CHAPTER-3

ISSUES AND CHALLENGES BEFORE MUSLIM SALARIED PEOPLE IN FINANCIAL PLANNING
# CHAPTER 3
## ISSUES AND CHALLENGES BEFORE MUSLIM SALARIED PEOPLE IN ISLAMIC FINANCIAL PLANNING

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CHAPTER 3
ISSUES AND CHALLENGES BEFORE MUSLIM SALARIED PEOPLE IN ISLAMIC FINANCIAL PLANNING

3.1. INTRODUCTION:

Islamic finance has grown rapidly over the past decade, and its banking segment has become systemically important in number of countries in a wide range of regions. Islamic finance is projected to continue to expand in response to economic growth in countries with large and relatively unbanked Muslim populations. It is also fueled by the large savings accumulated by many Islamic countries that are seeking to invest in Shariah-compliant financial products. The growing reach of Islamic finance it is often argued that Islamic finance is inherently less prone to crisis because its risk-sharing feature reduces leverage and encourages better risk management on the part of both financial institutions and their customers. It is also argued that Islamic finance is more stable than conventional finance, because: (i) Islamic finance involves prohibitions against speculation; (ii) financing is asset-based and thus fully collateralized; and (iii) It is founded on strong ethical precepts. Moreover, Islamic financial institutions (IFIs) are considered to be a good platform for increasing access to financial inclusion, including access to finance for SMEs, thereby supporting growth and economic development.

Islamic finance faces a number of challenges, despite the efforts of Islamic finance standard setters, in many countries the industry is governed by a regulatory and supervisory framework developed for conventional finance. Therefore, it does not fully take account of the special nature of Islamic finance. The industry is still largely a nascent one, lacking economies of scale, and operating in an environment where legal and tax rules, financial infrastructure, and access to financial safety needs and central bank liquidity are either absent or, if available, do not appropriately take into account the special characteristics of Islamic finance.

Islam prohibits the charging and payment of interest on financial transactions and advocates social justice and equality through distribution of wealth within the society. Following these principles, the Islamic banking and finance sector has experienced rapid global acceptance since the establishment of the first commercial Islamic bank in 1975. With annual growth rates of between 15 per cent and 20 per cent, the assets of the Islamic finance sector are expected to reach the US $ 2 trillion mark by the year 2015.¹

The strong performance of the Islamic financial institutions during the global financial crisis has further enhanced the reputation of the sector as a legitimate alternative to the conventional financing system. However, the sector faces many challenges as it continues to expand globally. These challenges include the regulatory environment in some countries that limit the ability of Islamic financial institutions to offer certain financing products, and a lack of consumer knowledge about the system.²
Indian banking laws do not explicitly prohibit Islamic banking but there are provisions that make Islamic banking an almost unviable option. Banks in India are governed under the Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiable Instruments Act 1881, and the state and central Co-operatives Acts. One of the most distinguishable features of these Acts is that they define Banking in such a way that Banks can accept deposits from the public only for further lending. A number of sections such as section 5 (b) and 5 (c) of the Banking Regulation Act 1949 prohibit banks from investing on profit and loss sharing (PLS) basis. Further, section 8 of the Banking Regulation Act 1949 reads, “No banking company shall directly or indirectly deal in buying or selling or bartering of goods.” Besides India is among the countries which explicitly provide deposit guarantee to banks’ depositors up to a value of Rs. 0.1 million through the Deposit Insurance and Credit Guarantee Corporation (DICGC). Government also interferes on the assets side by asking banks to provide concessional credit to certain priority sectors. Some other factors that help in stealing the shine of Islamic banking are the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) requirements. These together eat up about 30 percent of the banks’ total deposits. Adding to this priority sector lending leaves banks with very little capital, which they can invest in earning non-interest income. This topic deals with objectives of the study number 5 and 6 and also problem of the study number 1,2,4 and 5.

3.2. ISSUES AND CHALLENGES IN THE AREA OF ISLAMIC FINANCIAL PLANNING.

A. ISSUES IN THE AREA OF ISLAMIC FINANCIAL PLANNING:

Financial arrangements constitute an integral part of the process of economic development. A growing economy requires a progressively rising volume of savings and adequate institutional arrangements for the mobilization and allocation of savings. These arrangements must not only extend and expand but also adapt to the growing and varying financial needs of the economy. Perhaps it is due to these reasons that the Government of India has asked the RBI to look into the matter of Islamic finance. A well-developed and efficient capital market is an indispensable prerequisite for the effective allocation of savings in an economy. A financial system consisting of financial institutions, instruments and markets provides an effective payment and credit supply network and thereby assists in making best use of a country’s financial resources. Imbued with a high level of concern for equity and justice, a consciousness of differentiating the lawful (halal) from the prohibited (haram) and a sense of responsibility towards the weaker sections of society, Islamic banking began its modest operations in a small town in Egypt in the early sixties. Since then there has been no looking back for it. In fact, with each passing day it grew stronger and stronger. In certain quarters, it is believed that the oil boom in the mid-seventies led to the starting of Islamic banking practices but the facts and history do not support this hypothesis. Nevertheless, it cannot also be denied that the oil boom did help Islamic financial institutions in the Arabian Gulf to flourish. The seed of Islamic banking has however been sowed well before anybody could think of the oil boom in the Gulf region. Moreover, the concept of Islamic economics (a precursor of Islamic banking) had come not from the Arabian Gulf but from the Indian
subcontinent. In fact a failed attempt to establish Islamic banking in Pakistan during the mid-fifties also confirms this claim.

India’s endeavors in the field of Islamic banking and finance have been beyond routine experimentation. Major attempts have been made in this direction under the format of cooperatives or trusts. Under the latter the most popular legal format adopted by Indian Muslims is that of the “Muslim Funds”. The first of these was established in 1934. These Funds are mostly found in the belt of Muslim concentration in the North of the country. According to the information provided by the Federation of Interest Free Organization (FIFO), there are more than 130 Muslim Funds in the country. FIFO acts as their apex body in policy-making, liquidity arrangements, staff training and making representation to the Government. These Muslim Funds, cooperative credits and welfare societies are nonprofit institutions and were began either out of the need to rescue people from the usurious moneylenders or out of a concern for the economically backward and downtrodden. Much latter, from early 1980s, Muslims started venturing into profit oriented financing. This was made possible for three reasons; firstly, by that time, they had gained some expertise through successful running of non-profit financial businesses; secondly, the Islamic financial movement had gained momentum throughout the Islamic world and; thirdly, the new economic policy initiated in early 1990s focusing on liberalization, privatization, and globalization (LPG) had opened new vistas of opportunities for them. The decade of the 1990s saw proliferation of Islamic Non-Banking Financial Institutions. However, the Government’s abrupt decision to introduce large-scale regulatory changes in the non-banking financial sector did not augur well for the entire non-banking finance sector. The Islamic Non-Banking Financial Institutions appeared to have been more affected because of the distinct nature of their business and religious constraints in approaching conventional avenues of finance (interest based-financing) available to other financial institutions. In that fast-changing regulatory environment, conventional Non-Banking Financial Institutions preferred keeping their monies in commercial banks – an avenue that was not available to Islamic financial institutions - than risk the same in business ventures. On the other hand the small size of Islamic Non-Banking Financial Institutions the absence of a lender of the last resort besides their naive and complacent attitude towards the regulation also contributed in fair measure to their doom.

Following are the issues in the area of Islamic Financial Planning:

1. The Development of Economic Institutions:

Optimal functioning of an Islamic financial system, or for that matter of any system, requires that underlying economic and legal institutions are in place. The Islamic economic system is a rule-based system which dictates rules concerning property rights, contracts, expected behavior of economic agents, and social capital according to the teaching of Islam. As a result of several years of inactivity in developing such economic institutions, any effort to
build a financial system to comply with partial aspects of Islam is bound to face difficulties and result in suboptimal performance.

2. Promoting Risk-Sharing Instruments:

In the long run, the design of an Islamic financial system requires that the necessary institutions, based on Islamic economic tenets, are developed to be a foundation for the system. Institutions to support risk-sharing, partnership-based, and equity-style financing and investment are the most critical. By design, such instruments require close monitoring by the financial intermediary, which also incurs additional costs. Therefore, there is a need to develop systemic level mechanisms to perform collective monitoring of economic agents to reduce monitoring costs for the financial intermediary. Also, equity based securities and their efficient trading should be encouraged; in this respect, a stock market operating according to Shariah, which prohibits the use of leverage (use of margin accounts) and excessive speculation (including short sales).

3. The Alignment of Financing and Trading Activities:

Due to the nature of trade- and asset-based financing instruments, Islamic banks tend to act as more than mere financiers. Institutions are needed to facilitate the efficiency of these instruments and also to reduce extensive involvement of the financier so that the financier can focus on the financing function rather than being involved in the administration of the assets. For example, specialized institutions are needed to administer, maintain, and facilitate lease-related operations and to work closely with banks to provide the supply of funds. Standardizing the operations and instruments will pave the way for pooling heterogeneous assets for securitization purposes a much needed functionality for enhancing liquidity in the market.

4. The Development of Supporting Infrastructure:

Supporting institutions to facilitate financial contracting is a necessary ingredient of a robust financial system. Institutions such as rating agencies, audit agencies, trade associations, and dispute resolution organizations play a vital role. The function of rating agencies should not be limited to rating credit worthiness but should extend to evaluating and giving an opinion on the compliance and the quality of Shariah boards. Furthermore, although the Islamic International Rating Agency (IIRA) is mandated to rate financial institutions, there is a need to rate large numbers of counterparties with whom a financial institution may engage in partnerships. It proposes development of private, credit-rating agencies in all Muslim countries to facilitate the task of Islamic banks in choosing their counterparties. Similarly, the scope of an audit should include the effectiveness of controls on new product development to ensure Shariah compliance. Speedy and effective dispute resolution is a critical component of financial systems. Collectively, these institutions can provide the foundation required for a vibrant financial system.
5. Integration with the Global Financial Landscape:

Increasing globalization has spread Islamic finance to many different geographical locations where the infrastructure does not support Islamic finance-friendly institutions. This poses a problem for Policymakers and regulators and can create an obstacle for the growth of Islamic finance. For Islamic finance to integrate well with the conventional system there is a need to develop international institutions and standard-setting agencies that can provide the necessary support to local authorities and can also develop procedures and standards which can be adopted with ease.

6. Liquidity Risk and Lender of Last Resort:

Several studies have highlighted the issue of liquidity risk associated with Islamic financial instruments and the resulting exposure to Islamic banks. In addition; lack of a lender of last resort facility based on Islamic instruments further complicates the liquidity risk problem. Although, like conventional banks, a lender of last resort facility is usually available to Islamic banks, such arrangements are based on non-Shariah compliant financial instruments. For a fully functional financial system, a system of lender of last resort that complies with Islamic Law is another essential requirement.

7. The Payment System:

The absence of risk-free or high-grade investment securities and the dominance of trade-financed, asset-backed securities are of concern to regulators, as they threaten the payment system and increase its vulnerability to risk and illiquidity. In this context, it has been suggested that the concept of narrow banking be applied to Islamic banks. Fisher originally presented the concept of narrow banking, which is banking that specializes in deposit-taking and payment activities but does not provide lending services. Stability and safety are achieved if deposits are invested only in short-term treasuries or their close equivalents. In the context of the Islamic financial system, Islamic banks do not have access to relatively risk-free securities such as treasuries.

