

Establishing Islamic Banking in a Dual Financial System: Adverse Effects & Convergent Setbacks

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ABSTRACT

Establishing Islamic banking in a dual-financial system has shown persistent tensions between theory and practice. While convergence of theory and practice is lacking, convergence of Islamic into conventional banking operations is underway. This paper examines some of the factors affecting the latter. Islamic banks may have been mistakenly established as deposit taking banks to take on the challenge of *riba* as high capital requirement has frustrate efforts to utilize *al-bay* based real sector contracts. It is also deeply engulfed in the fiat money and fractional reserve banking system that supports fragility and financial instability. As a commercial bank, Islamic banking profitability objectives fall short to promote financial inclusion which are left to the development banks to embark on. The highly leverage deposit taking model calls for tighter control by regulators has made real sector contracts less viable. The way out has been the use of debt financing with *riba*-like consequences that are likely to trigger Shariah non-compliance risk events. This has led many Islamic finance stakeholders in the academia to turn their attention to new fields such as Islamic social finance, Islamic economics and lately sustainable finance. The remedy is to remodelled Islamic banking funding system where deposits are mainly utilized for transactional purposes while investment account funds for asset and project financing. This will reduce fragility as no debts are created from investment account funds. It will make real sector contract viable as banks under the investment account system are not required to hold high capital against the risky assets.

Key Words: Islamic banking, convergence, funding, deposits, regulation, investment account.

1.0 Problem Statement

Islamic banking institutions are established to provide an alternative financing arrangement that uses trading (al-bay) as opposed to usury in their business operations. The banking modality however is still based on the deposit-taking function where loans/finance are funded by deposits. Deposit funds are in essence loans acquired by banks from depositors who can make withdrawal on call, thus bank faces withdrawal risk and potential bank runs under economic shocks. While Islamic banks may label deposits funds under various Islamic contracts such as *mudarabah*, *wadiah* or *tawaruq* but as long as these funds are deposit in nature, they remain a loan the bank takes from depositors, hence subject to prudential regulation of the Basel Committee of Banking Supervision (BCBS).

The implication can be severe as potential loss from loans are only carried by banks and not the depositors as deposit contracts allow depositors to shift risks of deposit loss to the bank. For this, banks are required to make impairment provisions to absorb potential loss from loans which can diminish earnings from large unexpected defaults. Banks are required by the monetary authorities to hold adequate capital to support the loans against these unexpected losses arising from systematic risks. In a way, Islamic banks can pursue to increase earnings by extending more secured *murabaha* at reasonable rate or making more unsecured *murabaha* at a higher profit rate. In the latter, making more risky *murabaha* will allow banks to charge higher profit rate. But in doing so, they must hold more capital to back up these risky assets that may default. This skin in the game effect can be seen as their readiness to accept risks based on targeted earnings and also other non-monetary goals of banking (Agenor & Silver 2021).

Either ways, risk-taking behaviour is much controlled by regulatory capital requirement (CAFIB 2019). This is made to prevent excessive risk-taking from irresponsible lending by banks due to moral hazards of the highly leverage banking business (C. Hott 2021). For this reason, it is highly unlikely for Islamic banks to evidence its ability to finance the real economic sector using Islamic traditional contracts such as true sale and lease, *mudaraba* and *musharaka*, *salam* and *istisna*,

as adequate capital must be put against these inherently risky exposures. Risk-weights can be set as high as 400 percent for these Islamic contracts. (IFSB 2017). Skin in the game may not be viable for Islamic banks today as they are relatively lower capitalized than conventional banks.

Hence, much of the above problem are associated with establishing Islamic banks in a dual-banking framework. Little did the Islamic banking founding fathers knew that setting up an Islamic bank within a conventional infrastructure has opened it to inherit the ills of the conventional system. It will also make it relatively tougher for Islamic banks to realize its social goals and to positively contribute to financial stability. The objective of this paper is therefore, to critically examine the modality of Islamic banking inherited from conventional system that makes it less viable to leverage on Islamic traditional contracts where economic, social and equitable imperatives can be realized in balance. It helps explain the likely convergence of Islamic banking business into mainstream banking if less drastic steps are undertaken to find appropriate remedies. Five parameters are referred to in this paper which are examined in the following sections.

