Negative Impacts of Riba Banking on Performance of Islamic Banking

1. **Introduction**

According to the Islamic Banking Act of Malaysia 1983 an Islamic bank is defined as “any company carrying on Islamic banking business, which is further defined as banking business whose aims and operations do not involve any element which is not approved by the religion of Islam”. Today there are over 300 Islamic Financial Institutions operating in 75 countries with total assets exceeding USD750 billion and growing at an average annual growth rate of 15% - 20% (Bank Negara Malaysia, 2011). Apart from Iran and Sudan, all the Islamic banks in the world today can be said to be operating side by side with conventional banking. In the group of countries operating with the dual system, Malaysia is said to be taking the lead with the world’s first dedicated Islamic banking legislation called the Islamic Banking Act and also the world’s first Central Banking Act to specifically acknowledge the existence of a dual banking system, conventional and Islamic.

Islamic banking has been in existence in Malaysia since 1983. From basically one bank it grew to what is today. Today there are 17 Islamic banks in Malaysia operating side by side with 25 conventional Commercial banks and 15 Investment banks. Of the 17 Islamic banks, 5 are Islamic banks owned by Islamic banking groups whilst 12 are Islamic banks owned by conventional banking holding companies (Bank Negara Malaysia, 2011).

However, in spite of some progress there is an undercurrent of unhappiness with the achievements of Islamic banking in Malaysia due to many shortcuts in Shariah interpretations and seeing as just a mirror image of its conventional counterpart (Wong, 1995; Samad, 1999; Rosly, 2003; Asyraf & Nurdianawati, 2006; EngkuRabeah, 2006; Asyraf, 2008a & 2008b; Obiyatulla, 2008; Rosly, 2010). Some of the major criticisms of Islamic banking, which could be attributable to the impact of riba banking, are as follows.

1. Replication of conventional banking.
2. More expensive than conventional banking.
3. Not interested in microfinance.
4. Give financing mainly to big corporates just like conventional banks.
5. Encouraging ummah to take on more debts.
6. Over focusing on debt financing rather than equity financing.
7. Adopt conventional banking practice of wholesale transfer of risks to customers.

# Islamic banks do not exercise restraint when customers in financial difficulty.

1. Financial engineering to turn equity products into debt.
2. Legal documents that enhance transfer of all risks to customers.
3. Not a declared objective to achieve Maqasid Shariah.

However, most studies revolved around the comparison of efficiencies between Islamic banks and conventional banks and many conclude there are deficiencies in Islamic banking. The deficiencies are attributed to various reasons including wrong choice of products used and too much reliance on debt based products. By examining negative impacts of riba banking on its performance[[1]](#footnote-1) in a dual system like Malaysia, this study will attempt to analyze the position of Islamic banking in a different perspective, than normally done by previous researchers such as Kader (1995), Wong (1995 ibid, 2), Samad (1999 ibid, 2), Rosly& Abu Bakar (2003 ibid, 2), Asyraf (2008a, ibid, 2 & 2008b), HamimMokhtar, Naziruddin Abdullah & Syed M AlHabshi (2008), SudinHaron& Wan Nursofiza (2008), Hassan, Mohamad& Bader (2009) and Hutapea and Kasri (2010).

Hence, the main research question is “What are the negative impacts imposed by the riba banking system on the performance of Islamic banking in a dual banking system like Malaysia”. In order to identify the negative impact of riba banking on the performance of Islamic banking the researcher has identified five sub- research questions. These five sub-research questions are as follows:

1. Is the Islamic bank disadvantaged in the competition for deposits with riba banks?
2. Is the Islamic bank hindered by riba banking from extending *Mudarabah* and *Musharakah* Financing?
3. Is the Islamic bank hindered from extending highly ethical financing products?
4. In terms of risk, is the Islamic banking sector influenced by risks that should be confined only to conventional banking?
5. Are sukuk structures engineered to deliver conventional demands?

The rest of this paper is explained in four sections. The second section explores relevant literature. The third section presents research design. The fourth section discusses the findings and the last section concludes.

1. **Literature Review on the Criticisms of Current Islamic Banking Model**

This section focuses on the major criticisms of the Islamic banking model as practiced today. Mainly eleven issues are discussed in this section to highlight the opinions of prior researchers on the current Islamic banking practices.

*2.1 Replication of conventional banking*

Islamic banking does not appear to be much different from conventional banking in terms of effect. Instead of introducing unique new products to the market, Islamic banks seem to prefer to replicate and “Islamize” conventional products. (Asyraf & Nurdianawati, 2006; Lewis, 2009; Mirakhor & Smolo, 2010). The issue with replication of conventional product is that Shariah parameters are usually stretched in order for the Islamic products to achieve the same risk and rewards profile as the conventional products.