8. The Development of Benchmarks:

The practice of measuring the performance of an asset by comparing its return and risk to a well-defined benchmark is well established in a market-centered financial system. Markets are good at offering efficient, measurable, and consistent benchmarks for different asset classes and securities. The dearth of transparent benchmarks that can be used to compare risk-adjusted returns complicates the task of evaluating the efficiency of financial institutions. Such benchmarks are valuable tools for measuring the relative performance of different asset classes and, ultimately, the performance of the financial intermediary. The economic system in Islam suggests the use of return in the real sector as a benchmark for the return on the financial sector. However, the current practice of using interest-based benchmarks such as the London Interbank Offer Rate (LIBOR) is certainly in direct conflict.
9. Reputational Risk:

Islamic banks are exposed to reputational risk more than their counterparts in conventional banking. Depositors and other stakeholders of Islamic banks have placed a special “trust” in the management of these financial institutions, assuming that they are facilitating a sacred obligation, and any damage to this trust can lead to a breach of confidence. Furthermore, misconduct on the part of a single institution can bring the whole industry under the microscope and can result in irreversible damage to the industry’s reputation. This risk is not afforded any attention in either academic or in practical circles.

10. Illiquidity Risk:

Islamic banks are operating with a limited set of short-term traditional instruments, and there is a shortage of products for medium- to long-term maturities. One reason for these shortcomings is the lack of markets in which to sell, trade, and negotiate the financial assets of the bank. There are no venues for securitizing dormant assets and taking them off the balance sheet. In other words, the secondary markets lack depth and breadth. An effective portfolio management strategy cannot be implemented in the absence of liquid markets, as opportunities for diversification become limited. The most critical factor for the illiquidity is the composition of assets of Islamic banks which are dominated by trade-financing instruments. Such instruments are the result of a sale of commodities or goods and are, therefore, considered ineligible for sale in the secondary market due to the Shariah rule that a financing instrument cannot be treated as a negotiable financial claim. Since the needs of the market regarding liquidity, risk, and portfolio management are not being met, the system is not functioning at its full potential. There is growing realization that the long-term, sustainable growth of Islamic financial markets will depend largely on the development of well-functioning secondary markets and the introduction of liquidity-enhancing and risk-sharing products. Alternatively, Islamic banks need to reduce the weight of such assets in their portfolios and switch to those products that are market tradable. In order to switch to market-tradable securities; the Islamic financial industry requires the development of efficient and transparent money and capital markets.

11. The Lack of Appetite for Risk-Sharing Assets:

One of the major criticisms of Islamic banks is their reluctance to hold risk-sharing assets. By design, because of Islam’s economic principles prohibition of interest and pure debt, and sharing of risks Islamic banks should engage in partnerships and equity sharing financial assets, but in practice the portion of such assets on the balance sheets of Islamic banks is minimal. It is evident that Islamic banks’ first preference is for financing instruments that are generated through sale contracts and leasing instruments. Informal observation of more recent balance sheets shows a similar picture. Islamic banks’ heavy usage of the sale-based Islamic banks’ reluctance in regards to risk-sharing instruments such as Musharakah (equity partnership) and Mudarabah (principal–agent partnership) is problematic for achieving the true potential and promise of the system. The reason for shying away from such instruments
is a lack of appetite for risky assets, which in turn is due to Islamic banks trying to emulate conventional commercial banks where preservation of depositors’ principal is their foremost objective. By investing in financing and trade-related instruments, Islamic banks are able to provide low-risk and safe investment opportunities. Islamic banks should change this business model and expand their portfolio to include risk-sharing instruments. Islamic banks often claim that their reluctance is a direct reflection of the reluctance of the depositors for risk-sharing instruments. However, it is possible that the depositors’ low appetite for risk-sharing instruments is due to a lack of transparency and confidence in the ability of the financial intermediary. Therefore, Islamic banks should consider doing a better job of selecting and monitoring risk-sharing assets and enhance the transparency of the investment process by informing the depositors with good estimates of exposure to risks taken by the financial intermediary in investing in risk-sharing instruments.

12. Limited Scale and Scope:

Although Islamic banks have grown in number, the average size of their assets is still small compared to that of conventional banks. The majority of Islamic banks are below the benchmark asset size of US$500 million considered to be the minimum for an efficient conventional bank. There are only four banks with total assets in excess of US$10 billion, compared to the top six conventional banks, each of which has total assets in excess of US$1 trillion. Large institutions have significant potential for efficiency gains due to economies of scale and scope, organizational efficiency, and lower cost of funding. Due to their small size, Islamic banks are unable to reap these benefits. In the absence of debt markets, underdevelopment of equities markets, and lack of derivatives markets, financial intermediaries play a critical role in the provision of Islamic financial services. Financial intermediaries not only are the main source of capital and risk mitigation but also are expected to undertake activities with wider scope. The changing global financial landscape will require Islamic banks to go beyond their traditional role as commercial banks and develop areas such as securities, risk management, retail banking, assets management, and insurance that are either lacking or functioning on a limited scale. The nature of financial intermediation and the style of financial products and services offered make Islamic banks a hybrid between commercial and investment banking, similar to a universal bank.

Universal banking benefits from economies of scope due to its close relationship, established client base, and access to private information gained through the relationship. Combining different product lines (such as banking and insurance products) or commercial and investment banking lines may increase the relationship value of banking at a much lower average cost of marketing. Islamic financial institutions could realize the benefits of universal banking by strengthening this aspect of their business. For example, by expanding the scope of services, Islamic banks could spread the fixed cost, in terms of both physical and human capital, of managing a client relationship over a wider set of products, leading to a more efficient use of resources. Through expansion, Islamic banks could use their branch networks and other channels to distribute additional products at low marginal costs. As universal banks, Islamic banks would be able to capitalize on their good reputation established in one
product or service to market other products and services with relatively little effort. Finally, expanding the scope of Islamic banks would benefit consumers, who would save on searching and monitoring costs by purchasing a bundle of financial services from a single provider instead of acquiring them separately from different providers.

13. Concentrated Banking:

Islamic banks tend to have a concentrated base of deposits or assets. They often concentrate on a few select sectors and avoid direct competition. For example, one Islamic bank may specialize in financing the agricultural sector, while another might do the same in the construction sector, and neither attempts to diversify into other sectors. This practice makes Islamic banks vulnerable to cyclical stocks in a particular sector. Dependence on a small number of sectors lack of diversification increases their exposure to new entrants, especially foreign conventional banks that are better equipped to meet these challenges. This concentration in the base of deposits or assets reflects a lack of diversification, which increases exposure to risk. Islamic banks’ assets are concentrated in a handful of products. Islamic banks are not fully exploiting the benefits that come from both geographic and product diversification. At present, they rely heavily on maintaining good relationships with depositors. However, these relationships can be tested during times of distress or changing market conditions, when depositors tend to change loyalties and shift to large financial institutions which they perceive to be safer. By diversifying their base of depositors, Islamic banks could reduce their exposure to displacement or withdrawal risks. With the changing face of banking and the introduction of Internet-based banking, achieving a high degree of geographic diversity on the liabilities side is conceivable and should be encouraged. For Islamic financial institutions, geographic expansion of the depositor base could achieve diversification on the liabilities side. Diversification on the assets side could reduce the variance of the returns that accrue to claimholders of the financial intermediary. Also, geographic and sectorial diversification on the assets side could break up the financial institutions’ concentration in a region or a sector and thus reduce its exposure by creating less perfectly correlated risks. Geographic spread of products can further help the financial intermediary to improve its credit risk by selecting borrowers with the best credit and avoiding those with the weakest. With diversification, Islamic banks would be able to extend the maturity frontier.

14. Risk Management Framework:

Financial markets are becoming more integrated and interdependent, thus increasing the probability of expeditious contagion effects and leaving little room for swift measures against unexpected risk. Insufficient understanding of the new environment can create a sense of greater risk even if the objective level of risk in the system remains unchanged or is even lower. The current wave of capital market liberalization and globalization is prompting the need for enhanced risk-management measures, especially for the developing economies and emerging markets. Whereas risk management is practiced widely in conventional financial markets, it is underdeveloped in Islamic financial markets. Due to limited resources, Islamic
banks are often unable to afford high-cost management information systems or the technology to assess and monitor risk in a timely fashion. With weak management and lack of proper risk-monitoring systems, the risk exposure of Islamic banks is high. Islamic financial intermediaries need to adopt appropriate risk management not only for their own portfolio but also for that of their clients. Diversification and risk management are closely associated with the degree of market incompleteness. In highly incomplete markets, financial intermediaries are in a better position to provide diversification and risk management for the client because the responsibility for risk diversification shifts from the investors to the financial intermediary, which is considered to be better at providing intertemporal risk management. Islamic financial institutions need to take immediate steps to devise an infrastructure for implementing proper measures, controls, and management of risk and to create innovative instruments to share, transfer, and mitigate financial risk so that entrepreneurs can concentrate on what they do best: managing exposure to business risk in which they have a comparative advantage. Exposure can also be reduced by working closely with clients to reduce their exposure, which will ultimately reduce the intermediary’s exposure. In other words, if the debtor of the bank has lower financial risk, this will result in better quality credit for the bank. Furthermore, monitoring becomes vital in cases where Islamic banks invest in equity-based instruments because an institution with limited resources may not be equipped to conduct thorough monitoring. An institution with adequate resources may develop processes, systems, and training to undertake effective monitoring. There is clearly a need for Islamic financial institution that can offer guarantees, enhance liquidity, underwrite insurance against risks, and develop hedging tools for a fee. Finally, Islamic financial institutions need to realize the importance not only of financial risk and its management but also of operational risk, which is risk due to the failure of controls and processes. Currently, there is a serious lack of a risk culture and of enterprise-level sponsorship of active risk management. Formulating a strategy for risk management in Islamic financial markets will require holding comprehensive and detailed discussion of the scope and role of derivatives within the framework of the Shariah; expanding the role of financial intermediaries, with special emphasis on facilitating risk sharing; applying takaful (Shariah-compliant mutual insurance) to insure financial risk; and, finally, applying financial engineering to develop synthetic derivatives and off-balance-sheet instruments.

15. Regulatory and Governance Issues:

Several studies have identified weaknesses and vulnerabilities among Islamic banks in the areas of risk management and governance. Operational risk, which arises due to the failure of systems, processes, and procedures, is one area of concern. Weak internal control processes may present operational risks and expose an Islamic bank to potential losses. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. The role of Shariah boards brings unique challenges to the governance of Islamic financial institutions. Similarly, human resource issues, such as the quality of management, technical expertise, and professionalism, are also subject to debate. Implementation of a risk-management framework requires close collaboration among the management of Islamic financial institutions, regulators, and supervisors. Implementation of risk management at the
institutional level is the responsibility of management, which should identify clear objectives and strategies for the institution and establish internal systems for identifying, measuring, monitoring, and managing various risk exposures. Although the general principles of risk management are the same for conventional and Islamic financial institutions, there are specific challenges in the management of risk in Islamic financial institutions. Corporate governance in Islamic finance entails implementation of a rule-based incentive system that preserves social justice and order among all members of society. Governance processes and structures inside and outside the firm are needed to protect the ethical and pecuniary interests of shareholders and stakeholders. An institution operating within an Islamic system is expected to protect the rights of all stakeholders in the firm as well as in the society. At the operational level, there are serious issues relating to the rights of investment account holders (IAH) that is, the depositors as their participation in the governance structure is nonexistent. Similarly, Islamic banks maintain several reserves to smooth income and to compensate IAH in times when actual profits are below market expectations. However, there are no clear rules relating to the governance of such reserves. Implementation of financial disclosure is another priority. Ideally, jurisdictions where Islamic banks are present should implement accounting and reporting practices in line with standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This could be accomplished by adopting the official AAOIFI standards, creating AAOIFI-inspired national standards, or integrating select AAOIFI standards with existing accounting and auditing standards. AAOIFI standards present multiple advantages. First, the process of conducting periodic reviews ensures that only the best accounting and auditing practices are used. Second, they allow comparability across Islamic banks in different jurisdictions, although they may limit comparability between Islamic and conventional banks. Third, stakeholders involved in Islamic finance will find it easier to gain familiarity with a single accounting framework instead of multiple national ones. In spite of increased comparability across sectors, the simple extension of International Financial Reporting Standards (IFRS) or national conventional standards is not likely to bring the same clarity, because it may not allow the disclosure of relevant information. Poor corporate governance imposes heavy costs, but the mere extension of international standards to Islamic banks may not be sufficient. The principles and practices of Islamic financial services require a thorough review from the corporate governance perspective. Sound corporate governance requires the formulation of principles and enforcement. Many countries where Islamic finance is developing have weak contracting environments: regulators often lack the power to enforce rules, private actors are nonexistent, and courts are “underfinanced, unmotivated, unclear as to how the law applies, unfamiliar with economic issues, or even corrupt”. Furthermore, a “law habit” culture that is, a propensity to abide by the law must be rooted in society. While the ability to enforce regulations is inextricably coupled with the overall process of development, legislation enabling transparency, private monitoring initiatives, and investments in the rule of law by willing authorities can pave the way to the emergence of regulatory frameworks.
16. Shariah Governance:

The role of Shariah scholars is critical in Islamic finance and to the growth of the industry; given that Shariah scholars are one of the most significant stakeholders, their code of conduct, mode of operation and governance pose a serious challenge. During the last three decades, Shariah scholars have played a positive role in the growth and development of Islamic finance, but their role has also come under scrutiny and sometimes they have been unfairly attacked. The first issue is how to ensure that the rulings by Shariah scholars do not inadvertently encourage a practice which is in conflict with the essence of Islam. The role played by Shariah experts has gone through a cycle. In the early stages of development of Islamic finance, issuing a fatwa (legal ruling) was considered a public good and no financial benefit was expected from the service. However, the expansion of business and the current wave of commercialization have created a competitive market for Shariah scholars at the expense of less transparency. Today’s business world is changing rapidly and the circumstances and precedents familiar to Shariah scholars are very different. There is no doubt that Shariah experts have been doing what their training equips them to do, and they have been doing it well, but unfortunately their training is no longer well designed to serve the Maqasid-al-Shariah (objectives of Shariah) in circumstances very different from the environment reflected in the books they study. Today’s business environment calls for not only economic analysis but draws upon the latest developments in other social sciences such as sociology, psychology, political science, and management. Therefore, with a lack of proper institutional arrangements there is high probability of malfunction in Shariah advisement which can have dire consequences for this industry in its infancy.

17. Going beyond banking:

The distinction between traditional commercial banking and investment banking is becoming blurred, and there is a global trend to mix financial services with non-banking services. Although this trend is prevalent in major industrial economies, it has not been embraced by many of the emerging markets where Islamic finance is practiced. For example, a recent study that ranks several countries in the Middle East according to their level of financial development finds that countries throughout the region have a weak institutional environment and a poorly developed non-bank financial sector. Islamic finance has been dominated by commercial banking, and the relative size of investment banking, insurance, asset management, small and medium enterprise (SME) financing, and microfinance is very small. Islamic finance that claims to promote social justice and advocates equal opportunity for less fortunate segments of society needs to develop the SME and microfinance industry. A well-developed microfinance industry will promote economic development in underdeveloped Islamic countries. As poor segments of society are economically empowered, they will move from being “non-bankable” to being “bankable,” expanding the base of depositors and investors. Whereas microfinance institutions have been successful in conventional markets, there are only a few cases of such institutions operating on Islamic finance principles.
18. Economic development:

Besides the critical issues directly affecting the growth and development of Islamic finance outlined above, the growth of Islamic finance will be determined by the growth and development of the real sector of Muslim economies. By this we do not mean growth of gross domestic product (GDP) alone. Growth in GDP can be accompanied by little or no financial development, as for example would be the case if a country sells its oil abroad and imports all its needs. Broad based economic development requires higher savings and investment, a more educated and better-trained labor force, adoption of modern technology and best practices, efficient institutions (especially the rule of law), consistent economic policies, and an environment where a vibrant private sector can grow and develop. The synergy between the real and financial sector has been readily acknowledged. Economic growth of the real sector in such a setting will stimulate the financial sector, and the financial sector will in turn provide financing for the growing real economy. The largest and most developed economies tend to have the largest and most efficient financial sectors. Whereas Islamic finance has received considerable attention, no attempt has been made for system-wide implementation of economic tenets of Islam. The challenge for the Muslim countries wishing to embrace Islamic finance would be to understand the linkage between the economic tenets of Islam and economic growth. Islam’s notions of justice in exchange and distribution, the role of the society and the state, instruments to promote social welfare, inclusiveness, and promotion of mutual and collective help can lead to an equitable and just economic system.

19. Public Finance:

One of the key elements for sustained growth and development of any modern economy is sound public finances; that is, adequate public revenues and prudent public expenditures that promote economic growth and social welfare. An overbearing government that runs large budgetary deficits and finances wasteful expenditures does significant harm to promoting economic growth and development, and social welfare. An overbearing public sector, relative to the private sector, crowds out private sector investment and growth. A government that runs large deficits reduces resources for the private sector, damages macroeconomic stability, and reduces available policy options. Wasteful government expenditures, such as harmful subsidies and excessive military expenditures reduce economic growth and adversely affect social welfare. On the revenue side, efforts aimed at improving the elasticity and efficiency of the tax system need to be supported by improvements in administrative efficiency and tax enforcement. On the expenditure side, an improvement in the quality of public expenditure programs, especially the elimination of indiscriminate subsidies and the adoption of a fair and just social safety net, would enhance their contribution to economic growth. However, while not all Muslim countries have warmed to the concept of the market economy and broad-based reforms, nearly all to varying degrees have taken timid steps to reduce fiscal costs and improve efficiency by tackling a variety of complex and politically sensitive issues, including the need: to broaden the tax base and to reduce budget deficits; to address spending on subsidies, public sector employment, pensions, and health; to use taxation and income transfers in order to achieve a fairer distribution of income and wealth; and to introduce
greater transparency as part of governance reform. The attendant benefits of the improved fiscal conditions are also evident in lower inflation, smaller balance of payments deficits, more resources for private sector investment, and, quite recently, better growth rates.

20. Social safety net:

While over the last few decades the international community has adopted the position that broad-based economic growth is necessary for stemming the effects of systemic poverty, a growing consensus has emerged that social safety nets and social protection are also essential elements of any comprehensive framework for poverty alleviation. Not only are resources that provide basic services, such as health and education, important in their own right, they are also critical drivers for economic growth and development and essential to achieving an equitable distribution of income and wealth. An adequate social safety net is a central feature of Islamic economic doctrines and it is acknowledged to have a positive impact on economic growth and development. In the early 1980s, the general prescription for growth in developing countries was economic reform, focusing on developing a prudent combination of policies to enhance stabilization and adjustment, while little attention was placed on the potential social costs of such reforms; reforms were largely for reforms’ sake and did not incorporate the particular conditions of individual countries. However, by the late 1990s the pendulum gradually shifted towards a model of economic growth that included more attention to relieving constraints that were binding to individual countries, including specific provisions for social welfare and protection. It has also been recognized that safety nets alone cannot serve effectively as an instrument for alleviating poverty without sound macroeconomic policies that enhance sustainable growth. While restructuring efforts may create economic efficiency gains over the long term, they often times also lead to social dislocation, particularly over the short term. As Muslim countries adopt much needed economic reforms to promote fiscal discipline (eliminate government waste, reduce harmful subsidies), build effective institutions (enforce rule of law, reduce corruption), and promote economic justice in an effort to stimulate long-term growth, the development of a comprehensive structure to protect the vulnerable from declining deeper into poverty and improving the income distribution becomes even more pressing.

21. Human Resources Development:

Education, or knowledge, is today seen as a major, if not the major, input for sustained economic growth and development. In the development of a modern financial sector there is a critical need for highly educated professionals in the fields of economics, finance, accounting, and IT. At the same time, effective and prudent supervision and regulation of the financial sector requires highly trained specialists. Unfortunately, all of these specialists are in high demand the world over and are highly mobile. High-quality university education, a good working environment, and appropriate remuneration are key factors. Efforts should also be made to develop a multitude of customized research and training programs with certification in areas such as financial engineering and risk management. One cannot
emphasize enough developing cross-discipline activities to train Shariah scholars in economics and train the economists in the basics of Shariah principles.

B. CHALLENGES IN THE AREA OF ISLAMIC FINANCIAL PLANNING:

As is invariably the case in any emerging market, the emerging Islamic financial industry faces several challenges. The nature of these challenges is diverse, as there are numerous issues concerning theoretical foundation, infrastructure development, systemic implementation, integration with external systems, and enhancing the efficiency of operations. To foster the growth and stability of Islamic finance and financial markets, additional challenges are to achieve sustained economic development and growth of the real sector while maintaining sound public finances. There are challenges at both macro and at micro levels that require a careful analysis before a solution can be suggested. The approach to overcome some of these challenges will determine the future success or failure of the industry. Although the Islamic financial industry has enjoyed handsome growth, the sustainability of this success and the future growth of the industry will largely depend on which challenges are addressed and the degree of success that is achieved. If due attention is not paid to addressing these issues, Islamic finance will fail to achieve its full potential and will also fail to deliver its promise. Therefore, the stakes are very high and demand serious discussion of the issues.

Islamic banks are essentially governed by their Shariah boards the religious scholars that deem a product Shariah-compliant. But the challenge is that there is no central authority promulgating Shariah law, and the understanding of what is hence permissible and what is not varies among Islamic scholars and jurisdictions. The rapid growth of Islamic banking over the years has resulted in the introduction of complex banking products and structures, which now require Shariah harmonization at a global level. At present, that harmonization is lacking. Recently, a prominent Shariah scholar concluded that approximately 85% of Sukuks (Islamic bonds) in the market fall short of basic Shariah principles. While conventional banks have harmonized and approved regulatory standards that banks around the world follow, making it easier for them to expand and conduct operations in different countries, there are no approved standards per se for Islamic banks; they follow the conventional banking regulations. But because Islamic banking differs from conventional banking, it is difficult for Islamic banks to completely follow these global conventional standards. For instance, the capital structure in Islamic banks is different from that of conventional banks. Because of the prohibition of interest, Islamic banks mobilize and utilize funds using Shariah-compliant instruments or contracts that are not used by conventional banks and hence their capital structure primarily consists of Tier 1 capital only, while only a handful of Islamic banks have Tier- II capital. Another differentiation between the two banking models is the bank’s ownership of the asset: in Islamic banking contracts like Murabaha (sale on profit), Islamic banks have to own the asset for a period of time, a practice that is not required in conventional banking practices.
Following are the major challenges of Islamic Financial Planning:

1. Legal Support:

Islamic law offers its own framework for execution of commercial and financial contracts and transactions. Nevertheless, commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Islamic banking contracts are treated as buying and selling properties and hence are taxed twice.

The commercial, banking and company laws contain provisions that are narrowly defined and prohibit the scope of Islamic banking activities within conventional limits. It is necessary that special laws for the introduction and practice of Islamic banking be put in place.

The legal framework of Islamic banking and finances might include the following:

a. Islamic banking courts: The disputed cases of the Islamic banks are subject to the same legal system and are dealt with the same court and judge as the conventional one while the nature of the legal system of Islam is totally different. To ensure a proper, speedy and supporting Islamic legal system, amendments in existing laws, which are repugnant to injunctions of Islam, are required to promulgate Shariah compliant law for resolution of disputes through special courts.

b. Amendment of existing laws: Islamic banking has some kind of resemblance to universal banking, therefore, laws and regulations have to be amended accordingly to accommodate this new concept such as sections 7 (forms of business in which the banking company can engage) and 9 (prohibition of trade) of the Banking Companies Ordinance 1962 while Islamic banks are big or wholesale traders in reality.

c. Islamic banking law: In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and companies’ laws in several countries require suitable modifications to provide a level-playing field for Islamic banks. Furthermore, international acceptance of Islamic financial contracts requires them to be Shariah compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

d. Islamic banking balance sheet: Islamic banks do not show assets financed through Ijara (leasing or renting), Murabah (profit on sale) etc., on balance sheet because section 7 of Banking Ordinance 1962 does not allow a bank to own property or asset which section 9 prohibits to enter into any kind of trade. However, all the assets owned by Islamic banks be mentioned in their balance sheets.

e. Monthly payment agreement: The housing finance is executed on the basis of Diminishing Musharaka by the Islamic banks. Under this mode the house is jointly owned by the bank and the customer. The bank rents out its share to the customer on Ijara (leasing or renting) basis. The Islamic bank while executing Ijara (leasing or renting) with the partner/customer uses the term ‘Monthly Payment Agreement’ instead of having the Ijara agreement (leasing or renting) with the customer. It is so named as to safeguard the bank’s interest in case of refusal by the customer to pay rentals. No legal cover is provided to the Islamic bank to overcome this risk.
f. **PLS deposits:** Deposits in Islamic banks are usually based on principle of profit and loss (Musharaka or Murabaha). If something happens and the bank suffers loss it has to be transferred to the depositor directly. This fear of loss is the biggest barrier to deposit mobilization in Islamic banks. In some cases, it leads to withdrawal of funds. The depositors should be provided with some kind of protection.

