PROBLEMS AND ISSUES IN TRANSFORMATION FROM CONVENTIONAL BANKING TO ISLAMIC BANKING: LITERATURE REVIEW FOR THE NEED OF A COMPREHENSIVE FRAMEWORK FOR A SMOOTH CHANGE

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ABSTRACT

During last few decades, conventional financial systems are being transformed to Islamic financial systems in many countries around the globe. One of the major components of Islamic financial system is Islamic Banking. As most of the economies were not ready for this change, Islamic banks and financial institutions were and are confronted by many difficulties primarily due to non-existence of a comprehensive framework. We studied these transformation problems and issues in Far Eastern countries being the first entrants in this transformation phase. Among a large number of problems some are lack of general awareness among various stakeholders, existence of different schools of thought within Islam and insufficient/ineffective legal rules and regulations. Concerted efforts are not made to develop a new framework in line with the sensibilities towards the role of religion in commercial and financial activities of society and to introduce laws compliant with core Shariah principles, prudential standard requirements for supervision, disclosure requirements for financial statements, corporate governance and transparency requirements, new product development requirement, consumer code of conduct to name a few. New entrants in Islamic Banking may take benefit of this learning curve.

Key Words: Framework, Islam, Islamic Banking, Regulatory Standards, Transformation

JEL Classification: G18, G28, G21, K12, M48, N45, O53

INTRODUCTION

The legal aspect of any banking system includes both regulatory and legislative frameworks. The said frameworks work together to ensure fair and equitable system in terms of practicality. When considering Islamic law and its application to an existing banking system, consideration towards Shariah law is essential because it lays the foundations upon which Islamic principles can be applied to any aspect of life. This framework is further given another challenge to overcome which is the implementation of a financal system without interest; the fundamental operating core of all conventional finance transactions. All these aspects are the basis of the growing debate regarding functioning of Islamic banking (IB) in conventional frameworks.

Moving forward, when the implementation of a system of IB arises, the legal complexities in the transition cannot be overlooked. It is clear that the development of the system depends on a solid legal foundation but it is also important to understand the significance of the evolution of that system as the economy transitions from a conventional system to an Islamic banking system.

Over the last three decades, the implementation of an Islamic banking system depends on the social principles and political philosophies of the region. When considering the coexistence of conventional banking and Islamic banking in the international context, the skepticism regarding replacement of the market economy is linked to the dominance of the conventional banking system (Warde, 2010). Therefore, parallel execution of both systems within an economy would only be promising if the core principles of Shariah and its underlying frameworks are not violated due to partial application. When considering either partial application or complete alteration, it is essential to note that transformation cannot occur in a silo. The stages that an economy or industry must undergo in order to transform its activities according to new economic situations involves (1) recognizing the need to change, (2) gaining consensus amongst stakeholders regarding the necessity of this change, (3) agreement on the objectives and vision of the change, (4) designing a new organizational way of working/delivering products and services and (5) embedding practices in the change. As a result the organization cannot move back to how it was and achieves its intended benefits (Huber & Glick, 1993).

The goal of transformation at any level, macro or micro, organizational or industrial, remains to make fundamental changes in how business of the economy or the industry is conducted in order to help cope with a new and more challenging market environment. Survival in changing economic conditions is dependent largely upon the ability to alter existing processes into innovative and efficient practices. As such, it has become essential for economies and financial institutions to consider the application of Islamic Finance frameworks. The establishment of a comprehensive framework will contribute to the generalizability of the Islamic finance system, ensuring an easier transition for both Muslim and non-Muslim countries from conventional banking to Islamic finance systems.

During the early centuries of Islam, domestic and international trade of Muslim countries was managed without the use of interest. Savings and investments were based on profit sharing and other participation arrangements (Siddiqi, 1983; El-Gammal, 2000). Also finance was available on profit and loss basis by various financiers (Chapra & Khan, 2000). In late 14th century, the Islamic economies started losing its strong economic position and gradually the profit and loss sharing financing was replaced by interest based instruments. During 19th century, the western banks started opening their branches in Muslim countries (Wilson, 1999). The 20th century witnessed the revival of Islamic financial system and independence of a large number of Muslim countries (El-Ashker, 1987). Dubai Islamic Bank, the oldest Islamic bank was formed in 1975 in UAE (Saleh, 1986). It was followed by a series of Islamic banks in almost all other

Muslim countries. Now the Islamic banking is expanded to almost all major Muslim and non-Muslim countries (Halabi, 2000).