2.0 Deposit-Taking Bank

Islamic banks that take deposits to make murabahas as mentioned earlier will be restricted from using real-sector contracts under the pretext of *istisna*, *salam*, *mudaraba*, real sale and lease as deposits are risk-free funds, hence risks in loans and finance must be carried by the bank which it later shifted to borrowers. On the other hand, banks make loans only to the credit worthy borrowers funded by the low yielding deposit funds supplied by the working class, hence enlarging income disparity between the two groups is likely to take place. The fact that depositors do not take risks in exchanged for their fixed income placements will frustrate efforts to use deposit funds to finance less credit worthy but highly innovative customers such as those in the microfinance business, hence the un-bankable group will get less access to banking facilities which can further widen income disparities (Hsieh, Chen and Lin 2021).

More acute problem is associated with capital adequacy to operate risk-sharing or profit loss sharing (PLS) contracts as these contracts can generally be classified

into sale based, lease based and equity based. Sale and lease-based contracts are also subject to extremely high capital regulation once funding is sourced from deposits. Hence, Islamic contracts are by default prone to high capital charges due to price and ownership risks built into these contracts. Impact of the risk management process is certain as these commercial or business risks must be priced accordingly to provide credible expected loss estimates for provisioning purposes. For example, with risk weight of 400 percent, a \$100 million mudaraba assets will trigger a minimum capital requirement of $0.105 = k / 4 \times 100 = \42 million. Islamic banks can avoid such high skin in the game by simply offering secured tawaruq and murabaha at risk weight 20%, where now with less capital requirement ie \$2.1 million ($0.105 = k / 0.2 \times 100$ where $k = \$2.1$) is required to support the less risky asset. But doing so, will not allow financial innovation in many traditional Islamic contracts. At best, these tawaruq alternatives will allow convergence with the conventional space, as they are proven to behave in similar fashion with loans. This of course, frustrates the Islamic banking performance against usury as riba. It is thus, critical to note that as long as bank funding is acquired from deposits, there is no possible detour from existing debt financing which is mirror imaging interest bearing loans, hence convergence is inevitable.

3.0 Fractional Reserve Banking (FRB)

Islamic banks are established within the fractional reserve banking that is proven to be responsible for asset bubbles making the financial system increasingly fragile (Minsky 2008). The FRB allows money creation by commercial banks which when go out of control will lead to excessive money supply and runaway inflation. Banks, including Islamic banks are required to fulfil the statutory reserve requirement (SRR) while excess reserves are used to make loans, which becomes new deposits and money supply. For example, given SRR = 5 percent which gives a credit multiplier of 20, \$1 trillion of money printed by government is able to create up to \$20 trillion new money supply with \$19 trillion created by commercial banks.

The US government printed USD13 trillion between 2019-2021, partly for Cov-

id-19 stimulus as well as Biden reconstruction spending plans. Quantitative easing too contributed tremendously to money printing when the Fed buys bonds issued by the US government (Global Times, 2022). This further translates into commercial bank money creation when these new monies are used to make loans by banks (Deleidi and Levrino, 2017). Using $SRR = 5\%$, total money created from the USD13 trillion money printing is estimated at USD260 trillion. Not surprisingly, inflation shot up to more than 9 percent the US today. Hawkish Fed move to pull down inflation to 2 percent by raising interest rates will see the US economy sliding into a bad recession in 2023 (New York Times 2022).

Islamic banks within the dual banking system are not spared from the ills of money creation when new murabaha are issued funded by using deposits. The new murabaha debts created will eventually be turned into new deposits which is the money supply. Shariah compliant as they are, Islamic banks are still responsible for the inflation today. As a remedy, Islamic deposit funds should not be used to issue new debts which can help money creation by commercial banks. But this requires complete overhaul of the funding system of Islamic banks.