2. **Islamic prudential regulations:**

Supervision of Islamic banks is equally important. At present, lack of effective prudential regulation is one of the weaknesses of the Islamic banking industry. For instance, leasing prudential regulations are applied to Ijara (leasing or renting) where the nature of both is different, such as taking advances. The bank is the owner in Ijara (leasing or renting) so taking advances will render the contract of Ijara (leasing or renting) for conversion into Musharakah whereas the rules of Ijara (leasing or renting) are applied to it, which is illegal. And some of the Islamic banks are using the term of security, hence making the Ijara (leasing or renting) contract non-Shariah compliant as using the deposited sum under the heading of Ijara (leasing or renting) security (‗Rahn‘- security) is nothing but Riba (interest) which is strictly prohibited by Islam. Moreover, Ijara (leasing or renting) financing is subject to compulsory insurance which is essentially prohibited.

3. **Risks:**

The nature of risk in Islamic banking is different from those of conventional banking and therefore some special prudential, accounting and auditing standards should be applied to them.

4. **Benchmark:**

Taking the conventional interest based benchmarks (Kibor etc.,) as the base of pricing an Islamic financial product puts Islamic banks at the mercy of their conventional peers. A negative perception is created among the clientele that there is no prudent difference in Islamic bank products as these are also using the same interest based benchmark. The mechanism for long-term financing could be devised on the basis of prevailing renting system adopted by the private landlords while renting their assets/properties etc.

5. **Shariah based product:**

All Islamic financial institutions offer the same basic products, (90 per cent Murabaha (principal and agent financing and Ijarah (leasing or renting)) but the problem is that each institution has its own group of Islamic scholars on the Shariah board to approve the product. Consequently, the very same product may have different features and will be subject to different kind of rules in these institutions. Lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered.
6. Nature of Islamic banking:

Islamic banks are offering only Murabaha (principal and agent financing) and Ijarah (leasing or renting) while leaving the core and difference making Islamic financial instruments such as Musharakah (equity financing) and Murabah (principal and agent financing). It is necessary to enhance and facilitate the implementation of real Islamic banking activities i.e. promoting risk sharing through equity type facilities on the asset side and profit sharing investment accounts on the funding side.

7. Lender of last resort facility:

Islamic banks are reluctant to enter into long-term transactions due the lack of availability of liquidation through secondary market. There is liquidity support in the form of lender of last resort facility. There is no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah.

8. Islamic future exchange:

In conventional system, long-term finance is provided through long-term bonds and equities. Apart from the general public, the most important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, their need for equity markets is much higher. On the top of it, the most of the products in Islamic banks are based on goods and commodities while prices and currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of Salam (advance purchase) and Istisna (construction project or purchase financing). To hedge the risk, they are in need of derivative products and consequently of Future Exchanges.

3.3. ISSUES RELATED TO ISLAMIC INVESTMENT OF MUSLIM SALARIED PEOPLE

Investment is sometimes referred to financial stability of individuals but placing your investment without prior knowledge would jeopardize your investment. The 1997 crisis has proven that investments in the stock market have severe effects to individual and institutional investors. Investors were having the worst of time during 1997 but they forget that they also have enjoyed the best of time during the boom time. Stocks are not the only investment vehicles that we could place our money. There are other types of investments vehicles that could be used. If we place our money in a savings account, bond or derivatives also would be considered as a placement in investments. In the context of Muslims investors, there are several guidelines that must be adhered in order to achieve profit and also falah (happiness and well-being) maximization. A Muslim must not only consider profit as the main objective because falah (happiness and well-being) maximization also must be achieved for the days of hereafter.
Islamic Investments must be free from interest accumulation, maysir (gambling), gharar (uncertainties) and operations based on selling prohibited products. In addition, the Shariah also promote the giving of zakat and sadaqah (Islamic tax) for the well-being of the society.

These are some of the examples of the conventional and Islamic vehicles that are available in the market.

**Table 3.1 Examples of the conventional and Islamic vehicles that are available in the market.**

<table>
<thead>
<tr>
<th>Islamic Investments Vehicles</th>
<th>Conventional Investments Vehicles</th>
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<tbody>
<tr>
<td>Mudharaba Savings Account – Income derived from undetermined profit</td>
<td>Savings Account- Income derived from fixed interest</td>
</tr>
<tr>
<td>Shariah Compliance Stocks - Income derived from dividends and capital gains but with the</td>
<td>Stocks – Income derived from dividends and capital gains</td>
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<tr>
<td>exceptions that the company must be Shariah compliance whereby its operations are free</td>
<td></td>
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<tr>
<td>from riba (interest), maysir (gambling), gharar (uncertainties) and selling prohibited</td>
<td></td>
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<tr>
<td>products</td>
<td></td>
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<tr>
<td>Shariah compliance mutual funds</td>
<td>Mutual funds</td>
</tr>
<tr>
<td>Sukuk Bond – Income derived from buying and selling process</td>
<td>Bonds – Income derived from interest</td>
</tr>
<tr>
<td>N/A</td>
<td>Options</td>
</tr>
<tr>
<td>N/A</td>
<td>Futures</td>
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</table>

Now if we look at the vehicles offered by the conventional and Islamic investment, the risk associated with the investments vary. Therefore the Islamic investors must also diversify their pool of funds to minimize risk. Or in other word “do not put your eggs in a basket”. A portfolio of investment should be maintained by the investors combining different investment vehicles in order to minimize risk.⁶
1. Mudarabah (principal-agent financing) and Musharaka (equity financing) modes of investment are ideal but Islamic Banks are not going in these two modes, the reasons for the above are as follows:

There is no systemic analysis and research and no real efforts to introduce above mentioned two modes but the practitioners blame the following factors:-

a) There is lack of committed entrepreneur.

b) There is lack of committed professional who can create new Instruments.

c) There is lack of committed sponsors who can pressurize the professionals

d) There is shortage of skilled professionals.

2. The problem of forward contact/booking of foreign currency:

The value of US Dollars ($), Pound Sterling, Euro and others are not fixed in Bangladesh, they are fluctuating from time to time. Most of our imports and exports are made in USD and USD being a strong currency always moves upward and the exporters are in better position than the importer in our country. In Bangladesh Forward Booking is required to check the exchange fluctuation for import of heavy/project Machineries where it take long time say one year or six months to produce the same.

But due to the restrictions of Shariah we cannot cover the risk of Exchange fluctuation by forward contract as Forward Booking is not permitted by Shariah. As per Shariah, currency transaction is to be made under certain terms and conditions laid down for “sarf”(exchange of money) by Shariah, such as spot possession of both the currencies by both the parties which is not available in forward Booking. It is also prohibited to deal in the forward money market even if the purpose is hedging to avoid loss of profit on a particular transaction effected in a currency whose value is expected to be declined. This problem requires a solution by Shariah experts.

3. Inland Bill Purchase/Foreign Bill Purchase:

This is another problem of Islamic Bank where the exporters immediately after export of the goods approach to the bank for fund before maturity of the bills to meet their daily needs. Here the Bank has to deploy billions of Taka (Bangladesh currency) each year but how and on what mode of investment. The Bank cannot take anything by providing fund to the exporter except collection fee for collection of the Bill, which is very poor.
4. Unfamiliarity with the Islamic Banking System:

The first problem is that despite the growth of Islamic banks over the last 30 years, many people in the Muslim and non-Muslim world do not understand what Islamic banking actually is. The basic principle is clear, that it is contrary to Islamic law to make money out of money and that wealth should accumulate from trade and ownership of real assets. However, there does not appear to be a single definition of what is or not an Islamic-banking product; or there is not a single definition of Islamic banking. A major issue here is that it is the Shariah Councils or Boards at individual Islamic banks that actually define what is and what not Islamic banking is, and what is and what is not the acceptable way to do business, which in turn can complicate assessment of risk for both the bank and its customer. More generally, the uncertainty over what is, or is not, an Islamic product has so far prevented standardization. This is difficult for regulators as they like to know exactly what it is they are authorizing. It is also an added burden on the banks that have to educate customers in new markets.

5. Portfolio Management:

The behavior of economic agents in any country is determined partly by past experience and present constraints. The Islamic banks are still growing in experience in many countries. Regarding constraints, Islamic banks in different countries do not freely choose arrangements, which best suit, their need. As a result, their activities are not demand-oriented and do not react flexibly to structural shifts in the economic setting as well as to changes in preferences. It is known to the bank management that a certain portion of the short-term fund is normally not withdrawn at maturity; these funds are used for medium or long-term financing. However, a precondition for this maturity transformation is that the bank be able to obtain liquidity from external sources in case of unexpected withdrawals. Islamic banks, without having an interest-free Islamic money and capital market, have no adequate instruments to meet this pre-condition for effective maturity transformation. On the other hand, Islamic banks can enhance term transformation if there is an interest-free bond market or a secondary market for Islamic financial papers. Adequate financial mechanism still has to be developed, without which financial intermediation, especially the risk and maturity transformation, is not performed properly.

6. The Regulatory environment:

The relationship between Islamic banks and monetary authorities is a delicate one. The central bank exercises authority over Islamic banks under laws and regulations engineered to control and supervise both traditional banks. Whatever the goals and functions are, Islamic banks came into existence in an environment where the laws, institutions training and attitude are set to serve an economy based on the principles of interest. The operations of Islamic banks are on a profit and loss share basis (PLS), which actually does not come fully under the jurisdiction of the existing civil laws. If there are disputes to be handled, civil courts are not sufficiently acquainted with the rationale of the operations of Islamic Banking. Regarding the
protection of depositors, Islamic Banks are required to let the authorities know the difference between money paid into current accounts and money paid into investment accounts. Islamic banks operate two broad types of deposits:

a) Deposits, which cover transaction balance. These have a 100 percent reserve requirement and completely safe, thus satisfying the needs of risk averters, and

b) The PLS or equity account, in which depositors are treated exactly as if they were shareholders in the bank. There is no guaranteed rate of return or nominal value of the share.

In non-Muslim counties (i.e., the countries with less than 50% Muslim population) the central banks are very stringent in granting licenses for Islamic banks to operate. In order to be established in those countries Islamic banks must also meet the additional requirements of other government and non-government authorities. (So, apart from legal constraints there are economic measures that result operations of Islamic banks in the non-Muslim world difficult). In Muslim countries also they face economic restrictions. Besides funding, acceptable investment outlets is a major challenge for Islamic financial institutions.

7. Absence of Liquidity Instruments:

Many Islamic banks lack liquidity instruments such as treasury bills and other marketable securities, which could be utilized either to cover liquidity shortages or to manage excess liquidity. This problem is aggravated since many Islamic banks work under operational procedures different from those of the central banks; the resulting non-compatibility prevents the central banks from controlling or giving support to Islamic banks if a liquidity gap should occur. So the issue of liquidity management must come under active discussion and scrutiny by the authorities involved is Islamic banking.

