global financial system (IFSB, 2007, p.1)". In order to successfully restore trust lost throughout the crisis, financial institutions will need to understand the inportance and role of trust in their organisations, be able to systematically diagnose problems of trust, and develop stratagies and tactics geared at restoring trust.

[8] Trust plays role at the very foundation of the financial architechture. Be it horizontally among themselves or vertically in relation to their customers and supervisors, trust was and remains critical to well functioning financial institutions and the markets in which they interact. As regulators look to create a trustworthy financial system, individual institutions are struggling to regain the trust of their stakeholders and, in so doing, the sociteal license to operate.

5. Challanging of existing values:

One irrecoverable effect of the crisis is a fundamental undermining of many of the values long held true in financial services. For the first time, in a long time, financial institutions in a developed economies are being asked to justify their role in society and the profits they earn (Schwab, 2010, p. 13). More subtly, the definition of good leadership is being re-evaluated as is the role of values within financial institutions.

Solution: 'Value-oriented allocation of credit' is the solution of this challenge. (Chapra, 1985, pp. 200-201) has rightly said that since bank credit comes out of funds belonging to the public, it should be so allocated that it helps realise general social welfare. The criteria for its allocation, as for other God-given resources, should be, first, the realisation of the goals of Islamic society *(Maqasid Al Sharia'h)* and then maximisation of private profit. This could be attained, according to him, by ensuring that (i) credit allocation leads to an optimum production and distribution of goods and services needed by the majority of society, and (ii) the benefit of credit goes to an optimum number of business in society. He also mentioned that the appropriate way to achieve the first objective would be to operate a value-oriented plan and then to dovetail this plan with the commercial banking system for its efficient implementation.The approach should be, firstly, to make it clear to the commercial banks what secotrs and ares of the economy are to be promoted through commercial bank financing and what goals are to be realised, and secondly, to adopt the institutional measures necessary for this purpose.

He further said that the operation of market forces has been recognised by Islam, but within its 'value frame'. If the Plan defines the value frame and the necessary institutional measures (Like Islamic bank) are adopted, many of the undermining values, long held true in financial services, shall be revived.

6. Risk management:

One fundamental mindset shift that is already impacting the financial industry, concerns the fundamental approach to risk taking and risk measurement. "Before the crisis, signifcant faith was put in third party risk ratings, quantitative models, and the belief that the financial institutions were significantly advantaged underwriters and holders of a wide range of products meant to transform financial risks. Today, and increasingly so in near–term future, financial institutions and their customers are increasingly wary of risk and traditional methods of measuring and managing it. This evolution might ultimately lead to an increased price of risk which could broadly impact the financial service industry (Schwab, 2010, p. 22)".

Actually risk management was overwhelmed by the complexities of financial innovations and the lack of transparency, and which overly relied on external ratings.

Solution: The Islamic banking system is based on participatory approach and risk sharing. (Ahmad, 2008, p.22) wrote, “Islamic banks face unique and somewhat extra risks, compared to conventional banks. Basel II with certain modifications can be adopted subject to addressing the distinct nature of Islamic financial activities with accommodating differences in liability side and devising risk weights for assets”. (Dusuki, 2011, p.571) also mentioned that as IFIs face unique risks due to using Islamic financing instruments, they may require some distinctive risk management tools and approaches. To address the risk management issues related to IFIs, the IFSB, published *Guiding principles of Risk Managements for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services* in 2005. The document presents fifteen principles of management related to various aspects of risk facing IFIs.

7. Lack of corporate governance[9]:

The definition of corporate governancedenotes that the central aim of it is to ensure transparency, fairness and accountability. One of the important causes of the crisis was "Corporate governance mechanisms that did not impede inappropriate mangement decisions (Schwab, 2010, p. 18)”. Hence the stakeholder-value system is not upheld..

Solution: The concept of corporate governance in Islam refers to a set of organisational arrangements on how a corporation is directed, managed and governed and controlled. This provides the governance structure through which all stakeholders'

interests are protected, the company's objective is achieved and the principles of *Shariah* are complied with.

Corporate governance therefore is considered the most significant topics in Islamic finance and banking. "Sound corporate governance, specially within an Islamic paradigm is very imperative as it tends to encourage honesty, integrity, transfarency, accountability and responsibility amongst all stakeholders in an organisation (Dusuki, 2011, p.681)".