Frameworks for Islamic Banking – General

The development of a unified framework for IB would be classified as a teleological theory of change whose end goal is focused endorsement and social construction. The necessity for this development is driven by the increase in competition and resource scarcity. The implementation of this framework will be dependent upon the unit of change, which includes the interaction of organizations within the industry and environment, and the mode of change, which is approved by deterministic laws and produces first-order of change (Huber & Glick, 1993). The greatest challenge faced in this transformation from conventional to Islamic finance framework has been acceptance, in fact knowledgeable acceptance throughout industry for the purposeful application of innovation to achieve returns (Weick & Quinn, 1999).

Muslim countries, by and large, first appeared incompatible for Islamic finance due to their interest based economies. However changes in government priorities and public sensibilities allowed IB to gradually acquire legitimacy, particularly within the last two decades (Ali, 2008; Cader, 2007). In almost all Muslim countries it has been the government that had taken the initiative to introduce and expand IB (Hamzah & Ibrahim, 2010).

However to date there are very few comprehensive regulatory frameworks for IB in some Muslim and non-Muslim countries. These prudential and regulatory frameworks were initially developed as a first step towards a comprehensive framework specifically to deal with IFIs (Archer & Karim, 1997; Freixas et al., 1999). Bahrain was the first country to develop and implement a regulatory framework for IB when Islamic financing got momentum in 1990s (Ali, 2002).

In 1991, a non-profit autonomous body namely "Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)" was established. It main functions include preparation Auditing, Accounting and Corporate Governance standards based on Shariah principles for Islamic financial services industry (Chapra & Ahmed, 2002; Karim, 2001). In recent years AAOIFI got encouraging response regarding the adoption of their standards from various countries including Syria, Qatar, Sudan, Jordan, UAE, Bahrain and Lebanon to name a few. Countries like South Africa, Pakistan, Indonesia, Australia, Malaysia and Pakistan are trying to issue guidelines on the basis of pronouncements and standards developed by AAOIFI. However AAOIFI is still facing major challenges to develop consensus to implement its standards for global Islamic financial services industry (Khan, 2007; Hassan & Choudhury, 2004; Sharif, 2006).

Frameworks of Islamic Banking – Muslim countries of Far East

In 2002 Islamic Financial Services Board Act 2002 was promulgated in Malaysia under which Islamic Financial Services Board (IFSB) was established established to act as a standard setter for supervision and regulation of IFIs (El Razik, 2009). Its main aim is to provide a platform to support true practices of Shariah compliant financial instruments used in money markets, capital markets and banking industry (Mawdudi, 1986; Merton, 1995). The IFSB works for the emergence of a transparent and sound Islamic financial services industry based on principles of Shariah keeping in view today's challenges (Commission, 2007; Warde, 2010). The IFSB itself is of the view that stand alone Legal framework is best suited for the effective implementation of Islamic financial system across various jurisdictions (Rammal & Parker 2013; Chami, et al. 2003).

In Indonesia, IB was formally recognized in 1983 and the first full-fledged Bank Syariah started in 1991. The Shariah aspect in each Islamic financial institution is supervised by its in house Shariah supervisory board whereas prudential regulations are devised by "Bank Indonesia" in a manner very similar to conventional banking (Lindsey, 2012). Besides, "National Shariah Board of the Ulama Council of Indonesia" deals with religious aspect through Fatawas. This Board is responsible for overseeing doctrinal compliance by Islamic financial institutions (IFIs). Islamic financial disputes are settled through "National Shariah Arbitration Body".

Research Question

"Why is there a need to develop a robust and comprehensive framework for IFIs in Muslim countries of Far East which should be acceptable to all stakeholders and can be replicated in other economies?"

The main objective of this paper shall be on delineation of comprehensive framework specifically for Far Eastern Muslim countries. Although a number of research publications in the Islamic world as well in the Western world deals, directly or indirectly, with general framework for IB but by and large these publications are silent on the development of country specific comprehensive frameworks acceptable to all stakeholders within that country.