4.0 Fiat Money

Transactions in Islamic banking are facilitated via the fiat money system where currency is issued without any backing of gold. This will make it relatively easy for governments to print money which forms the monetary base essential for initiating deposit creation. This further contributes to fragility from the inherent booms and busts of economies (Diamond & Rajan 2001). In the days of the Mamluk Sultanate in the 14th century A.D., the use of fulus or copper coins as opposed to gold dinar as money, have produced human suffering from the hyperinflation it created arising from plentiful supply of cheap copper imported from Italy and neighbouring areas which was turned into currency (fulus) by the sultanate. Al-Maqrizi then proposed the use of gold dinar as the remedy where it was successfully implemented and worked well to overcome the hyperinflation (Rosly & Barakat 2002).

Of course, now there is no way out for Islamic banks to leave the fiat system as they are deeply estranged into the modern financial system where interest as *riba* plays a great role in money creation. This is true as loans and thus debts, are only created from the interest-bearing contract. While the government prints money ie issues fiat money, the Islamic banks further participated in creating debts and deposits which are part of the money supply. Hence these complicit acts between Islamic financial institutions can make Islamic finance and banking equally responsible for high inflation that are prone to damage public welfare (*maslahah*) if less is done to remedy.

Shariah scholars at the supervisory levels should take this matter seriously. Fatwa should be issued to explain the Islamic position of fiat money. Although fiat money is a promise to pay by the prevailing state or government in power, the upsides and downsides (*manfaah* and *madarah*) of using fiat money should be documented as part of the evidences (*dalil*) required in any Islamic verdict (*fatwa*) issued by Shariah scholars (Jaafar, Abdullah and Meera 2017).

5.0 Commercial Banking

As a commercial bank, an Islamic bank puts paramount importance to its profitability objectives. Its fiduciary duties to shareholders and depositors warrant banks to operate efficiently so that profit can be maximized and costs minimized. Hence, they not established to achieve social goals such as making *qardul hasan* loans to the poor or nurturing new start-ups. Development role of commercial bank is not a given mandate from the shareholders. Hence, banking business and risk strategies are mainly aimed at achieving targeted return on equities (ROE) and return on assets (ROA) and interest/profit margins (Mennicuci and Pelocci, 2017). Some have advocated the *Maqasid Shariah* as the basis of establishing an Islamic bank with a social mandate (Ishak and Asni 2020). Little did they understand about the pitfalls of the dual-banking much responsible for the lack of social purpose in Islamic banks today.

For this reason, it is not strange to see factors determining banking profitability

are generally associated with banking risks, capital, liquidity, deposits size and other external factors such as economic growth, inflation and financial deepening (Dietrich and Dazenrich 2017). Role of social parameters are less captured in bank profitability other than the amount allocated for corporate social responsibility (CSR) purposes (Yeung 2011). This has further produced social and economic difficulties for the unbankable group during economic slowdowns. It reduces good reputations of commercial banks, hence CSR is critical to evidence financial sustainability of financial institutions (Letner, Sigetti and Tibor 2015).

However, commercial banking business and risk strategies are still divorced from developmental objectives such as nurturing small business as these banks are not established towards that end. We would like to see how social ends such as supporting small business and start-ups can be built into the Islamic banking business and risk strategies similar to current banking engagement with environment, social and governance (ESG) risks and credit ratings. (Devalle, Framdino and Cantillo 2017).

6.0 Basel Regulation

As depositor funds are used by Islamic banks to extend murabaha financing, control is essential to deter bank from taking excessive risks that can endanger deposits. This is because banks do not use their own money namely, capital, to make loans. Banks capital holding made up only a fraction of total deposits as defined by Basel 3 leverage ratio of 3 percent (BIS 2014). Thus, prevention of moral hazards is critical as bank risk-taking behaviour can go out of control due to this highly leverage banking business (Holt 2021). Risk control via prudential regulation emphasizes responsibility of the board and senior management in risk governance (Abid, Gul, Hussin and Nyugen 2021). These include minimum capital adequacy requirements and prudential limits to prevent excessive risk-taking which in line with the Basel Standard (BNM 2019). While this is good to uphold sound prudential standard, it has adverse impact on Islamic banking. Apparently, Islamic banks will have less opportunity to use of real sector contracts as these contracts are highly risky hence with punitive effect on capital requirement.