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[9] "A set of relationship between a company's management, its board, its shareholders and other stakeholders, thereby plays essential functions to provide the structure through which the company goals are set and means of attaining those objectives and monitoring performance are determined." *See*, OECD, "Principles of Corporate Governance (Revised)." Paris: OECD. Available at *http://www.oecd.org/dataoecd/32/18/31557724.pdf.Accessed:25 February* 2010.

8. Achieving the millennium development goals (MDGs)[10]:

The MDGs seems to be one of the global financial challenges, because "as of 2013 progress towards the goals was uneven. Some countries achieved many goals, while others were not on track to realize any. A UN conference in September 2010 reviewed progress and concluded with the adoption of a global plan to achieve the eight goals by their target date. New commitments targeted women's empowerment and children's health and new initiatives in the worldwide battle against poverty, hunger and disease".[11]

Solution: Driven by the motivation to involve women in the development process in order to achieve the MDGs – recognizing that women are the poorest of the world's poor population and that they spend their earnings more on family welfare has led governments, banks, development practitioners and donor agencies to focus on microfinance as a strategy capable of reaching and empowering women (Kulkarni, 2011, p.10). It is generally agreed that women's empowerment is necessary for poverty alleviation.

In a study (Ahmed, 2013, pp. 70-76) found that 'Rural Development Scheme (RDS), an Islamic microfinance programme, of Islami Bank Bangladesh Limited (IBBL) has shown an immense potential to empower women. There are five issues required for women's empowerment under Islamic microfinance. Such as - (i) Islamic faith; (ii) access to resources; (iii) reconstruction of deeply engrained personal/traditional systems of social relations; (iv) acquisition of new practical skills; and (v) expansion of choice.

The RDS of IBBL have successfully addressed the issues mentioned above. It reveals the potential of the RDS to empower women. To improve the potential, three Islamic modes of finance namely, *wakala*, *mudrabah* and *musharakah* may be implemented through the RDS programme. Islamic microfinance programme of the IBBL has a positive role in poverty alleviation with a huge untapped potential as an effective socioeconomic development tool, because Islamic microfinance advocates economic empowerment through entrepreneurship, risk sharing and financial inclusion.

III. Conclusion And Suggestions

[10] The (MDGs) are eight international development goals that were established following the Millennium Summit of the United Nations in 2000, following the adoption of the United Nations Millennium Declaration. All 189 United Nations member states at the time (there are 193 currently) and at least 23 international organisations committed to help achieve the MDGS by 2015, the goals are: 1. To eradicate extreme poverty and hunger; 2. To achieve universal primary education; 3. To promote gender equality and empowering women; 4. To reduce child morality rates; 5. To improve maternal health; 6. To combat HIV/AIDS, malaria, and other diseases; 7. To ensure environmental sustainability; and 8. To develop a global partnership for development.

[11] *See, www.en.wikipedia.org/wiki/**Millennium_Development_Goals**.*

The Islamic banking solutions for global financial challenges is on our basic philosophy of life. The global financial crisis provided an avenue for rethinking it. No solutions can be effective unless it is addressed to the main spiring of the challenge. Nevertheless, the mistake which is commonly committed is that cosmetic solutions are being suggested. The leaders of financial institutions may immensely be benifitted from this study in order to rapidly adjust to new realities.

In order to make the Islamic banking a more stronger solution for the global financial challenges, following four suggestions have been made.

Suggestions:

1. *Shariah* governance should be improved. It adds value to the existing corporate governance framework. It inculcates transparency, trust, ethical behaviour, credibility, philosophy, values and beliefs underlying faith and beliefs (*Aqidah*), *Sharia'h* and ethics (*Akhlac*) (Nathan & Ribieri, 2007).
2. Again, interest-based debt financing afflicts the monetary system as well as financial system at both domestic and international levels, causing impoverishment of the poor and enrichment of the rich. So while the role of non-interest based debt instruments is acknowledged, a greater emphasis should be given to the equity-based and risk-sharing instruments as well.
3. Furthermore, a standardization of Islamic financial products could further enhance the stability, credibility and transparency of the industry which shall re-enforce the acceptance of the Islamic banking as a solution to global financial crisis.
4. Why did economists fail to predict global financial crisis? It may be studied in future to justify the future of economics which shall help understanding the architecture of Islamic banking as a solution to global financial challenges.

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