*2.2 Islamic banking seems more expensive than conventional banking*

This impression started in the early days of Islamic banking in Malaysia when fixed rate BaiBithamanAjil (BBA) Islamic house financing was being compared to floating rate conventional housing loans. It would seem more expensive (Kader & Yap, 2009) in times of low interest rates but it does not seem to have been proven over the long term. In prolonged periods of low interest rates and high liquidity it would appear than Islamic banking seems more expensive than conventional banking.

*2.3 Not interested in microfinance*

It does not address social needs of society. It does not appear to be interested in helping the poor. For example it is not interested in micro financing (Asyraf 2008b ibid, 2, Abdul Rahman 2007).

*2.4 Preference of Islamic banks to give financing mainly to big corporates*

Islamic banking does not appear to be interested in helping Small Medium Sized Enterprises (SME’s) get financing (Asyraf 2008b, ibid, 2). Like conventional counterparts they appear to be keen only on giving financing to big corporations. Since Islamic banks focuses more on debt financing than equity financing (Wong, ibid, 2), preference will be for companies that possesses collateral and have high paid up capital. As will be explained in detail later, this contributes to the rich getting richer defeating the Maqasid Shariah objective of a wide distribution of wealth in the economy.

*2.5 Encouraging ummah to take on more debts*

Currently, Islamic banking seems to encourage Muslims to take unnecessary debts. For example excessive advertising to use credit cards, take personal financing, go for *umrah* and *haj* on credit. Personal financing facilities should be made available when people are in financial distress; to market personal financing as a business and to offer to people who do not really need them is not good for the *ummah.* One goes for *umrah* or *haj* only when one can afford it and one must be debt free; to incur debt to go to *haj* and *umrah* goes against such injunctions[[2]](#footnote-2).

*2.6 Over focusing on debt financing rather than equity financing*

Islamic banking does not appear to be interested to extend equity financing based on *Mudarabah* and *Musyarakah*. (Asyraf & Nurdianawati, 2006; Samad, Gardner & Cook, 2000). Whilst it is acceptable for Islamic banks to extend debt financing, over focusing on debt financing will lead to misallocation of resources to the rich only at the expense of the poor. This is because debt financiers prefer to extend financing to those who can give collateral.

*2.7 Islamic banking seems to adopt the conventional banking practice of wholesale transfer of risks to customers*

Islamic banks seem just as keen to transfer all risks to customers as conventional banks (Mirakhor & Smolo 2010). The classic example is *BaiBithaman ‘Ajil* (BBA) house financing where reluctance to purchase house directly from developers before selling to customers under BBA has led to much hardship to customers when the developer abandons the project. If the developer fails to deliver the house, the customer is held accountable by the bank for failing to deliver the house to the bank under the Asset Purchase Agreement. The bank should purchase the house from the developer before selling to the customer; however the bank prefers to force the customer to sign a Sale & Purchase agreement with the developer first. After that the bank will enter into an *‘Inah* like transaction with the customer, buying and selling the same house. An *‘Inah* transaction is forbidden in most *mazhab*; it involves buying and selling with the same party to deliver cash in a manner that seems to be circumventing riba. In this way the Islamic bank is absolved of all construction and delivery risks making it not much different from conventional banks. What is obvious is that whilst the BBA *‘akad* (contract) seems valid enough it is the conditions deliberately placed in the legal documents which is responsible for the wholesale transfer of risks to the customers like conventional financing.

# *2.8 Islamic banks do not exercise restraint when customers in financial difficulty*

Ayah 280 surah al-Baqarah states *“And if the debtor is in strained circumstances, then (let there be) postponement to (the time of) ease; and that you remit the debt as alms giving would be better for you if you did not know”*.

The customers who suffer in BBA house financing when developers abandon housing projects half completed, will include young couples who would then have to make 3 monthly house related payments, the rent for the house they are occupying, the installment for a new house purchase, and the BBA installment for the house they will never own which the Islamic bank still insist they pay (Zaharudin, 2010). Some Islamic banks may have tried to adopt the spirit of Ayah 280 but it is the failure in implementation of this credit policy, which results in them appearing not to exercise restraint when customers are in difficulty.

*2.9 Financial engineering to turn equity products into debt*

In equity concepts of Musharakah for example both parties should share business risks. When Islamic banks enter into a Musharakah arrangement with their customers there is a tendency to introduce terms which absolves Islamic banks of all business risks (Lewis 2009). This could take the form of purchase undertaking to be signed by the customer to buy out the bank’s share without any loss to the bank if the musharakah project is not profitable (AAOIFI, 2008).