8. Use of Advanced Technology and Media:

Many Islamic banks do not have the diversity of products essential to satisfy the growing need of their clients. The importance of using proper advanced technology in upgrading the acceptability of a product and diversifying its application cannot be over emphasized. Given the potentiality of advanced technology, Islamic banks must have to come to terms with rapid changes in technology, and redesign the management and decision-making structures and, above, all introduce modern technology in its operations. Many Islamic banks also lack the necessary expertise and institutional capacity for Research and Development (R & D) that is not only necessary for the realization of their full potential, but also for its very survival in this age of fierce competition, sophisticated markets and an informed public. Islamic banking cannot but stagnate and weaken without dynamic and ongoing programs. In addition, Islamic banks have so far not used the media appropriately.

Even the Muslims are not very much aware that the Islamic banking is being practiced in the world. Islamic banks have not ever used an effective media to publicize their activities. The authorities concerned in Islamic banks should address these issues on a priority basis.
9. Need for Professional Bankers:

The need for professional bankers or managers for Islamic banks cannot be over emphasized. Some banks are currently run by direct involvement of the owner himself, or by managers who have not had much exposure to Islamic banking activities, nor are conversant with conventional banking methods. Consequently, many Islamic banks are not able to face challenges and stiff competition. There is a need to institute professionalism in banking practice to enhance management capacity by competent bankers committed to their profession. Because, the professionals working in Islamic banking system have to face bigger challenge, as they must have a better understanding of industry, technology and the management of the business venture they entrust to their clients. They also have to understand the moral and religious implications of their investments with the business ventures. There is also a need for banking professionals to be properly trained in Islamic banking and finance. Most banks’ professionals have been trained in conventional economics. They lack the requisite vision and conviction about the efficiency of the Islamic banking.

10. Blending of Approach of Islamic Scholars with the Approach of the Conventional Bankers:

Bankers, due to the nature of their jobs have to be pragmatic or application-oriented. There is and will be tendency in the bankers practicing in Islamic banks to mould or modify the Islamic principles to suit the requirement for transactions at hand. Additionally, being immersed in the travails of day to day banking, they find little time or inclination to do any research, which can make any substantial contribution to the Islamic banking. Islamic Scholars active in researching Islamic Banking and finance, on the other hand, typically have a normative approach, i.e. they are more concerned with what ought to be. A very few of them are knowledgeable about banking or the needs of the customers.7

3.4. CHALLENGES RELATED TO ISLAMIC INVESTMENT OF MUSLIM SALARIED PEOPLE.

The Islamic investment faces a number of challenges. First, they have not yet been successful in devising an interest-free mechanism to place their funds on a short-term basis. They face the same problem in financing consumer loans and government deficits. Second, the risk involved in profit-sharing seems to be so high that most of the banks have resorted to those techniques of financing which bring them a fixed assured return. As a result, there is a lot of genuine criticism that these banks have not abolished interest but have in fact only changed the nomenclature of their transactions.

Third, the Islamic investment does not have the legal support of central banks of their respective countries, which exposes them to great risks. Fourth, the Islamic investment do not have the necessary expertise and trained manpower to appraise, monitor, evaluate and audit the projects they are required to finance. As a result, they cannot expand despite having
excess liquidity. The future of Islamic investment hinges, by and large, on their ability to find a viable alternative to interest for financing all types of loans. They should recognize that their success in abolishing interest has been at least partial and they have yet to go a long way in their search for a satisfactory alternative to interest. Simultaneously, Islamic investment needs to improve their managerial capabilities by training their personnel in project appraisal, monitoring, evaluation and performance auditing. Moreover, the future of Islamic investment also depends on developing and putting into practice such accounting standards which provide timely and reliable information of the type that the Islamic investment would require for profit-sharing, rent-sharing or for cost-plus financing. These standards are yet to be developed. The Islamic investment would have to work hard to pursue their clients to accept these standards so that a reliable information base is established.

The emergence and growth of the Islamic finance industry is a phenomenon that has generated considerable interest in the financial world in recent years. Given its ability to offer innovative financial solutions to an under-served market, it is seen as a socially responsible, faith-based banking niche with considerable growth potential. In the Muslim world and increasingly in the West, significant segments of the institutional and retail markets are increasingly choosing Islamic finance for their financing and investment needs. Today, more than 500 Islamic financial institutions are operating throughout the world. Western banks are also doing Islamic banking, through their Islamic units in the UK, Germany, Switzerland, Luxembourg and other countries. The industry is growing at a rate of roughly 15 percent per year, and could serve 40 to 50 percent of the world's Muslim population within a decade.

State Bank of Pakistan's released figures indicate that branch network of Islamic banks in Pakistan has grown in excess of 649 branches in March 2010. The total asset base of local Islamic banking industry is Rs 366bn and the deposit base is - Rs 283bn. The industry has shown tremendous growth rate of 55% since inception. The ever-increasing share of Islamic banking in the local banking system stands at 5.9%. Despite the impressive growth, the Islamic banking industry is facing a number of challenges that are preventing it from attaining an even higher pace of growth. Some of the most important issues are identified below. Short-term liquidity management: The lack of investment avenues, especially short-term, has been one of the major problems faced by Islamic financial institutions (IFIs). The IFIs cannot invest in conventional interest-based sovereign debt instruments such as T-bills and Pakistan Investment Bonds. Therefore, short-term liquidity management has been a key challenge.

### 3.2.2.1. Regulatory and tax reforms

The government patronage and regulatory/tax reforms play a pivotal role for any industry to grow with leaps and bounds. On the international front, governments, like the United Kingdom and Malaysia, are offering relaxed rules and taxation for tapping the great demand for Shariah-compliant investment by Muslim investors, especially from the Middle East. Pakistan too can become a regional hub for Islamic finance if proper regulatory reforms are introduced. To achieve this goal, the government needs to revamp the existing structure of taxes and duties to make them conducive to Islamic finance. The most important areas where incentives can be offered are:
i) Stamp duties:

Stamp duties, especially the land revenue duties paid at the time of transfer of property increase transaction costs and hampers assets-based financing.

ii) Tax incentives for investors:

Islamic banks are new players in the market and they should be given some relaxation in terms of taxation. Theoretically speaking, depositors in Islamic banks are partners with Islamic bank and they share in actual profits and losses, as against interest-based banks where depositors are creditors and their principal is protected. Therefore, to encourage people to invest in Shariah compliant products, the government should introduce incentives in the form of tax credits. When we look at international markets, for example, the Malaysian government has given certain incentives for investors in Islamic finance industry till the year 2016 to make Malaysia a regional hub for investment.

iii) Regulatory reserves and capital requirements:

The regulatory capital requirements like minimum capital requirement (MCR), current reserve requirement (CRR) and statutory liquidity reserve (SLR) requirements serve to stabilize the financial sector. However, the nature of depositors in the Islamic banking industry is entirely different from that of conventional banks; therefore, percentages for regulatory reserves for Islamic banks should be relaxed further keeping in view their peculiar risk profile. This will create a level playing field and better reflect risk sharing nature of deposits in Islamic bank.

iv) Human capital:

Since the inception of the industry, the supply of trained or experienced human resource has lagged behind the expansion of Islamic banking. There is a dearth of qualified bankers, who are well-versed in Islamic laws as well as contemporary economics and finance. Currently, few universities and training institutes are offering courses in Islamic finance, but they also face lack of competent human resources to conduct these courses.

At the experts’ level, there are only a few scholars with the requisite knowledge and expertise in the field of Islamic finance. Therefore, the industry has to rely on a handful of Shariah scholars for the product development needs and these scholars find it difficult to accommodate multiple requests for their time. To cater to the needs of the industry, both business schools and religious schools should offer specialist courses in conjunction with industry experts to prepare the next generation of Shariah scholars and Islamic-financial managers.

v) Investment avenues:

Islamic principles stipulate certain conditions that need to be adhered to while developing Islamic banking products. Having left with no choice due to the absence of attractive investment avenues, Islamic banking products mainly rely on asset-based financing to generate returns for their depositors. The SBP figures indicate a heavy concentration of trade-based product of Murabaha (cost plus sale) in the total financing portfolio of Islamic banking to the tune of 37% as at March 31, 2010. Together, Murabaha (cost plus sale), Ijarah (leasing
or renting) and Diminishing Musharakah (equity financing), which are all essentially asset-based, fixed return products, constitute more than 80% of the financing portfolio of Islamic banks in Pakistan.

Although no less Shariah-compliant, these fixed rate trade based products draw criticism from certain quarters of the economy due to their apparent resemblance with conventional, interest bearing counterparts, usually in terms of returns only. The critics demand a more 'Islamic' way of investment by way of profit and loss sharing arrangements for investments by the banks in the form of equity based financing rather than trade based financing. However, this is easier said than done; due to lack of documentation in the economy, Islamic banks are finding it difficult to enter the profit-and-loss sharing-based real business ventures with their customers instead of fixed return products. Moreover, entrepreneurs and industrialists are also reluctant to share profits with the financiers in low risk ventures.

vi) Standardization of contracts:

The introduction of various Shariah standards by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFIs) has started to bring some uniformity into the Shariah-based legal framework of the Islamic finance industry, but efforts are needed to bring these agreements in conformity with the local taxation and related laws so as to make them more acceptable among all users.

vii) Perception of users:

Due to unsatisfactory experiences in the name of Islamic banking in the past, some Muslims individuals are now skeptical about the authenticity of Islamic banking practices. Part of it could be attributed to psychological tendency to stick to the decades' old banking habits and perception of banking. Most customers have opinions that are based on misinformation and represent lack of understanding of Fiqh (Islamic jurisprudence) issues. Changing these perceptions has been one of the greatest challenges for Islamic banks that can only be addressed through collective efforts by all, especially the media.

viii) Benchmark:

Using the conventional interest-based benchmark (KIBOR) as the base of pricing an Islamic financial product puts Islamic banks as well as their customers at the mercy of movements in the interest-based money market. Also, a negative perception is created among the clientele that there is no real difference in Islamic banking products as these are also using the same interest based benchmark. It is argued that Islamic banks should have their separate benchmark for investment pricing. This was not possible initially due to limited market, however, some Pakistani banks have now taken the initiative and work has already started to develop an Islamic benchmark.⁸
ISSUES AND CHALLENGES RELATED TO THE SHARIAH LAW AND PRINCIPLES.

Shariah or the Islamic Law is defined as a body of divine laws, rules, code of conduct and teachings which are intended to benefit the individual and society. It refers to the Islamic canonical law based on the teachings of the Koran. This law imposes certain strictures on the types of financial and commercial activities that Muslims can engage in. While trade and investment are encouraged, Shariah investing rules prohibit involvement in businesses related to certain haram (prohibited) activities.

Among the issues and challenges faced by the Islamic Banking Institutions in Malaysia is firstly, the level of consumer understanding about the instruments offered by Islamic banking. According to the previous studies related to the knowledge about Islamic banking among non-Muslim respondents reveal that their understanding of Islamic banking is relatively low. The findings of their pilot study indicated that non-Muslims have yet to fully accept Islamic banking as an alternative to conventional banking. Their study also found that the non-Muslims’ level of understanding about riba (interest) or usury is still very low even if they know the meaning of riba (interest). For those who have used Islamic banking, the most popular product is the savings account and the factors that influence their choice of bank is the high interest offered by the Islamic savings accounts and the overall quality of service. This means that Islamic banking can also be well received by non-Muslims if the criteria required by them can be provided by Islamic banks. Thus, the researcher wants to conduct in-depth examination of how the level of understanding and awareness of the Muslims or non-Muslims about the benefits of Islamic banking institutions can be enhanced.

The second issue is concerned with the application or use of various denominations among the Shariah advisers. The process of identifying the obligations or compliance of a financial instrument, Islamic law requires the ability of the scholars to understand these instruments in terms of concept and implementation. The strong understanding between market practitioners and these religious scholars should be the primary basis for assessing the compliance of any instrument to the Shariah principles. To safeguard the correct and effective implementation of Shariah decisions, the role of certain parties in coordinating and administering issues related to Shariah is crucial. This is to ensure the development of Islamic financial instruments run effectively and in an orderly manner. From a legal perspective, the regulator needs to ensure that the Islamic financial system should always be protected and secured. As far as product development is concerned, the regulatory authorities need to provide clear guidance on a product to be developed.

