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Title Challenges and Future Prospect of Islamic Banking

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Challenges and Future Prospect of Islamic Banking

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Abstract:

Islam has its peculiar economic system which is based on just economic activities in a society. Islam bases its economic system on Riba/ interest free economy the aim of which is to provide equal opportunities to all the inhabitants of the society. Islam desires at promoting societies in which all have equal opportunities and in which wealth is not confined to few people only. Through the principal of Riba/ interest free economy, Islam halts various forms of usury and exploitation. Riba/ interest based economic system vows to facilitate people with loan whenever they need it but in fact this system usurps people's freedom by putting them under constant pressure when they have to pay back additional money. Sometimes people pay more than what they have received still they cannot win their freedom back in case they are late in returning the money in time and heavy fine is imposed upon them. Islam categorically forbids this and stands for Riba/ interest free system. Today many Muslim and non-Muslim countries have adopted Islamic Banking system which is getting more and more popular. Coming out of traditional and interest based banking system and to completely adopt the Islamic banking system is not a straight forward issue. It has many challenges despite having a bright future prospect. Some challenges are extremely complicated and they need efforts from international block to overcome. The present article addresses these challenges and future prospective of Islamic banking in Pakistan.

Keywords: Challenges, Islamic Banking, peculiar, Riba, economy

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Introduction

Islam has its peculiar economic system which is based on just economic activities in a society. Islam bases its economic system on Riba/ interest free economy the aim of which is to provide equal opportunities to all the inhabitants of the society. Islam desires at promoting societies in which all have equal opportunities and in which wealth is not confined to few people only. Through the principal of Riba/ interest free economy, Islam halts various forms of usury and exploitation. Riba/ interest based economic system vows to facilitate people with loan whenever they need it but in fact this system usurps people's freedom by putting them under constant pressure when they have to pay back additional money. Sometimes people pay more than what they have received still they cannot win their freedom back in case they are late in returning the money in time and heavy fine is imposed upon them. Islam categorically forbids this and stands for Riba / interest free system. Today many Muslim and non-Muslim countries have adopted Islamic Banking system which is getting more and more popular. Coming out of traditional and interest based banking system and to completely adopt the Islamic banking system is not a straight forward issue. It has many challenges despite having a bright future prospect. Some challenges are extremely complicated and they need efforts from international block to overcome. The present article addresses these challenges and future prospective of Islamic banking in Pakistan.

One major difference between conventional banking and Islamic banking is the focus and concern of the money advanced. While Islamic banking is more concerned with the utilization and output of the money advanced, conventional banking is more concerned with the return and payback of the money advanced without much care for the client. Conventional banks do not worry about client as much and they are not ready to take risk while Islamic banking risk the money advanced and free the client from major losses if it be so. All activities are sharia based in Islamic banking and they share both profit and loss with their clients and they don't remain one dimensional as far as profit and loss is concerned.

Objectives of the study

Pakistan being one major Muslim country provides big opportunities for the growth of Islamic Banking. It is very unfortunate that we did not pay much attention to developing a system of Islamic economics. The public of Pakistan were demanding for Islamic banking and economic system since long but at government level there were highly any efforts put in this regards. Until the start of 21st century there did not seem any substantial efforts from the government of Pakistan. In the early years we witnessed considerable efforts which materialized the dream of Islamic banking but

still there are many hurdles which need removal for the complete implementation of Islamic banking in Pakistan. So, the present study aims at achieving the following objectives:

1. To assess the potential of growth of Islamic banking
2. To assess the challenges of Islamic banking in Pakistan and to offer practical solutions to them
3. To assess the future prospect of Islamic banking in Pakistan

Literature Review

Numerous studies have been conducted on performance Islamic and conventional banks throughout the world. Most of the studies are theoretical in nature. Few empirical studies are found.