*2.10 Legal documents that enhance transfer of all risks to customers.*

One *Qaidah Fiqhiyyah* or Legal Maxim is *Al-Ghunm bi Al-Ghurm* or gain accompanies loss. A Muslim is not entitled to a gain unless he is willing to expose himself to a loss. A situation where one party bears all the risk whilst the other party is absolved of all risk but is entitled to gain will go against the aforesaid legal maxim (Mirakhor & Smolo, 2010). In a *Musharakah Mutanaqissah* co-purchase financing of a house, both the customer and the bank contribute an agreed amount and enters a joint venture to purchase the house. The customer is then required to make installment payments to the bank comprising of rent portion and part purchase of bank’s share of house. By the last agreed installment the customer would completely own the house. If an event of default occurs, the customer is required to purchase the remaining bank’s share of the house. Amongst the listed event of default in a standard *Musharakah Mutanaqissah* Agreement are as follows:

* 1. Property abandoned incomplete by the developer
  2. Bankruptcy of Developer
  3. Nationalization of subject property.

Hence, it is believed that these are risks beyond the control of the Customer as a joint venture partner with the Bank, and in a *Musharakah* agreement should be jointly shared by the *Musharakah* partners.

*2.11 Not a declared objective to achieve Maqasid Al-Shariah*

A particular deficiency in Islamic banking today is the failure to achieve *Maqasid Al-Shariah. Maqasid Al-Shariah* is the higher objectives of Shariah and these will include the following:

1. Achieving maslahah or benefit for mankind including equitable distribution of wealth, widely circulated wealth in society, justice and fairness in all transactions and dealings amongst men, upliftment of the plight of the poor, and a guaranteed minimum standard of living for the *ummah.*
2. Preventing fasad or corruption in society. Prevention of harm and injustice to befall society
3. The objectives of Shariah are further divided into essentials, exigencies and embellishments, with the essentials relating to the protection of religion, life, progeny, intellect and property.

Many have argued that Islamic banking today have failed to achieved *Maqasid* in spite of complying with legal rules (Rosly, 2003; Asyaf, 2008). For example motivated by profit maximization, focusing mainly on debt financing, there is distortion in the allocation of financing with bias towards the big companies thus negating the *maqasid* requirements of helping the poor and ensuring proper circulation of wealth.

**3.0 Research Method, Data, Sample and Data Analysis**

This research is approached from a qualitative aspect by interviewing experts from the Islamic banking industry. Both primary and secondary data are used to complete this research. Peers in Islamic banking and finance and/or those who understand the workings of an Islamic bank are selected as respondents in this study. They are existing and former Islamic bankers especially pioneers who worked in full-fledged Islamic banks for at least 15 years, and academicians and scholars who have studied the subject well. The structured interview is used as the researcher have identified five possible situations where riba banking can said to be negatively impacting Islamic banking and the same situation is posed to all peers and experts to seek their response as to whether they agree these are examples of such negative impacts. However, an element of the unstructured interview is also incorporated in that they are asked to justify their response in detail and also to give other examples of the negative impacts of riba banking they are aware of. In the case of data analysis, descriptive statistics and contents analysis are used to explain the interview results.

**4.0 Discussion on Findings**

*4.1 Background of the Respondents*

30 peers and experts comprising 10 scholars, 10 academicians and 10 pioneer and existing Islamic bankerswere approached for the interview. Breakdown of origin of countries include 20 from Malaysia, 4 from Saudi Arabia, 2 from Pakistan and 1 each from Qatar, Iran, Brunei and Indonesia.Of the 30 peers and experts approached, 12 agreed to be interviewed, all from Malaysia, including 2 Scholars, 2 Academicians and 8 pioneer and existing Islamic Bankers.This represents a 40% response rate. The list of the interviewees can be referred to the following table.

**[TABLE 1: List of Interviewees]**

*4.2 Findings for each question*

*4.2.1 Findings on question one on whether Islamic banking is disadvantaged in competing for deposits in a dual system.*

The overall answer from the peer group interviewed is that they agree with this contention. The most poignant answer came from Islamic Treasury Specialist who is an Islamic banking treasury pioneer with over 20 years’ experience in that area. He says that Islamic banking mobilization of deposits is fully influenced by conventional banking. Even after 30 years of Islamic banking now customers are still comparing to conventional rates before placing with Islamic banks, no emphasis was ever placed on the sinful aspect of riba banking.