In addition to the regulatory body, the role played by the Shariah advisors is also very central. This is because the relationship between Islamic scholars and those who are experts in the field of modern finance cannot be separated, like two sides of a coin. Thus, the coupling of the two parties who are experts in their respective fields, in particularly the economic experts and Shariah scholars is a necessity. Thus, Shariah advisors will be appointed by any financial institution that chooses Islam finance as their activities. The role played by the Shariah advisors is particularly important in ensuring that every instrument complies with the
principles of Shariah. Similarly, the development of Islamic finance, particularly in terms of policy planning and product developments need to progress smoothly and in accordance with Shariah principles. To allow the Shariah advisers to fulfill their duties and functions, the institution must provide a task force or secretariat to assist in administrative matters and research. The secretariat should conduct a preliminary investigation on aspects of Shariah standpoint pertaining to issues raised so that the Shariah advisors can see the overall picture before making a decision. Research conducted by the secretariat will allow a broader discussion by the Shariah advisers on issues that were previously raised, which supported by the Shariah edicts. All financial institutions offering Islamic financial facilities are required to establish a Shariah Committee. Among the duties and responsibilities of the Shariah Committee is to advise the board on matters of law and to ensure that the bank's business operations comply with Shariah principles at all times, to approve Shariah Compliance Manual and to validate related documentation. This committee is also required to provide Shariah reviews or decisions in writing for the purpose of record and reference.

To ensure the duties of the Shariah committee can be executed efficiently, every Islamic financial institution has the responsibility to provide assistance to the Committee in carrying out its duties. Islamic financial institutions are required to refer all Shariah issues to the committee for advice and subsequently adopt the relevant advice. Islamic financial institutions are also required to ensure product documentations containing the Shariah issue are approved and endorsed by the Shariah committee, allowing the committee to examine all relevant records, transactions, handbooks or other related information to enable the Shariah committee members to perform their duties effectively.

In addressing the current issues concerning Muamalat (Islamic jurisprudence), fiqh scholars seriously consider the subject matter contained in the Istinbat al-ahkam tradition (legal formulation methods) such as the issue of halal (lawful) and haram (unlawful), usury or riba (interest), gharar (uncertainty) , maslahah and Maqasid syar`iyyah (objectives of Shariah). However, in carrying out their responsibilities, the fiqh scholars have always taken a balanced approach between the theoretical and practical aspects and the compliance of Shariah principles with `urf al-iqtisadiyyah (the customary practice of economic activities). In this context, fiqh scholars normally apply the principle of required changes as well as changes based on the instructions of the Quran and al-Sunnah. Based on the explanation above, the combination of intellect with religious revelations renders Shariah law dynamic, flexible, and able to handle any life issues that occur in any occasion or era. However, understanding and the assessment of human reason should be consistent with the requirements of the religious revelation and must be conducted according to the general guidelines established. Thus, the researcher aims to investigate how the resolutions of the securities commission of the Shariah Advisory Council (SAC) are formulated.

The third issue is the extent to which the views of the Shariah advisory council can bind the judges’ verdict in the trial of cases involving Islamic banking. It involves the intervention of the principle of division of power (Separation of Power). According to the Central Bank of Malaysia 2009 in Section 55, banks and financial institutions should consult the Shariah Advisory Council (SAC). In addition, Section 56 states that the court or the arbitrator should
consult the Shariah Advisory Council (SAC) in Shariah issues. Section 57 states that the 
resolution of the Shariah Advisory Council (SAC) is binding on the Court of Justice and 
Arbitration. Section 58 of the Shariah Advisory Council (SAC) is higher than other Shariah 
committee and section 59 (3) states the failure to comply with the resolutions of the Shariah 
Advisory Council (SAC) is an offense and can be punished with a penalty. This is because 
the rapid development of the economy and Islamic banking will bring some new issues 
pertaining to the law. Even this situation has become increasingly complicated when a judge 
has the right to choose to follow or otherwise because the final result of the case will be 
decided by a judge. The researcher will examine what are the Muamalat (Islamic jurisprudence) cases which had to be referred first to the Shariah advisory council. The 
questions that need to be asked are whether to place a duty on the court to refer any matters 
concerning Shariah banking to the SAC, whether to make the rulings into binding court 
decisions and whether the provisions in question have no retrospective effects.

Islamic finance advisory bodies should be respected because it is responsible for safeguarding 
the implementation of the Islamic principles in financial affairs. The results and the 
clarifications of this committee should be obeyed to ensure that the principles of Islamic 
banking are protected. The view of the committee should not be questioned because its 
members are Islamic scholars and experts in Islamic banking. Based on the cases that have 
been decided, it is clear that only the civil court has the jurisdiction over matters concerning 
banking and Islamic finance. Although the amended act has been enforced, we can see the 
actual response to the opinions and information provided by the SAC to explain the principles 
of Islam in matters relating to Islamic banking and finance, which still remains under the 
jurisdiction of the civil court judge. Therefore, the suggestion to establish Islamic commercial 
courts which are preside by representatives of the civil and Shariah court judges must be 
expedited. In the interim, the initial step is to ensure that the judges and legal practitioners are 
trained in Islamic banking and finance. The next issue is what are the criteria and eligibility 
of the judge appointed to hear cases concerning Shariah Law? How is this dealt with in terms 
of knowledge about the Shariah law? There need to be a paradigm shift in understanding and 
appreciating the principles and practice of Islamic banking based on the established standards 
or merit.  

3.5.1. FOLLOWING ARE THE ISSUES AND CHALLENGES RELATED 
TO SHARIAH LAW AND PRINCIPLES:

1. Choice of Law:

As with the conventional counterpart, Islamic financial institutions shall carefully consider 
which law is to govern the contracts and the relationship between the parties if, for example, 
the Islamic financial institution, the client and the asset(s) are located in three different 
jurisdictions. That’s paramount so as to ensure the contracts are legally binding and the 
parties can have the contracts legally and effectively enforced. While the issues revolve 
mostly within these parameters in conventional transactions, Islamic financial institutions 
will face additional risk due to contractual provisions that would require the contract and the 
parties to abide by certain Shariah standards in addition to the applicable legal requirements.
2. Proper Forum:

Determining the proper forum for dispute resolution is very important in the event the parties cannot have amicable settlement. This is due to several factors including ensuring the chosen forum will recognize that the contract is lawful and binding on the parties. Furthermore, the forum should have the authority and mechanism to ensure enforcement. Usually, the rule of thumb is to follow where the asset is. In the case of Shariah compliant financing, however, that may not be the best option in cases where assets are merely used as underlying for the transaction and/or where the assets are located in jurisdiction where Shariah principles are considered foreign. Additionally, Islamic financial institutions should take the additional precaution so as to ensure that it will not choose a forum where the prevailing view in that jurisdiction is in conflict with the Shariah principles and/or structure applied in the contracts.

3. Taxation:

The risk of double taxation is another aspect that the parties have to carefully consider before entering into cross border financing. In fact, the risk increases when the financing is based on Ijarah (or its variation) or Murabahah (principal-agent financing) where the local law requires the legal transfer of title to signify ownership and the Shariah board of the entity requires title to be obtained prior to the subsequent Murabahah (principal-agent financing) sale.

The complication that may arise here is that not only taxes may be charged for the act of providing financing facility; the parties may also be subjected to multiple taxes for each transactions they need to undertake as part of the Shariah compliant financing structure. Unless the parties carefully examine the implication that each part of the transaction structure may pose, it is plausible that the parties may be subjected to taxes from all angles.

4. Shariah ‘arbitrage’:

There is a diversity of opinion as to whether particular practices or products are Shariah compliant. This means that some products and services may be approved as being Shariah compliant by some Shariah scholars but not by others. On a global level, the approval of Islamic firms’ products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators. The Financial Service Authority (FSA) is in no position to assess the suitability of the scholars consulted by Islamic firms. It does, however, want to see the basis on which an Islamic firm claims to be Shariah-compliant is communicated appropriately to the consumer. More generally, it supports moves to develop common Shariah standards by organizations such as the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The IFSB, for example, has recently called for a dialogue within the industry to adapt current insurance regulations to meet the specifics of Islamic finance. Greater standardization could reduce the potential for Shariah ‘arbitrage’ as well as making it easier for bankers and investors to understand the market.
5. Shariah compliance throughout the product life cycle:

For Islamic finance providers, gaining approval from the Shariah Supervisory Board (SSB) on Shariah compliance of a product before its launch is vital. Equally important for firms is recognizing that Shariah compliance is a continuous process that means their products and services are adequately monitored. Unlike conventional finance, this has implications for an Islamic firm’s prudential requirements as well as conduct of business: some products, if they breach Shariah compliance rules, can adversely affect a firm’s solvency by converting an asset into a liability on the balance sheet. Effective monitoring of Shariah compliance by an Islamic firm may involve reinforcing more remote SSB oversight through the Internal Shariah Audit process and by developing more knowledge and expertise within the firm.

6. Issues for Shariah scholars:

Several of the potential issues for Shariah scholars that, it is worth highlighting two more. The shortage of appropriately-qualified Shariah scholars in the Islamic financial industry means it is common for individual scholars to hold positions on the SSBs of a number of Islamic firms. This raises concerns over the ability of SSBs to provide enough rigorous challenge and oversight of firms’ products and services. Another issue is where the SSB of a firm is responsible for the yearly Shariah audit as well as approving products for Shariah compliance. As with conventional firms, the FSA would like to see these conflicts recognized and carefully managed.

7. Human resources:

It is widely acknowledged that there is a global shortage of experienced professionals in the Islamic finance sector. There is clearly scope for more education and training in the UK and some positive steps are now being taken. These include university degrees and professional training courses. The shortage of resources also extends to Shariah scholars who have relevant banking experience. To address this, some firms have placed less-experienced scholars alongside experienced ones on their SSB, thus helping to develop more knowledgeable scholars.

8. Contract and documentation risk:

In contracts for Islamic transactions, the enforceability of terms and conditions depends on the governing law. In the case of a dispute, it is unlikely that a UK court will give a verdict based on Shariah law. To mitigate this risk, contracts have to be written very carefully to minimize potential disputes and state the governing law.
9. Risk of contagion:

In the UK, the risk of contagion to the wider economy and financial markets through a failure of an Islamic financial institution is limited as the market is currently relatively small. In countries where Islamic institutions have a larger share of the market the impact would be wider. The industry is still very young and it is still building its reputation and credibility. Additionally, in some countries, Islamic finance and its various business models (which have so far tended to be conservative) have not yet been tested in a severe economic or market downturn. Given these factors, a significant failure now in the Islamic market might have a damaging impact on the future development of this sector.¹²

3.6. ISSUES AND CHALLENGES RELATED TO THE ISLAMIC FINANCE AND SHARIAH AWARENESS.

Due to lack of awareness, the Islamic Financial Institutions (IFIs) of 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 Islamic Banking (IB) products among Muslims 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 to 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. 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.¹³
The speed and degree of success with which Islamic banking will emerge in conventional systems will largely depend on whether potential depositors and investors are well informed about the opportunities and risks at hand, and on whether Islamic banking is perceived as a transparent and well-regulated activity. From a prudential standpoint, regulators should communicate to the public what types of Islamic institutions and products will be supervised. They should also require institutions offering Islamic products to actively pursue awareness campaigns. For instance, commercial banks should inform investment (mudarabah- principal-agent financing) depositors of the profit-and-loss nature of their deposits. In practice, these tasks can be easily accomplished by simply providing an explanatory prospectus to interested customers. There remains a great need to harmonize Shariah Law with the existing legal framework. This creates huge difficulties and challenges in the event of disputes and legal matters as Islamic Financial concepts are not recognized by certain legal frameworks. There should also be a drive to create more innovative products and gradual shift from products that closely resemble conventional financial products such as commodity Murabaha (principal-agent financing) and Tawarruq (Islamic financing product).