Empirical measurement of the performance of Islamic banks began slowly, owing to a lack of data. Initial studies examined individual banks. Given the corresponding growth in performance studies of conventional banks and the expansion of Islamic banks, it was only a matter of time before Islamic banks would be more thoroughly investigated.

There are few empirical studies the performance Islamic banks and conventional banks for example The study of (Iqbal, 2001) entitled: "Islamic banks and conventional banks in the 1990s a comparative study of aimed at this paper to a practical study for Islamic banks with a view to bridging the gap in the data from 1990-1998, is used, a researcher with multiple hypotheses to get out of the results of on the application during the period of the study. That the practical application of the experiment has been measured by the analytical equations, and there were some goals reached, has been the comparison with traditional banks from the same group to get out the results. In general, Islamic banks are well capitalized, profitable and stable. They also seem to be making an effective use of the resources at their disposal. However, they do not appear to be cost-effective in their operations. When compared with conventional banks, Islamic banks as a group outperformed the former in almost all areas and in almost all years. However, there are considerable variations among Islamic banks in terms of growth as well as performance.

Also ,The study (Al-Bashir, 2000), entitled: efficient of the performance of the Islamic banks in the Middle East,"the study the efficiency of the performance of Islamic banks in the Middle East from 1993-1998, and test the study of data in the amount of what has been achieved from the banks of an output or profit, the selection of the determinants of clarifying the features of this performance, it is assumed, a researcher in Islamic banks to achieve the required efficiency, and the outcome of that foreign banks profits more than local banks with equal conditions and data.

Furthermore the study (Bltajjy 1997) entitled: criteria for evaluating the performance of Islamic banks to study the theory of applied. The main purpose of said study was to

develop criteria to assess the performance of Islamic banks to identify the extent to which Islamic banks for its objectives for which it was created over two decades, through the use of a model contains a number of standards and measurement tools and the application of that on a sample of Islamic banks, has found a field study carried out by that there is no accounting standards for use in evaluating the performance of Islamic banks, which put an end to Islamic Development Bank to call for the Board of accounting and auditing for Islamic financial institutions to find criteria for Islamic banks, issued by this body the first criterion, which is the criterion of the presentation and disclosure-general of Islamic banks in 1994. The Section has researcher – until the study – Islamic banks to levels, according to their performance, went out the study several conclusions and recommendations.

So, although a number of single country studies exist. (Hassan, 1999; Sarker and Hassan, 2005; Ahmad and Hassan, 2005, examining Bangladesh), there are advantages in examining Islamic bank performance across country borders. Efficiency shows how well a bank performs. During the 1990s especially, there was a fundamental push for banks to lower costs. Hence measures of ‘cost’ efficiency were seen as important. Regulation and other operational aspects of Islamic banking also influence performance. Therefore these will all be examined.

Nienhaus (1988) examined the individual financial statements of a number of Islamic banks operating in different countries. He stated that in many countries there was only one Islamic bank, making a comparison between banks in different countries was the best option at that stage. He compared the performance of Islamic banks with conventional banks and concluded that Islamic banks were viable, but not as profitable. A seminal article provided by Zaher and Hassan (2001), found that Saudi Arabia did not distinguish between conventional and Islamic banking, whilst numerous Islamic banks in Pakistan had non-Islamic transactions despite attempts to comply fully with the financial system and Islamic principles.

As for (Al-Sahati and Al-Osaimi, 1994), he had discussed an estimate of a function of the costs of Islamic banks and commercial banks,. The study were valued a function of the costs logarithms of a number of Islamic banks and traditional working in the Arab Gulf for the year 1990, in order to measure the difference between the economies of scope (volume) elasticities replacement for Islamic banks and banks traditional, results showed that the Islamic Banks enjoy the volume of savings is positive, unlike most traditional banks. As it showed Islamic banks advantage in reducing the average total cost of the more expanded its work and services, that the total assets of the bank to about 556 million dollars. The substitution elasticities between labour and the size of investment deposits (equity capital), it was possible in all banks.