In particular respect of the research question he highlighted that during the liquidity crisis of 1997-1998 Islamic banking deposits was bleeding on a daily basis as there was nothing Islamic banks can do to stop the migration of deposits to conventional banks as conventional interest rates on deposits skied.

It was around this time that Islamic banking started introducing deposit products that allow them to also predetermined returns up front such as Negotiable Islamic Deposits Certificate (NIDC). Islamic Treasury Specialist agrees this is the sort of innovations that borders on the rewriting of Shariah rules in order to stay in the dual system. If the dual system forces us to stretch Shariah interpretations then Islamic Treasury Specialist agrees that it goes without saying that this is clearly a negative impact of riba banking on Islamic banking.

Today there is Profit Equalization Reserve (PER) to top up profits whenever Mudarabah deposit profits are low. Pioneer Islamic Capital Market Specialist says this is an aberration and does not solve the issue. PER may only be used to top up Mudarabah deposits profits on the 15th of every month; so whenever conventional rates are increased between the 16th of the relevant month to the 14th of the following month there is nothing the Islamic bank can do. Deposits maturing in this period usually will move to conventional banks if conventional rates are higher. Scholar A questions the transparency in calculating returns on Mudarabah deposits where today it seems profit sharing ratios are more the function of how much profit the Islamic bank wants to pay instead of being based on real returns. He also questions that if Islamic banks constantly top up Mudarabah deposits such that depositors always associate mudarabah deposits with compulsory positive returns then the product may have crossed into the realms of riba.

International Islamic Banker brings up an interesting point not often considered before and that is how the implicit government guarantee of conventional deposits makes it tough for Islamic banks to sell Mudarabah deposits. Implicit government guarantee of conventional deposits makes conventional deposits cheap. In Mudarabah it is forbidden to guarantee against business losses so the risk perception of Mudarabah deposits is higher than conventional deposits. In such a situation it is very difficult for Mudarabah deposits to compete with conventional deposits. The fact that Mudarabah deposits exist today must be due to depositors’ belief that it is also guaranteed by the government. The belief cannot be discounted when the Islamic Banking Act clearly states that the government guarantees all Islamic bank deposits. Some may argue that the government’s implicit guarantee extends also to Islamic bank debt deposits. This fact merely reiterates the tough position for Islamic banks to uphold the principle of Mudarabah in collecting deposits.

Pioneer Islamic Banker B brings to the fore two interesting possibilities that are hoped does not take place in the industry. That is the possibility of the staff of the Islamic banking subsidiary of Conventional banking groups influencing their deposit customers to move their deposits to their conventional bank holding companies whenever rates are better in conventional banking. This is to prevent the depositors from moving the deposits to other conventional banks. The other possibility is the offer of a combination of Islamic and conventional facilities to an Islamic banking house financing customer. The logic from the banking group’s point of view is that the floating rate conventional overdraft is a natural hedge for the fixed rate Islamic banking house financing.

In addition, Pioneer Islamic Capital Market Specialist raises the issue of the impiety of the ummah. However, the point is if riba is made illegal for Muslims then the question of impiety will not arise. Islam in governance requires certain Islamic transgressions to be made illegal by the state. Pioneer Islamic Banker A and Pioneer Islamic Banker B amongst others fully endorse that riba should be made illegal to Muslims.

Among the voices that disagree with the contention that riba banking negatively impacts Islamic banking in collection of deposits, both Islamic Banking Organization & Methods Specialist and Academician A suggest, in terms of minimizing cost of funds Islamic banks focus on current and savings accounts instead of term deposits. Academician A further pointed out that using term deposits under General Investment Account (GIA) label for financing will trigger capital charge but will not carry similar capital charge when financing is funded by Profit Sharing Investment Account (PSIA) deposits. GIAs are general mudarabah deposits where the deposit customers invests in the business of the bank; Profit Sharing Investment Account are specific mudarabah deposits where the deposit customers invests in specific mudarabah projects of the bank’s financing customers. In terms of capital adequacy ratio calculations of the bank, the bank have to set aside capital whenever it’s financing is based on GIA deposits, hence the phrase capital charge. Using PSIA instead the bank does not have to set aside capital as losses are borne entirely by the PSIA deposit customers.