The study concluded that the customer’s awareness level towards Islamic banking products is not good. Some people known about the current account, time deposit account but most of the people are not known about the major Islamic banking products like Mudaraba (principal-agent financing), Musharaka (equity financing), ijara (leasing or renting financing) etc. regarding the Islamic banking selection criteria most of the customer have adopted Islamic banking due to the religious, but there are some other factor that motivate the customers for the adoption of Islamic banking system. The result shows that the overall Islamic banking customers are mostly satisfied with the banking services. The study shows that most of the customers are not aware of the different Islamic banking products such as Ijara (leasing or renting financing) financing, Murabaha (principal-agent financing) financing. It is having the meaning that Islamic banking industry has to give consideration to providing awareness to their customers.

3.7. ISSUES AND CHALLENGES RELATED TO THE SHARIAH BASED FINANCIAL PRODUCT.

Islamic banking products are increasing day by day and previous studies found that Islamic banking products are on a par with conventional banking products. Following are the Shariah financial products and issues and challenges related to this:

i. Bai’ al ‘inah (sale and buy-back agreement):

Bai’ al ‘inah is a contract which involves sell and buy back transactions of an asset by a seller to the customer. The seller will sell the asset on spot basis but the customer will buy back the asset on deferred payment at a price higher than the cash price. In other words, subsequently the asset is sold to the customer on a deferred-payment basis and the price is payable in installments.
ii. Bai’ bithamanajil / BBA (deferred payment sale):

BBA refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. It means that the Islamic bank will purchase certain assets on a deferred payment basis and then sell the goods back to the customer at an agreed price including some margin or profit requested by the customer. The customer will paid in installments over an agreed period.

iii. Murabahah (mark-up):

Murabahah is a cost-plus financing contract where a sale is made at a specified profit margin. It establishes a form of mutual contract between two parties where they agree to the mark-up. The bank acts as an intermediary and purchases the goods requested by the customer. The bank will later sell the goods to the customer in a sale and purchase agreement, whereby the lender re-sales to the borrower at a higher price agreed on by both parties. Murabahah is derived from the root word which means profit, gain or a legal addition.

iv. Mudarabah (trust financing):

Mudarabah is a form of partnership where one party (rab al-mal) provides the funds and the other party (mudarib) assumes the role of the entrepreneur through effective management. The parties share the profit of the business venture based on agreed percentage and bear any loss incurred. In the event of losses the entrepreneur loses his or her labor and the financier loses the capital.

v. Musharakah (partnership contract):

Musharakah is a word of Arabic origin meaning ‘sharing’. It is a form of shirkat al-amwal where all partners invest capital into the joint-venture. Musharakah emphasizes practical participation of parties in the partnership business and it is a form of partnership between two or more parties based on mutual trust. Musharakah means partnership whereby the Islamic financial institution provides the capital by the customer with the understanding that they both share the profit and loss according to a formula agreed before the business transaction is transacted.

vi. Ijarah (leasing):

Ijarah is a financing mechanism involving rental of an asset or hire purchase where a form of rental fee is paid for a stipulated period of time agreed by the parties. This is more in accordance with the Shariah concept of leasing where the bank acquires ownership based on the promise and leases back to the client for a given period. The customer pays the rental but the ownership still remains with the bank. As the ownership remains with the lessor (bank), who is responsible for its maintenance, it continues to give the service for which it was rented.
vii. Istisna (Manufacturing contract):

Istitna is a manufacturing contract of a made-to-order asset based on a deferred delivery basis. It is a transaction on a commodity before the commodity is produced. The manufacturer is morally obliged to produce items which are at the agreed time and in accordance with specifications (price, quality, description). The price, specification, description and quality of the commodity to be manufactured should be fixed with the consent of the parties to the contract. Normally, Istisna is used to finance construction and manufacturing projects.

viii. Takaful (Islamic insurance):

Takaful is a conventional Islamic insurance and also is an alternative form of cover that Muslims can avail themselves against the risk of loss due to accident. It is depend on the concept of what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many customers enables each individual to enjoy the advantage provided by the law of large numbers.

The Islamic financial markets have not introduced any viable mechanism for transferring risk. This has causing the serious consequences for the Islamic financial intermediaries, who are exposed to a wide array of credit, market, and operational risks but are unable to properly hedge most of their risks. This concentration in the base of deposits or assets reflects a lack of diversification, which increases their exposure to risk. Islamic banks’ assets are concentrated on few products. There have two types of risk faced by Islamic banks which are financial risk and non-financial risk. Financial risk comprises of credit, market and liquidity risk. For non-financial risks includes operational risk, regulatory risk, business risk, legal risk, strategic risk and banking risk. All the risks are governed by a sound risk management to help to reduce their exposure to risks and enhance their ability to compete in the market. Due to the ambiguous concept for Islamic financial institutions, there are insufficient experienced professional in Islamic finance sector which retard the development of Islamic financial institutions. There is an extreme insufficient of scholars available, who obtain working experience of both Islamic fiqh and modern economics and finance. In addition, many existing employees under Islamic banking are not been trained well in the use of Islamic financing modes. This leads the development problem of Islamic financial institutions occur.

Islamic banking is lack of effective supervisory framework and it is one of the weaknesses of the prevailing system and deserves serious attention. The roles of both the Shariah advisory boards and the Central banks need to be stream lined and strengthened. Islamic banks have devised their own practices and procedures to accomplish their banking activities. However, commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Hence that depend the problem of tax discrimination, Islamic banking contracts are treated as buying and selling properties and hence are taxed
twice. Lack of effective prudential regulation is one of the weaknesses of the Islamic institutions.\textsuperscript{14}

Shariah risk is related to the structure and functioning of the Shariah boards at the institutional and systemic level. This risk consists of two types; the first is due to nonstandard practices in respect of different contracts in different jurisdictions and second is due to failure to comply with Shariah rules. Different adoption of Shariah rules results in differences in financial reporting, auditing and accounting treatment by Islamic banks. Banks are exposed to the risk of non-compliance with the Shariah rules and principles determined by the Shariah board or the relevant body in the jurisdiction. The nature of relationship between the bank and investors/depositors is not only of an agent and principal, but it is also based on implicit trust to fully comply with the Shariah where this relationship distinguishes Islamic banking from conventional. In case where the bank is unable to maintain this trust and the bank’s actions lead to non-compliance with the Shariah, the bank is exposed to the risk of breaking the confidence of the investors/depositors. Breaching the trust and confidence of the depositors/investors will lead to serious consequences, including the withdrawal and insolvency risk. To some extent, a few Shariah scholars have suggested that if a bank fails to act in accordance with Shariah rules, the transaction should be considered null and void and any income derived from it should not be included in the profits to be distributed to the investors/depositors.

3.8. ISSUES AND CHALLENGES RELATED TO THE ISLAMIC FINANCIAL MARKET.

In spite of the growth potential in Islamic banking, there are several challenges facing Islamic Financial Market.

1. Shortage of experts in Islamic banking:

The supply of trained or experienced bankers has lagged behind the expansion of Islamic banking. The training needs affect not only Arab domestic banks, both Islamic and non-Islamic, but foreign banks as well.

2. Absence of accounting (and auditing) standards pertinent to Islamic banks:

Uncertainty in accounting principles involves revenue realization, disclosures of accounting information, accounting bases, valuation, revenue and expense matching, among others. Thus, the results of Islamic banking schemes may not be adequately defined, particularly profit and loss shares attributed to depositors.

3. Lack of uniform standards of credit analysis:

Islamic banks have no appropriate standard of credit analysis. Similarly, there is a widespread training need involving related aspects such as financial feasibility studies, monitoring of ventures, and portfolio evaluation.
4. Potential conflicts with central banks:

Islamic banks have been established as separate legal entities; therefore, their relationships with central banks and/or other commercial banks are uncertain. Problems may be further aggravated when an Islamic bank is established in a non-Muslim nation, and is subject to that nation's rules and requirements.

5. Potential conflict between domestic banks, foreign banks, and Islamic banks:

It appears that domestic banks and foreign banks will experience continuing difficulty in adopting Islamic banking practices until they can become more confident of the results of investing ventures.

6. Instruments that meet the demand of specific investment requirements:

One of the biggest challenges facing institutions is the provision of short-term investment instruments. Several institutions have tried to develop high quality short-term instruments, but have been hampered by their ability to generate assets, by their credit ratings, and by liquidity.15

Risk management is widely developed in the conventional financial market frameworks. However, it is underdeveloped in the Islamic financial markets due to limited resources, high cost and lack of technological machinations to assess and monitor risk in time. Islamic banks face crucial challenges in improving their risk management strategies as they are exposed to various types of risks.

1. Conventional risk management techniques and tools are based on interest, gambling and speculation, which are prohibited by Shariah. Islamic finance is sorely lacking on product breadth, depth and sophistication. There are still only few risk hedging instruments and techniques in Islamic finance despite its rapid growth. A number of risk management techniques are not available due to requirements for Shariah compliance. In particular, these are credit derivatives, swaps, derivatives for market risk management and money market instrument. Hence, the development of prudential regulations and systems related to risk management, capital adequacy and corporate governance of Islamic banking is all the more pertinent.

2. Financial engineering is another operational challenge for Islamic banks, which demands standardization of the process of introducing new products in the market. An Islamic bank currently has its own Shariah board examining and evaluating each new product, without having coordinated efforts with other banks. This process should be streamlined and standardized to minimize time, effort, cost and confusion. Cross border comparison of Islamic banking performances is difficult because the regulatory frameworks of Islamic banking jurisdictions are not standardized and remain highly divergent, ranging from frameworks that promote dual banking such as in Malaysia to frameworks that only recognized Islamic banking system such as in Iran.
3. Islamic banks may have higher operational risk; greater number of contracts, newer supporting system, evolving skill sets and lack of consistency of best practice. Islamic banking is perceived to be more exposed to operational risks associated with the failure of controls, procedures, information technology systems and analytical models. The issue of capital framework and liquidity standards is central to adopting the Basel III. The banking institutions are required to raise minimum capital requirements and hold a capital buffer. However, Islamic banks are exposed to operational risk arising from compliance to Basel III requirements. Some of the principles of risk management as proposed in Basel III can be applicable to the Islamic financial industry with necessary modification and adaptations. Even so, Basel III could not answer all the risk management issues for Islamic financial institutions; hence there has been a need for alternative and supportive standards on risk management. Nevertheless, serious and sustained efforts are needed to find the applicability which is specific to countries and markets.\textsuperscript{16}

3.9. ISSUES AND CHALLENGES RELATED TO THE ISLAMIC FINANCIAL PLANNING ACCORDING TO THE SHARIAH RULES.

Islamic banking is a banking system that compliance with Islamic Law – Shariah. The rules and practices under Islamic banking are in accordance with the primary sources of Shariah Law. In the absence of such specific practices which does not state under the primary sources, secondary sources which developed by Muslim scholars. Islamic banking emphasizes on profit and loss sharing. They do not allow excessive earning that does not involved with real hard work and productivity. The investments under Islamic financial institutions involved with real assets instead of financial assets. Under Islamic banking, the returns are not guaranteed since they share the profit and loss together with depositors. Islamic banking operates banking business with the following Shariah principles:

i. Prohibition of Riba (Interest) or Usury:

Under Islamic finance transaction, it is strictly disallowed the charging and receiving of interest between both parties. This is because interest is deemed as profit which had been generated without involving the actual productivity. Under Islamic financial institutions, all the profits gained must involve with the “real” hard work in the kind of business which permitted by Shariah. The money provided by lender is only a medium of exchange, which do not have any intrinsic value itself. It could only become valuable as a return if the money is employed in a productive manner. If interest exists, it will causes severity effects to the entire economy system since investors will not care on the nature of the business activities that undertakes by the invested company, even if the nature of business carrying on by the invested company is prohibited in Shariah. What the investors’ concern about is just the rates of returns on their investments capital. If this scenario happens, it will affect the well-being of society. Moreover, if interest is charged, it causes a severe socioeconomic imbalance between poorer and wealthier group. The purpose of borrowers to borrow money is because they are facing financial difficulty. If interest is charged on the loan, borrowers will become poorer since they have to pay more out of their loan while lenders will become richer because they will earn extra profit from their original contribution.
ii. Prohibition of Gharar (uncertainty) and Maysir (gambling):