In addition (Turen, 1997) measurement of the performance of Bahrain Islamic Bank on the one hand and the rest of the conventional banks in Bahrain, on the other hand were compared for the period 1980-1989. He was using the three financial ratios, a

ratio of return on equity, return on investment, and the ratio of net profit before tax likely to risky assets. In addition to the analysis of financial portfolio, in which the bank shares. The results showed that the Bahrain Islamic Bank came to yield the largest and smallest factor of a test compared with the traditional banks, and that the addition of the shares of this bank to achieve diversified portfolios of financial risk better and less. Islamic banks are subjected to the same risks faced by conventional banks; Islamic banks also face stiff competition from traditional banks, investment funds.

As pointed out (Younis, 1996) (that there are dangers joint exposed to both groups, namely: 1) the risk of the constant return in employment (in the benefits of traditional banks debts Murabaha in Islamic banks) in exchange for deposits are under way with the cost of changing according to the market. 2) the risk of liquidity, as both sides depends on deposits callable in return for uses, time-bound. 3) speculation risks in international stock markets, which resorted to by traditional banks to cover the risks of the interest rate, and resort to Islamic banks under the pressure of retained deposits in foreign currencies, and on the role of risk management in promoting confidence in Islamic banks,

(AL-agool, 1997) measure the efficiency of the financial performance of Islamic Banks: An Empirical Study on the Jordan Islamic Bank, 1997. Evaluated as the economic aspect of the experience of Islamic banks by building a model to measure the efficiency of the financial performance of Islamic banks, using a set of financial indicators dependent inductive analytical approach, using data and bulletins issued by the Jordan Islamic Bank for the period (1980-1994), The study on the hypothesis that indicators financial measure of scientific and practical to assess the financial performance of Islamic banks, and the results showed the validity of such hypothesis. (Hassan 2003) reported that the Islamic banks were relatively less efficient than conventional banks elsewhere. Efficiency results produced from both parametric and nonparametric methods were highly correlated with ROE and ROA, suggesting that ratio analysis was also suitable for performance measurement. Cost efficiencies for Sudan, Pakistan and Iran averaged 52 per cent, whilst profit efficiency was 34 per cent. A locative efficiency which measures how well management resources are applied to the intermediation process was 79 per cent, whereas technical efficiency, or how well technology is applied to the intermediation process, was much lower, at 66 per cent. Hence Islamic banks in these economies could readily improve their efficiency by better use of technology. Efficiency for Islamic banks has generally improved with the expansion of business rather than improvement in the use of inputs and outputs into or out of the production process. As might be expected, larger banks and more profitable banks were generally also more efficient.

Yudistira (2003) this study makes an empirical analysis on efficiency and provides new evidence on the performance of 18 Islamic banks over the period 1997-2000. Based on efficiency measurement in which the non-parametric approach, Data

Envelopment Analysis, is utilised to analyse the technical and scale efficiencies of Islamic banking. Several results emerge. First, the overall efficiency results suggest that inefficiency across 18 Islamic banks is small at just over 10 percent, which is considerable compared to many conventional counterparts. Similarly, Islamic banks in the sample suffered from the global crisis in 1998-1999 however they performed very well there after. Second, the findings further shows that there are diseconomies of scale for small-to medium Islamic banks which suggests that M&A should be encouraged, moreover, publicly listed Islamic banks are less efficient than their non-listed counterparts

In fact, Naceur (2003) used Return on Assets (ROA) and Net Interest Margin (NIM) to determine the profitability of ten Tunisian banks between 1980 and 2000. As in other studies, internal and external variables were used. Internal variables studied were overhead expenses, total assets, capital ratio and loan and liquidity ratio. External variables used were macro-economic measures such as GDP growth, inflation and financial structure. Results show that NIM is negatively related to size, which suggests that large banks tend to have lower interest margins. Also, high net interest margins tend to be associated with banks that hold large capital and have large overhead expenses. Macro-economic indicators have no impact on profitability for Tunisian banks.