*4.2.2 Findings on question two on whether riba banking is preventing the extension of mudarabah financing*

The overall answer from the group of experts is to neither agree nor disagree with the contention. Many felt that the shortness of deposits is not confined to Islamic banking but is also felt by conventional banking. So, it cannot be the shortness of deposit that is preventing Islamic banks from extending mudarabah financing. The researcher had argued that conventional banking’s use of rental of money concept introduced the short-term deposits with returns to society. This in turn forces the Islamic bank to follow suit by engineering short term deposits with returns which borders on the Shariah prohibited concept of rental of money. If Islamic banks do not do this in a dual system they will lose deposits to the conventional system. Hence their inabilities to extend Mudarabah since majority of deposits are short term. The interviewees however do not clearly see the root cause of the shortness of deposits to come from conventional banking. Hence they are reluctant to agree with the contention. They seem to take the shortness of deposits as a given and said there are other reasons why Islamic banks do not give Mudarabah financing. Amongst the reasons include the risk averse nature of Islamic bankers in a dual system. They generally feel that Islamic banks could extend more Mudarabah financing if they want to.

However they raised a myriad of points that is food for thought for the Islamic banking industry. Pioneer Islamic Banker A underlines the view of many, especially the former and existing Islamic bankers that Islamic banking is in the debt market and therefore cannot be expected to do much in terms of equity. This view is supported by Islamic Treasury Specialist, Pioneer Islamic Banker B and Islamic Corporate Banking Specialist. Their view is that bank deposits will always be short term because banks operate in the debt market. A debt market being where people temporarily place short-term monies; long-term monies they will find other avenues which deliver higher returns. The view is that if one wish to extend equity financing one must operate in the equity market. Pioneer Islamic Banker A agrees on the formation of a new type of bank to be called Musharakah bank to deal with mudarabah and musharakah financing. Others refer to institutions like venture capitalists and investment banks. The general consensus is that the Islamic commercial bank cannot evolve into the Musharakah bank desired; it has to be two separate institutions, the Islamic Commercial bank and the Musharakah bank. Pioneer Islamic Banker A described expecting the Islamic Commercial bank to extend equity as pushing a square peg into a round hole.

Academician A however disagrees that an Islamic Commercial bank cannot evolve to extend equity financing. He believes it can be done by experimentation, not overnight. He quotes today there are Islamic commercial banks that involved themselves directly in housing development. He also quoted that Islamic banks can follow the example of universal banks in Germany and Japan who while extending debt to certain companies also take a 10% stake in the share capital of the company using shareholders’ funds. The Researcher merely wonders whether the debt market will exist in a single Islamic system built up from scratch. In other words could it be that the debt market arose only out of the riba system, which many now take, as they must also exist in the Islamic system. Pioneer Islamic Banker B insists there must be a debt market in Islamic banking however he concedes that the volume of debt financing extended by Islamic banks today does seem to suggest that Islamic banks may be embracing the rental of money concept which is the domain of conventional banking.

Another reason offered for the lack of Mudarabah financing is the risk averse nature of Islamic bankers. This is the view proffered by Islamic Corporate Banking Specialist, Scholar A and Islamic Treasury Specialist. Hence the Islamic bank will choose to always do debt financing where they are assured of returns. The Researcher wonders whether this obsession with risk is not a conditioning that came from the riba industry. The Islamic banker in carrying risk management must be able to differentiate between money lending risks and business risks. Islamic banks should only concern themselves with business risks; money-lending risks should not be allowed to creep into Islamic banking, they are the domain of riba lenders.

International Islamic Banker feels the implicit government guarantee of bank deposits not only make it tough to attract mudarabah deposits; it also makes extending mudarabah financing very difficult when conventional bank lending is cheap because of their cheap government guaranteed deposits.

*4.2.3 Findings on question three on whether riba banking is preventing the extension of Parallel Istisna’ house financing*

Overall the group of experts agrees with this contention. Pioneer Islamic Banker A raised an interesting point regarding Al BaiBithamanAjil (BBA) house financing in that in the early days of Islamic banking, the pioneer Islamic bank always signs a Novation Agreement taking over the position of their customer in the Sale and Purchase Agreement with the Developer. This means the Bank assumed responsibility if the developer fails to deliver the house. However, this practice was dropped when the concept of Al-‘Inah was popularized making the Novation Agreement as superfluous. Pioneer Islamic Capital Market Specialist, Islamic Treasury Specialist and Academician A feels the Islamic Banks should cease just being a financier, and get involved directly in housing development. Pioneer Islamic Capital Market Specialist raised the current issue of present legislation prohibiting banks from being housing developers. Such and all other legislations, which were relevant when only conventional banks were in existence, need to be reviewed by the relevant authorities so that they do not become a hindrance to Islamic banks. Pioneer Islamic Capital Market Specialist feels generally Islamic banks should step out of the box and be more of an entrepreneur and asset manager. He quotes the operations of Kuwait Finance House as housing developer as an example to emulate. Islamic Treasury Specialist suggests like a syndication Islamic banks can group together to act as housing developers cum financiers.