METHODOLOGY

Business transformation comprises of fundamental changes in how business is conducted to handle the altering market environment. The need for transformation arises due to a myriad of external factors, obsolete product and service offering, changes in income streams, rise of new regulations, and increase in intensity of market competition to mention a few.

Transformation of conventional financial system to Islamic financial system is a new phenomenon so needs investigation. A new investigation often starts with qualitative studies exploring new phenomena (Blumberg, 2005) so the research approach will be exploratory in nature to obtain deeper understanding about various dimensions of problems and issues being faced by these countries and the need to develop a comprehensive framework required for Islamic finance. The references used in the literature review cover for three facets of the discussion based on existing but partial studies- awareness of IB, schools of thought and legal frameworks. Each paper reflects research of IB in an area of development that can be operationalized for future research. For this paper the exploratory study is based on literature review only however in future various other methods may be used.

Delimitations

This paper is focused only on the challenges being faced by Muslim countries of Far East due to non-existence of comprehensive frameworks and therefore issues of secondary importance are not discussed. In addition, this area encompasses a second wave of the concentration of development in Islamic finance. The convergence of frameworks as applied in this area will contribute significantly to future development. Multiple common problems are identified during this study of which only three that are considered more important are elaborated over here. Although the challenge is universal, this research shall cover the issues of Far eastern Muslim countries only. Far East includes three Muslim countries: Malaysia, Indonesia and Brunei. Due to insignificant presence of Islamic financial sector in Brunei, only Malaysia and Indonesia are considered for this paper.

LITERATURE REVIEW

To date the dream to transform the whole economic system of Far eastern Muslim countries to an interest free Islamic financial system could not translate into reality because of the conversion of the system without creating the necessary and comprehensive framework, infrastructure and human capital. Today IFIs of Muslim countries of Far East are confronted by many difficulties and are facing various challenges that limit their operations to move forward. This article aims to discuss those problems and issues and to highlight the need to develop a sound, robust and comprehensive regulatory framework that would prove helpful to solve them.

Issues and Suggested Measures

General Awareness

Due to lack of awareness, the IFIs of Far eastern Muslim countries face problem of general acceptability. In the early phase of Islamic finance in these countries, professional bankers took the lead but they were not well-versed in the Shariah. The management and staff of IFIs do not have an orientation of Islamic framework and for this reason there was a complete lack of ownership among them.

A critical analysis of the awareness of IB products among Muslims by Rammal and Zurbruegg (2007) specifies that respondents who were interested in IB products lacked appropriate information about their functioning. Majority of the respondents specified that they would require credit services in order to switch from conventional to IB products. This is in contradiction with Shariah principles and indicates their lack of knowledge. Further, awareness and knowledge about IB are not enough to ensure the successful implementation of an IB system, willingness is a crucial element too. Simply understanding the products will not persuade customers to convert from a conventional system to an IB system when the services are provided.

A study conducted by Abduh and Omarov (2013) finds that maximum willingness can be divided on two elements - Shariah compliance and superior services. Over 70 percent of respondents are willing to utilize the services of IB due to Shariah compliance while 65 percent feel that IB will provide better services than conventional banking. While brands are rarely discussed when considering IB systems, research indicates that brand preference plays a significant role. Utilizing factors like convenience, human interaction and reliability, it was found that the proxy of bank's reputation for brand perception plays the most significant role in selection of bank (Ahmad, Rustam & Dent, 2011).

Awareness should also be considered from the perspective of qualified professionals. Very few dedicated training institutes exist to meet manpower needs of existing and future IFIs resulting in lack of enough qualified manpower and literature on the Islamic financial products. Another important fact is that no standardized vocabulary is being followed for financial products of the IFIs. One finds a lot of differences in the use of terminologies. Selective interpretation of Arabic terms creates confusion among the clients and the public.

Business community and common man whether Muslim or non-Muslim are unaware about the utility of Islamic financing and reluctant to shift to Islamic financial system due to ambiguities and less understanding. Public education campaigns are not seriously considered. Very few institutes of higher education are offering full-fledged degree programs in Islamic finance. Minimum efforts are being made to include concepts of Islamic financial system in academic curriculum of business administration programs.