Risky contracts can be viable when funded by equity funds but this is not the case for Islamic banking. Islamic banking debts are predominantly funded by deposit funds, hence an analysis of the funding side is critical, but sadly overlooked in many studies. Many Islamic banks have adopted the deposit-taking model but still riding on the equity label such as mudaraba investment deposits. This absolute oxymoron prevails in many Islamic deposit products that can ultimately trigger some degree of Shariah-non compliance risk if let out of control. Many Shariah Boards caught asleep on this matter have failed to see that Mudaraba is an equity position but readily applied to promote deposits which are essentially loans as defined by the Basel Standard.

7.0 Setbacks and Convergences

Such weak oversight in Shariah governance has given birth to efforts circumventing *riba* as Islamic banks have no options but to offer debt financing funded by deposits similar to interest bearing loans. Collateral based debt financing such as *inah* and *tawaruq* are widely popular as finance charge is set based on expected loss (EL) which measures the credit standing of borrowers (BNM 2013). While they are contracted by a sale contract as claimed, contract outcomes are identical to interest-bearing loans. These include pricing based on expected loss, early debt settlement, recovery and restructuring under a default event and profit compounding. While funding is claimed operated under a mudaraba system, collateral based debt financing can hardly generate attractive returns to commensurate the risky character of the mudaraba deposits. For this reason, many are disappointed with the rate of return accorded to these deposits also known as profit-sharing investment account (PSIA) despite its risky profiling as equities (Rosly & Zaini 2008, Hamza 2015)

Doing so saw the gradual convergence of Islamic banking into its mainstream counterparts at both sides, assets and liabilities. The *tawaruq* regime has spread like cancer devouring many financing and deposit products into its habitat despite its contentious standing in Islamic law (Al-Ghazali & Rahman, 2014). It can be exposed to Shariah non-compliance risk (SNCR) over operational issues reported

in many Shariah non-compliance events (Ali, Kamali & Adil, 2019). For deposit products, depositors are contracted with fixed profits and protected principle upon placement entry to be redeemed in full at maturity like any interest-bearing fixed deposits (Shafie, Zain & Rashid 2020). Likewise, in financing, liquidity is made readily available based on sales agreements that guaranteed upfront profits and capital recovery for banks. This has produced significant frustrations to many Islamic finance stakeholders, particular the academia many of whom have turned their research attention to key performance areas left out by Islamic banks such as Islamic social finance (Kuanova, Sayegiva & Shirazi 2021), Islamic moral economy (Asutay, 2013) and sustainable finance (Brascie et 2021, Habieb, M. et 2015). Convergence between principles and practices of Islamic banking is key to evidence successful adoption Islamic banking model such that all performance parameters, namely profitability with social justice are equally impacted (Sidiqqe, Z., 2021). However, when this is not achievable, convergence of Islamic banking into the conventional space is set to take place, which will be a great tragedy to the Muslim world (Mirakhor, 2007, Rosly 2019).

8.0 Competition from larger conventional banks

Islamic banks were set up in many ways. Early Islamic banks are mainly full-fledge banks, but many are now subsidiaries and windows of well-established and bigger conventional banks, hence competing with the latter can a challenging one, if not fighting a losing battle. Conventional banks are generally well-capitalized and larger in size, hence they have scale economies which Islamic banks often lack (Rani & Kasim 2020). This can adversely affect their earnings and capacity to bid for larger customer base. Business and risk strategies will be limited to a few saturated markets as they are not able to leverage on the many Islamic real sector contracts available. For this reason, pricing follows interest rate of conventional banks as most Islamic products are based of debt with credit risk posing as the major risks of banks.

Doing Islamic banking business within a dual-system has been a tough road for too long when banks are expected to perform beyond profitability which they cannot due to adoption of wrong banking model by the early pioneers of Islamic

banking. Some have criticized Islamic banks as been materialistic and mundane in their business objectives as profits have become their only concern. Such a gross misunderstanding of Islam must be corrected as the main objective of business (tijari) is to earn profit. It is indeed blasphemous to say that Islamic banks are not Islamic when social objectives are not met. Those who abandon Islamic banking due to such misguided understanding should not fall into despair. Instead, changes should be sought within the Islamic banking system where these social and economic factors can be built in the banking business and risk strategies. This endogenous approach can be pursued when funding side of banking is restructured to influence investment behaviour of depositors.