*4.2.4 Findings on question four on whether the Islamic banking sector is being influenced by risk that should be confined only to conventional banking*

Overall the group of experts agrees with the contention. The researcher is seeking an answer on whether conventional banking is exporting its risks to the Islamic banking sector in a manner that can be described as a negative impact of riba banking on Islamic banking. What was discovered is that Islamic banking is deliberately benchmarking its products against conventional interest rates. This is confirmed by almost everyone interviewed. Therefore, as a result of that strategy whatever risks faced by the conventional sector by definition will be felt by the Islamic sector. If conventional banks are exposed to interest rate risk so will the Islamic banking sector.

The question that needs to be asked is why the Islamic bank is benchmarking against the conventional sector. The obvious answer is that they are their competitors. They would not be their competitors if law forbids Muslims to patronize conventional banks. So it seems correct to say that it is not conventional banking that is negatively impacting Islamic banking in terms of risks but the lack of regulations preventing Muslims from using riba banking that is negatively impacting on Islamic banking.

There are linkages between the conventional and the Islamic market that’s perpetuating the risk infection. Firstly conventional banks are allowed to participate in the Islamic money market although the reverse is prohibited. Secondly Muslim depositors are allowed to deposit in conventional banks as well as take loans from conventional banks. With this two givens unchanged, plus the deliberate benchmarking to interest rates by Islamic bank it is hardly surprising that risks confined to conventional banks are being felt by Islamic banks. Pioneer Islamic Banker B feels that if Islamic banks can get more income from the equity side compared to the debt side, they will be less sensitive to movements in conventional interest rates. Academician A offers the main reason why Islamic banks benchmarks their products against conventional products and interest rates is because the Islamic bank’s product behaves like a loan. Al’Inah for example is not a sale; it’s a false sale because it does not trigger a tax charge and capital charge. Since it behaves like a loan it’s no surprise it is benchmarked against interest-rateon loan.

*4.2.5 Findings on question five on whether sukuk structures are engineered to deliver conventional demand*

Overall the group of experts agrees with the contention. Islamic Corporate Banking Specialist aptly describes the situation as follows. All Islamic banks everywhere are not yet ready to move away from debt based financing which is directly influenced by the interest based system. Much is heard about Mudarabah and Musharakah structures but that part is usually confined to the capital injection part only. For the profit and capital return part they always revert back to debt with for example liquidity facilities[[3]](#footnote-3) and purchase undertaking[[4]](#footnote-4).

Similar sentiments are expressed by all including Pioneer International Islamic Banker and Pioneer Islamic Capital Market Specialist. Pioneer Islamic Banker A says the Sukuk structurers went to the debt market to sell equity. It’s the wrong instrument in the wrong market hence the financial engineering. Academician A says it is the normal behavior of the bond market. Issuer wants funding but does not want to lose control. They went to the debt market that then offer their usual conventional flavors in the form of minimum risks and capital guarantee.

Academician B corrected that AAOIFI did not retract their approval for the capital guarantee; they have never approved it in the first place. They merely reiterated their position because they never approved capital guarantee for equity structures. Academician B agrees that the arrangers would not have proceeded with the structures if their Shariah advisers did not approve it. He suggests this is a governance issue on the part of Shariah advisers. Scholar B stresses that Shariah advisers must understand fully the nuances of Islamic financing structures or they will fail in their advice. Academician B suggests that Shariah Advisers must look at structures in totality and not approve based on micro positions only. He quotes local structures which seemingly sets out independent individual akads (contracts) but then allow a Master Agreement to tie up and fuse the individual akads in a manner that contradicts Shariah. It’s long overdue that an independent team of Islamic banking peers and experts be set up to act as go between and as check and balance between Islamic finance structurers and Shariah advisers. Their job being to translate complex financial structures into Shariah issues for Shariah advisers to advice on, and conversely to translate Shariah decisions into financial language for the Islamic finance structurers to amend their structures. It is conceivable that the Shariah implications of complex financial structures may not be fully understood by all Shariah advisers. Conversely the nuances and demands of Shariah may not be fully appreciated and therefore followed by all Islamic finance structurers.

*4.2.6 Findings on question 6 on whether the group of experts agrees that overall riba banking negatively impact the performance of Islamic banking in a dual financial system like Malaysia*

Overall the group of experts agrees that riba banking negatively impacts the performance of Islamic banking in a dual system like Malaysia. The researcher posed the following 5 questions as possible situations where riba banking is negatively impacting Islamic banking.