Islamic Schools of thought

A particular problem in developing uniform framework is the existence of different schools of thought within Islam. Many Islamic jurists were capable of juristic reasoning like Al-Shaafi, Abu Hanifa, Malik, Ahmad bin Hanbal, Al-Awzai, Layth bin Saad, Al-Thawri and Ibn Jarir al-Tabari but the approaches of only five main jurists became established, as outlined in Table 1.

All the Imams of these schools of thought are of the views that in case of any conflict between their Fatawa and Quran or Sunnah (Sahih Hadith), then follow the teachings of Quran & Sunnah only. In these countries followers of all school of thoughts live but no common framework has been developed for consensus and contention which are the integral part of these schools. However, recently some efforts are being made to develop common framework for selected Islamic financial products. An example of one such product is “Diminishing Musharakah”. In case of Diminishing Musharakah, the client and the financier (Islamic bank in this case) are required to enter into a joint ownership agreement of an asset. The portion of financier (Islamic bank) is divided into a number of pieces known as units. The client purchases those units step by step thus increasing his own share. After the purchase of all units of financier, the client becomes the owner of the asset. Islamic scholars are unanimous on the validity of this transaction because the ultimate result is full ownership. The financier charges rent from the client which is also permissible. However lease of undivided share to a third party is pint of contention between Muslim jurists. Imam Shafi and Imam Malik are of the view that the undivided share can be leased out to third party whereas Imam Abu Hanifa hold that the undivided share cannot be leased out to a third party.

The Shariah boards of Indonesia and Malaysia is currently working to develop a draft framework for common rules and regulations of Diminishing Musharakah (and few other products) acceptable to all Islamic school of thoughts.

Legal Framework

Over the last 30 years in general, and the last decade in particular, the development and progress of Islamic finance cannot be ignored. This development is accompanied with challenges and opportunities to various stakeholders involved in this system. Supervisory authorities and industry face significant regulatory challenges that must be overcome to make the environment more favorable for this infantile industry (Ibrahim, 2007; Belouafi & Belabes, 2010). Analyzing the legal aspects of structure and methodology, it was found that legal impediments were the most considerable hurdle in implementation of an IB system (Aldohni, 2011).

An appropriate framework which can be applied universally, across geographies and schools of thought would allow the IFIs to expand. The convergence of Islamic theory and practice is necessary for stable expansion and universal acceptance, especially among Muslim populations. Dusuki and Bouheraoua (2011) stress the fundamentals of Maqasid al-Shariah and their role in contributing to resolve various Islamic finance issues and challenges. In addition, particular attention to the Maqasid al-Shariah will lead to rational and realistic solutions to the problems that are arising due to different legal frameworks (Asmat, 2014).

Previous researches analyze the regulatory frameworks of various economies that have implemented either a partial or complete Islamic system. This can be divided into two categories, specific issues and general issues. Siddiqi (2004) analyzes various regularly practices by IFIs. He examines how IFIs deal with delays in payment of debts resulting from murabaha, permissibility of securitization, sale of debts resulting from murabaha and other credit transactions. His analysis utilizes the central debate where classical theory is very clear against charging penal interest in case of defaults. In practice, however, it is largely acceptable to apply such charges so long as these do not contribute towards the bottom line profits of the company. Rather these should be utilized for charitable causes, leading to the welfare of society.

At present, in Muslim countries of Far East, most of the aspects of Islamic finance are growing without proper legal cover with some exceptions. Initially their commercial laws were developed primarily to protect the creditor (banker) and to date enough changes are not made to make them compatible with Islamic finance framework. No fundamental changes are made in Contract Laws, Sales of Goods Act, Mortgages and Pledges etc. Using similar laws for Islamic financial and commercial activities technically indicates that the relationship between the creditor (lender) and debtor (borrower) is unchanged. Presumptions exist that whenever there is a conflict between the Islamic finance framework and the existing law, the latter will prevail. Adjudication of recovery of bank receivables is presently interest-based that is haram in Islamic finance. Transaction costs and financial risks are considerably high for IFIs. No alternate mechanism was developed and provided for in the law to cater the need of those IFIs which develop real and genuine market links with suppliers and marketing agencies. Besides no regulations exist for Islamic financial products specifically for oppressed and vulnerable sections of society including pensioners, orphans and widows etc who are mostly dependant on fixed income.