9.0 Alternative route: Investment Account Fund

A promising way forward is evident in the Malaysian experiment of the Investment Account Fund (IAF) in 2013 (BNM 2013). Islamic banks are now required to segregate deposit funds from the investment account funds (IAF), as the latter is now a purely equity product. Gone were the days where mudaraba contract was applied to a deposit product where mixing both can expose Islamic banks to Shari'ah non-compliance risk (SNCR). Establishing IAF is like setting a limited purpose bank (Kotlikoff 2007) within a bank but even better since no new overheads are required.

As an equity fund, IAF will absorb risks of real sector venture and investments, hence Islamic bank can benefit from considerable capital savings. Unlike mutual funds, IAF can be invested in ventures, hence opening up SMEs to possible partnership with the fund. Here are some possible benefits of IAF which can open new avenues for greater and wholesome performance of Islamic banks operating within the dual-banking system:

1. Improve income distribution: higher returns from IAF relative to deposits will increase income of customers. In Malaysia, average returns from IAF is consistently around 6-7 percent per annum compared with tawaruq and interest bearing fixed deposit at around 2 percent.

2. Reducing contract concentration risk: the intensified use of tawarruq opens the bank to SNCR when desperate defaulters may use Shariah as a defence against bankruptcies. IAF can open the application of real sector contracts as risks are now carried by IAF holders, thus diversification is now possible.

3. Stimulate real sector financing offerings: since the bank will not carry risks of ventures, IAF should be able to finance SME ventures tailored made to the risk appetite of corresponding IAF holders. This will help increase employment, income and purchasing power of people and the GDP as well.

4. Increase fee-based income of Islamic banks: This will further improve performance of Islamic banks, hence to be less reliant on operating profits. Expertise of banking will transcend beyond credit appraisal and debt collection and move into venture financing and asset management.

5. Pacify the fractional reserve banking which is responsible for uncontrolled money creation and fragility: as more people are attracted to IAF, more fixed depositors and equity investors may move to IAF market. Eventually deposits will be used for transaction purposes like the e-wallet system with less deposits now being used to make loans and murabahas. This reduces deposit creation and fragility as well.

However, all is meaningless if Islamic banks saw IAF as a distractor and disruptor of the status quo, which is tawarruq. The off-balance sheet factor may deter banks from IAF but to be impactful and therefore a worthy alternative to riba, Islamic banks via IAF should be able to champion all expectations - profit, ethical and social. Islamic finance should take sustainable finance to a higher level where usury as riba is to be rejected by ESG system as one factor like fossil fuels, child labour and corruption that must be removed in achieving sustainable development.

10.0 Conclusion

This paper has attempt to examine issues associated with Islamic banking perfor-

mance, with special reference to the application of al-bay and challenges associated with it. Establishing Islamic banking in a dual-financial system has shown persistent tensions of theory over practice. While convergence of theory and practice is lacking but that between Islamic and conventional banking operations are underway. This paper examines some of the factors affecting the latter. Islamic banks were actually mistakenly established as deposit taking banks to take on the challenge of *riba* as high capital requirement has frustrate efforts to utilize al-bay based real sector contracts. It is also deeply engulfed in the fiat money and fractional reserve banking system that does not help reduce fragility and financial instability. As a commercial bank, Islamic banking profitability objectives fall short to promote financial inclusion which are left to the development banks. The highly leverage deposit taking model calls for tighter control by regulators has made real sector contracts less viable. The way out has been the use of debt financing with similar *riba* consequences. This has led many Islamic finance academia to turn their attention to new fields such as Islamic social finance, Islamic economics and lately sustainable finance. The remedy is to remodelled Islamic banking funding system where deposits are mainly utilized for transactional purposes while investment account funds for asset and project financing. This will reduce fragility as no debts are created from investment account funds while making real sector contract viable as banks under the investment account system are not required to hold high capital against the risky assets.

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