Samad (2004) evaluate evaluated the performance of Islamic Banks in Bahrain over the period 1992-2001 using financial ratio measures. The paper concludes that there is a significant difference in profitability and liquidity between Islamic and Conventional Banks and that Islamic Banks are relatively superior in terms of their credit performance. The study found that there is a significant difference in Islamic Banks' performance and Conventional Banks. Similarly, using financial ratios, Rosly & Bakar (2003) in their study to evaluated the relative performance of the Islamic Banking Scheme (mainstream banks offering Islamic services) to mainstream banks (conventional) in Malaysia for the period 1996-1999 found that mainstream banks performed better than Islamic Banking Schemes due to larger market size and greater experience, and thus concluded that Islamic Banks should put more on the morals and principals of trade taken from the holy Quran so as to achieve efficiency.

Iqbal and Molyneux (2005) stated that one of the reason of the importance of studying efficiency of IBs include an improvement in cost efficiency as a mean in achieving higher profits and increasing the chance of survival in deregulated and competitive market. There are few studies which investigate the relationship between efficiency and financial performances especially on profitability and he found that profitability is significantly related to measure pure technical efficiency (PTE).

Saleh and Rami (2006) evaluate the Islamic banks' performance in Jordon, examine and analyse the experience with Islamic banking for the first and second Islamic bank, Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB) in Jordon. The study highlights the domestic as well as global

challenges being faced by this sector. The study used performance evaluation methodology by Conducting profit maximization, capital structure, and liquidity tests, several interesting findings result from the study. First, the efficiency and ability of both banks have increased and both. Waive

Banks have expanded their investment and activities. Second, both banks have played an important role in financing projects in Jordan. Third, these banks have focused on the short-term investment. Fourth, Bank for Finance and Investment (JIBFI) is found to have high profitability. Finally, the study concludes that Islamic banks have high growth in the credit facilities and in profitability.

Challenges of Islamic Banking

Ever since its inception in 1967 in Egypt Islamic banking has faced many challenges both theoretically and practically. These two types of challenges needed minute and precise attention of the scholars and they still need more research and exploration of possibilities. In the present article I will mention a few of these challenges.

Lack of Authentic/ Acceptable Fatwa

The biggest theoretical problem faced by Islamic banking is the lack of one authentic and acceptable-for-all fatwa which can convince Muslims across the globe in favour of Islamic banking. There are hundreds of thousands of Muslims who still think that there is nothing like Islamic Banking in this world so far. They are of the view that there are basic issues involved in IB which make it similar to conventional banking. There are fatawas issued by different scholars in the field whom are followed by great number of Muslims across the globe still there is need of a single acceptable fatwa which can potentially come from a council of jurists or something like that.

Penalty on Defaulter

There is another big issue faced by Islamic Banking. Because Islam doesn't allow imposition of penalty in case on doesn't pay back in time there is big problem being faced by Islamic Banking. If they impose penalty it becomes un-Islamic and if they don't impose penalty then there is great number of defaulters. Experts of Islamic banking have introduced many ways but so far they have failed to come up with a practical solution which can enhance the performance of Islamic banking.

Pricing Formula

Another issue being faces by the IB is lack of proper, long lasting and acceptable for all pricing formula applicable in different modes of finance. Currently they are seen

charging more than what the conventional banking is charging in different activities of finance. So, customers are reluctant to pay more than what conventional banks are charging.

Conclusion

Although an emerging concept which is rapidly gaining popularity and applicability in the world there are still challenges which need proper research and attention of scholars of the field. In the present article we have discussed only few very basic problems of Islamic banking but there are many other issues as well. I am sure that if scholars can address these issues then Islamic banking will make much more rapid progress not only in Islamic world but in the other parts of the world as well where Islam is not followed.

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