1. Is the Islamic bank handicapped in competition with conventional bank?
2. Is the Islamic bank hindered in its ability to extend its equity products?
3. Is the Islamic bank hindered in extending its highly ethical products?
4. Is the Islamic bank exposed to risks that are risks of conventional banking?
5. Is the Islamic bank forced to engineer and stretch parameters of Shariah in order to deliver conventional demands?

The interviewees agree on four questions and are unable to neither agree nor disagree on one question. Calculating the overall average of the five questions the result was 3.91 showing that the interviewees agree with the research question that riba banking is negatively impacting the performance of Islamic banking. However, when the research question was posed directly as question number 6 the result improved to 4.08 showing stronger agreement with the research question. This appears to be the consequences of question number two i.e. is the Islamic bank hindered in its ability to extend its equity products, where the interviewees are undecided. The interviewees seems unsure whether it is the risk averse nature of the Islamic bankers or the duality of the system which is the reason why not much Mudarabah financing is extended. However, it could also be argued that the risk averse nature of Islamic bankers could well be the result of years of conditioning by riba banking.

*4.2.7 Findings on question 7 on whether the group of experts agrees that Islamic banking will perform very well if riba banking is banned and the country adopts a single Islamic banking system.*

Overall the group of experts strongly agrees that Islamic banking will perform very well if riba banking is banned and the country adopts a single Islamic banking system. Of all seven questions posed this was the only question where the interviewees agree strongly with the proposition. The researcher understands from this position that while the interviewees fully support the position that Islamic banking will perform very well if it operates in a single system devoid of conventional banking they are not willing to absolved Islamic bankers entirely from their perceived shortcomings in the implementation of Islamic banking. This is again illustrated in the response to question two where the interviewees clearly wants to also highlight the weakness of Islamic bankers in retaining the risk averse attitude of conventional bankers which is clearly misplaced in the context of Islamic banking financing products of Mudarabah. In the researcher’s opinion the general unhappiness with the attitude of present day Islamic bankers is also in a way reflected by the interviewees decision to only ‘agree’ and not ‘strongly agree’ with the other four questions. This response contrasts strongly with their response when asked a direct question whether Islamic banking will perform very well if riba banking is banned and the country adopts a single Islamic banking system.

**5.0 Summary, Significance, Limitation and Area for Future Research**

*5.1 Summary Findings*

The main objective of this research is to examine whether the conventional banking system has negative impacts on the Islamic banking and the summary findings are as follows:

**[TABLE 2: Summary of Findings]**

*5.2 Significance of the research*

The main significance of the research is to bring to the fore a new factor that is impacting on the performance of Islamic banks and that is the negative impact of riba banking. The regulators will recognize the existence of this factor and Islamic banking will be better regulated commensurate with this finding. Islamic bankers will find a voice to bring to the fore other negative impacts not uncovered by this study. The ummah will benefit if as a result this new finding enables more ethical products. Academicians will find a new direction in their research to help improve the performance of Islamic banking.

However, the most important significance of the research is if all concerned recognized that Islamic banking is not meant to exist in a dual system. That is the most important message of the study, that Islamic banking should be a sole single system in a nation devoid of the riba banking system. Whether the economic system and the laws of the country are Islamic in nature is a separate issue at this stage of the proceedings. The researchers do not doubt that it is difficult to achieve but with the will of the ummah it is certainly not impossible. All parties must agree this is the ideal we should work to, an outline plan be then worked out, and a target date set.

*5.3 Limitations of the Research and Suggestions for Future Research*

The principle limitation of the study is that due to constraints of time the study is conducted on a qualitative instead of a quantitative basis. Nevertheless the researcher feels even with a quantitative research the interview of peers and experts as conducted in this research is indispensable and especially invaluable to conduct in view of the very youthful nature of the knowledge that is Islamic banking. If the study is conducted on a quantitative basis measurable dimensions would need to be formulated to represent the construct of the negative impacts of riba banking on Islamic banking. This pose an exciting challenge to all future researches related to the study’s research question of the negative impacts of riba banking on Islamic banking.

The second limitation is that it must always be understood that Islamic banking today is operating in a fractional reserve banking and seigniorage of fiat money system with all its attendant accusations of fraud and deceit on society by the system. Fractional reserve banking refers to the unabated creation of fiat money by banks when they accept deposits and extends loans. Seigniorage of fiat money is the deceitful advantage given to bank customers to use the fiat money given to them to purchase assets which are then paid for by permanent inflated prices suffered by society (Meera & Larbani, ibid,3). How Islamic can a system be when the environment it is operating in is accused to be so fundamentally flawed. It is beyond the scope of this assignment to address the credibility of Islamic banking in a fractional reserve banking and seigniorage of fiat money system. It would be an exciting challenge for future researches to not only establish the ideal Islamic banking system as is attempted by this study, but also to research and establish the ideal Islamic economic system that operates without fractional reserve banking and seigniorage of fiat money.