During the last few years, there is a positive trend of development of Shariah governance systems in IFIs which could facilitate implementation across systems (Hasan, 2009). Although some standardized legal frameworks are developed by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), still many of them are vague and sometimes are incompatible with International Financial Reporting Standards (IFRS) and Basel guidelines of Bank for International Settlements (BIS). Besides, there is no clarity about formats and disclosure requirements in Financial Statements of Islamic Banks. Governments of these countries are the biggest borrowers but Islamic instruments to finance public debts are not available.

DISCUSSION

There are three aspects of any legal framework include laws empowering and governing the regulator, the rules for regulation of various sectors, and the broader legal framework underpinning the payment system, government debt management and other infrastructure elements (IMF, 2005). When considering these three aspects, the suggestions regarding formulating a comprehensive framework can be considered as follows:

- The incompatibility among the standards and regulations set by AAIOFI, IFRS and BIS is a significant hurdle. When financial institutions do not have a clear and cohesive format regarding disclosures and requirements, then standardized application becomes unfeasible. The impracticality of this hurdle is preposterous and it must be dealt with immediately.
- Regulatory laws specifically include the regulation of product structure. When evolution of the products is essential to ensure the continuous alignment of offering and demand, regulations should set a time when each product should be revised and

updated to meet all necessary requirements. In addition, the heavy concentration of majority IB portfolios in controversial products is alarming. Regulations should set standards on the portion of portfolio that should be mandatory for non-controversial products such as modaraba and musharakah. Furthermore, to ensure the applicability of standards, terminologies and products structures should be standardized. This would further eliminate the issue of various schools of thought and the adoption of certain standards.

- The legal framework through which the system operates is crucial. The literature review has emphasized a strong need for alignment of Shariah standards as set by regulators and the Maqasid al-Shariah. Any violations of fundamental principles should be addressed immediately. This would also eliminate the issue of the adoption of certain standards because of consensus and interpretation.

Directions for future research could include two major aspects. The first is identifying the reasons for lack of adoption of standards set by governing bodies. Further a comprehensive study on standardization of the terminologies regarding IBs worldwide.

CONCLUSION

Islamic finance is neither religion based nor for a specific community. Since mid 20th century Islamic finance is experiencing a revival because of the struggle of the Muslims to regain independence from colonial masters and that now has been spread in every nook and corner of world with zeal and zest. It has gone beyond the boundaries of Islamic world to almost all global financial markets. The importance of Islamic finance remains not only within Islamic communities, but internationally due to a rising awareness of the problems prevalent in conventional banking and a growing interest in Islamic finance. Leading IFIs spread their networks across all continents and create far reaching impacts in world economies.

Transformation of one business model to another business model occurs due to the failure to meet particular demands of stakeholders. There is a dire need to develop comprehensive framework for IFIs for smooth transformation. Islamic finance exists within the basic tenet of a capitalist economy, utilizing the existing system to achieve its principal function – to provide a financial system that is asset backed and free of interest. The focal point is that the economic activities under Islamic Financial System are governed by the fundamental injunctions of Shariah and not by the human desires and experiences. The ultimate objective of Shariah is to achieve Falah (prosperity) and to seek the pleasure of Allah (swt).

The development of such a framework will guide future research by addressing existing problems in the fragmented framework. Once these problems have been addressed, and laws are fine tuned to meet the requirements outlined, it will become relatively easier to adopt Islamic finance principles and implement relevant legislation. This will further aid the smooth and manageable transformation from conventional banking system to Islamic banking system.

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TABLES

Table : Islamic Schools of Thought

School of thought	Headed by
HANAFI	Imam al-Nu´man ibn Thabit (Abu Hanifa) [80AH-180AH]
MAALKI	Imam Malik ibn Anas al-Asbahi [93AH-179AH]
SHAAFI'I	Imam Muhammad ibn Idris al-Shafi´i [150AH-198AH]
HANBALI	Imam Ahmad ibn Hanbal [164AH-241AH]
JAAFARI	Imam Ja'far ibn Muhammad al-Sadiq [83AH-148AH]

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