A very important lesson of this study is that, any assessment of the Islamic banking system must take full and serious cognizance of the environment the system is operating in; the banking system it operates in and the economic system it operates in. All future studies into Islamic banking and finance can no longer afford to ignore the effect of the environment, in particular the dual environment Islamic banking and finance system is operating in. If future studies further supports the conclusion that Islamic banking and finance should exist as a sole and single system devoid of the duality of riba banking, then in the researcher’s opinion, a sole and single Islamic banking system devoid of riba banking must then be the declared objective of all Muslim nations.

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Table 1: List of Interviewees

|  |  |
| --- | --- |
| Names of the Respondents | Relevant Short Description |
| 1. Dato’ Dr Abdul Halim Ismail | Founder Bank Islam Malaysia Bhd /Sharia Committee Member, Securities Commission of Malaysia |
| 1. Dr Hikmatullah Babu Sahib | International Islamic University Malaysia (IIUM) Sharia Dept/Sharia Committee Member of an Islamic bank |
| 1. Dr Azman Md. Nor | IIUM/ Sharia Committee Member of an Islamic Bank |
| 1. Prof. Saiful Azhar Rosly | INCEIF/Sharia Committee Member of an Islamic Bank |
| 1. Academician | Writes in International Academic Journals on Islamic Banking & Finance/Sharia Committee Member of an Islamic Bank |
| 1. Existing Islamic Banker | Chief Executive Officer of an Islamic Financial Institution |
| 1. Dato’ Wan Ismail Wan Yusoh | General Manager Bank Islam Malaysia Bhd |
| 1. Dato’ Ahmad Tajuddin Abdul Rahman | Former Managing Director, Bank Islam Malaysia Berhad |
| 1. Wan Abdul Rahim Kamil Ali | Islamic Capital Market Advisor to the Securities Commission of Malaysia/ Sharia Committee Member of an Investment Bank |
| 1. Abdul RaisMajid | Former Head of International Islamic Financial Market, Bahrain/ Former GM, Bank Muamalat Malaysia Bhd |
| 1. Mustafa Omar | Islamic Development Bank, Jeddah (Formerly Bank Islam Malaysia Bhd) |
| 1. YazitYusof | General Manager OSK Investment  Bank (Formerly Bank Islam Malaysia Bhd) |

Table 2: Summary of Findings

|  |  |
| --- | --- |
| Main Questions | Likert Scale Results |
| 1. Is Islamic banking disadvantaged in competing for deposits? | Agree |
| 1. Is riba banking preventing the extension of Mudarabah financing? | Neither Agree nor Disagree |
| 1. Is riba banking preventing the extension of Parallel Istisna’ house financing? | Agree |
| 1. Is Islamic banking sector influenced by risks which should be confined only to conventional banking? | Agree |
| 1. Are sukuk structures engineered to deliver conventional demand? | Agree |
| **Overall Average Result of the 5 questions** | **Agree** |
| Additional Questions | |
| 1. Riba banking negatively impacts the performance of Islamic banking in a dual financial system like Malaysia? | Agree |
| 1. Islamic banking will perform very well if riba banking is banned and the country adopts a single Islamic banking system? | Strongly Agree |
| **Overall result**  **Does *riba* banking negatively impact the performance of Islamic banking?**  **Agree** | |

1. The definition of performance will not refer to the Islamic bank’s profitability as such but more towards the Islamic bank not being able to be it’s true self or to fully comply with Shariah because of the existence of conventional banking in a dual system with Islamic banking. [↑](#footnote-ref-1)
2. Sheikh Muhammad S Al Munajid Islam Question & Answer Fatwa no.65494 <http://www.islamqa.com/en/>ref/65494 > Accessed 13th September 2011 [↑](#footnote-ref-2)
3. Liquidity facilities are where Issuers draw on bank facilities to deliver to equity sukuk holders as profits when there are no profits. [↑](#footnote-ref-3)
4. Purchase Undertakings provides a capital guarantee to equity sukuk holders; inability of issuer to distribute profits because of business losses is an event of default requiring the issuer to buy out the sukuk holders share such that the sukuk holders will not incur any loss by participating in the sukuk so far. [↑](#footnote-ref-4)