Gharar refers to the uncertain outcome results from a risky transaction due to insufficient knowledge and information available to predict the nature and the quality of the subject matter. Under Islamic Law, transaction exposes to excessive risk are prohibited to execute. Hence, most of the conventional financial instruments such as forwards, futures, options, short selling and speculation are strictly forbidden to be executed because they involve with the uncertainty of the price for the underlying asset in future date. The purpose of Islamic financial institutions to do so is to ensure all parties involving in transaction are free from losing their money in exchange contracts that are risky and uncertainty. Islamic financial institutions emphasizes on justness, they make sure the financial operations undertaken based on transparent and accurate information which are available to all parties. Transparency and fully disclosure of information is vital to avoid any of the party to exploit the advantages over the other party. This principle had reduces the unpredictable losses for all parties to the minimum. Maysir refers as gambling activities or any kind of games of chance that winning just based on lucks. Businesses related to lotteries, casino or gambles are banned by Shariah. All these activities involve uncertainty and the obtaining return is not based on hard work and productivity. It goes against the concept of money in Islamic banking that “money is just a medium of exchange”. Money will only become valuable if it’s invested in productive manner.

iii. Ethical Standards:

Under Islamic investing, it is crucial for the investors to clarify whether the invested company or businesses are compliance with Shariah. Certain activities are strictly forbidden to be invested in Islamic banking such as businesses that involved with gamble, pork and alcohols. When investors would like to make investment, they have to overview the background of the potential company, including the company’s policy, products and services produced, method for South East Asia Company to operate the business and the positive or negative impacts of the products or services contributed to the society.

iv. Moral and Social Values:

Same as others religions, Islamic Law emphasizes on the moral value of caring and sharing to poorer by wealthier peoples. Peoples with more financial ability have to aids and support the destitute. Welfare of destitute is strongly concern under Islamic Financial Institutions. This is also one of the reasons that Riba (interest) is prohibited since it will increase the burden of the borrower by paying extra (interest). A kind of interest-free loan, called as ‘Al Quard Al Hasan’ has being offered to the needy in Islamic finance. Under this profit-free loan, the borrower only require to pay back the principal amount of loan without needing to pay extra for interest, mark up cost or others. Besides the profit-free loan, Zakat is offered to support for needy. Zakat acts as religious tax which is compulsory to be contributed by every Muslim. The concepts of collection Zakat is to promote the moral values by providing financial support for needy and poor from peoples who have greater financial abilities.
v. Liability and Business Risk:

All parties in Islamic transaction must share together both risk and profit. Profit must bear together with liability. As the lender financing the borrower, lender has to provide some contribution as an exchange for his return. He has to either accept the investment risk involved in the business or provides some relevant services to the invested project such as offering an asset. All the profits gained must derived from hard work. Hence, Islamic Law emphasizes the lawful profits from others kind of gaining through this principle. In order to ensure all the Islamic financial institutions operate under these principles, Shariah Board is established to meet the objective. Shariah Board is formed by individuals who have a professional knowledge in Islamic jurisprudence and finance. They serve as corporate governance for Islamic financial institutions. They are responsible to monitoring the operation of Islamic financial institutions to make sure they are running their business with the compliance of Shariah Law. In addition, they also responsible in managing the Shariah non-compliance risks making sure Islamic financial institutions run their businesses efficiently with a minimum risk.\(^\text{17}\)

3.10. ISSUES AND CHALLENGES RELATED TO THE AGE, EDUCATION, SEX, LOCATION, STANDARD OF LIVING, INCOMES, SAVINGS, EXPENDITURES AND AWARENESS OF MUSLIM SALARIED PEOPLE.

Despite the challenges, and driven by growing demand, the Islamic economy sectors continue to flourish. This Report represents the global Islamic economy as core sectors and their ecosystem structurally affected by Islamic values driven consumer lifestyle and business practices. Collectively these majors sectors are: Islamic Finance, Halal Food and lifestyle sectors (Modest fashion, Travel, Pharmaceuticals and Cosmetics, and Media and Recreation.) This 2014 –15 Report estimates that the global expenditure of Muslim consumers on food and lifestyle sectors grew 9.5% from previous years’ estimates to $2 trillion in 2013 and is expected to reach $3.7 trillion by 2019 at a compound annual growth rate of 10.8%. This forms the potential core market for Halal Food and lifestyle sectors. In addition, this Report estimates Islamic Finance assets at $1.66 trillion in 2013. Islamic funds and Sukusks (Islamic bonds) led the growth with 14% and 11% growth year-on-year, whereas banking experienced a 5% drop in its assets. This Report estimates potential the universe of Islamic Finance assets in its core market (assuming optimal scenario) to be $4.2 trillion in 2014.

The customers of this Islamic economy are universal with shared values. At the highest level, values-based customer needs that are driving these Islamic economy sectors include Islamic/ethical financing, Halal (lawful) and Tayyab (pure) food, modest clothing, family-friendly travel, gender interaction considerations, and religious practices. These needs also extend to business practices that seek Islamic business financing, investment and insurance services (Takaful). It is however important to recognize the wide diversity in awareness and adoption of Halal within the core customer base of Muslims globally.\(^\text{18}\)
Currently, around 2 billion adult Muslims lack access to financial services and their options in saving and boosting their wealth is limited. While some Muslims may not be categorized as part of the ‘unbanked’ they too face similar problems in investing due to small savings and/or limited Islamic financial services. These Muslims would normally not enter the investment market, either due to Shariah incompatibility of the investment or because they did not fall under the wealthy category to invest the large sums needed.

1. Issues and challenges related to the age:

18-30 years of age of Muslims facing more issues and challenges while making investment of their money. These age categories of Muslims facing more inflation as they do not have financial literacy knowledge about the Islamic financial market.

2. Issues and challenges related to the education:

The status of Indian Muslims has a poor human development status because of widespread illiteracy, low income, irregular employment, high incidence of poverty. Education is an indispensable means for helping the Muslims out of their economic misery because economic dependency is the major factor contributing to the low status of Muslims. Indian Muslims are far behind in achieving the literacy status because of their economic conditions, no availability of schools, more drop-outs, less likely to survive educationally, lack of resources in the available schools and low level of interest in education, lack of honest leadership in the community. It has also been reported that the dropout of the Muslim Students from schools and other educational institutions is of higher rate. Female literacy among the Muslims is also significantly low and this is one of the important reasons of ignorance and illiteracy in Muslim community. Again the adult education among the Muslims (both male and female) is significantly lacking. Beside formal education, the learning of new skills and technology is also not very satisfactory among the Muslim community. All these facts have shown that the ignorance and illiteracy are the characteristics of the Muslim society in India.

3. Issues and challenges related to the sex:

Female Muslim salaried people facing more issues and challenges while making investment of their money as compare to male Muslim salaried people. Females should also strike a balance and keep in mind their future endeavors, such as the home they want to buy, the children they will have, the charity they will give, and the list goes on. With financial responsibility comes discipline. Financial professionals all agree that saving a portion of one’s money each month for the future is the best investment. Most of the Muslim females still facing orthodox community and not allowing gaining education, doing independent job and investing their money to secure future.
4. Issues and challenges related to the location:

Rural areas Muslims still not much educated and do not believe to take risk and to make investment to secure future. They do not have much financial literacy knowledge about to make investment their money in financial market as compare to urban areas Muslims. They do not have awareness of Shariah rules related to Islamic financial planning and investment of savings.

5. Issues and challenges related to the standard of living:

The study shows that most of the Muslims are orthodox and not much educated. Muslims are not only the victims of poverty; rather have accepted inequality and discrimination as their inevitable fate. They also suffer from recurring insecurity, because of devastating episode of mass communal violence. Thus they should take education as a matter of highest priority in order to improve their pathetic state of life. Majority of Muslims are leading life at periphery of well-being. Economic development of any nation is contingent upon the saving potential and consumption pattern of its people. While, the channelization of savings in productive investment avenues leads to increased capital formation, the rise in consumption expenditure leads to higher aggregate demand and elevated economic growth of a country.

6. Issues and challenges related to the Income, savings and expenditure:

Islam holds that the payment and distribution of Zakah (Islamic Tax) promotes a more equitable income distribution that ultimately enables those on a lower income scale to begin saving as their standard of living improves. Evading this obligation, according to Islam, will cause an inequitable distribution of income and encourage an increase in poverty. The Prophet emphasized the fact that if some members of society are deprived it must be that other members are living in luxury. When it comes to government expenditure in a Muslim country, public expenditure should be focused on providing a level playing field where all citizens have the means and an equal chance to be productive and to improve themselves. Public expenditure must uphold the Islamic sense of social and economic justice. This means a concentration of expenditure on social and physical infrastructure, including world-class education, healthcare, and access to housing. Muslims facing problems for saving their money and making investment due to large family size, inflation, traditional belief, lack of Shariah knowledge, Financial illiteracy etc.

7. Issues and challenges related to the Shariah awareness:

Shariah or the Islamic Law is defined as a body of divine laws, rules, code of conduct and teachings which are intended to benefit the individual and society. It refers to the Islamic canonical law based on the teachings of the Koran. This law imposes certain strictures on the types of financial and commercial activities that Muslims can engage in. While trade and investment are encouraged, Shariah investing rules prohibit involvement in businesses related to certain haram (prohibited) activities. Due to lack of awareness, the Islamic Financial
Institutions (IFIs) of 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 Islamic Banking (IB) products among Muslims 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.

3.11. ISSUES AND CHALLENGES RELATED TO THE ISLAMIC MARKET ECONOMY, INFLATION, MARKET FORCES, LIBERALIZATION, PRIVATIZATION AND GLOBALIZATION AND DEMONETIZATION.

Globalization is a process that enhances the flow of goods, services, capital, people, technology, and ideas across national borders. It is a phenomenon whereby numerous countries combine and increasingly appear as one country; complete globalization is akin to the unification of states that today make up the United States of America. The process of globalization proceeds more rapidly when barriers between countries that affect the movement of goods, services, capital, technology, and labor are reduced, and are enhanced by reduced information and transportation costs. It is a multifaceted and multidimensional process of growing interconnectedness among the nations and peoples of the world. Its main dimensions are: (i) economic and financial, (ii) cultural, and (iii) socio-political. Its economic and financial dimensions include growing trade flows across countries, flows of capital and investment, flows of technology, and labor flows (both skilled and unskilled), accompanied by standardization of processes, regulations, and institutions, all facilitated by the free flow of information and ideas. Its cultural implications are the amalgamation of cultures, adverse impact on languages (diminution of their use) that are used by a few and are not important to business and commerce, and diminution of distinct cultural identity. Its socio-political tendencies are convergence of ideas, political and economic institutions, and norms. It is a process that affects every dimension of life and existence. The reverse of globalization may be termed de-globalization. Globalization and de-globalization are ongoing processes, and at any point in time one dominates the other; as such, the process is continuous, whether the world is becoming more, or less, global. While the impact of globalization on conventional finance has been studied and recognized, its impact on Islamic finance, a relative newcomer, has not been addressed. Islamic finance is a system of finance that prohibits debt-based financing; thus, it prohibits interest, and the financing of activities that are not permitted in Islam, such as gambling and the manufacturing and distribution of spirits and wines. Islamic finance is based on risk sharing, trust, transparency, and the
upholding of Islamic values. It has developed and grown side by side with conventional finance over the last 40 or so years.

Muslims have endeavored to develop their societies by following the principles of Shariah, and there were no exceptions for economic activities. An economic system according to Islam is based on preservation of property rights, emphasizing sanctity of contracts, ensuring justice in exchange and markets, expecting high ethical standards, sharing risks, and promoting social justice. The financial system is pivoted on the prohibition of riba (interest), which includes payment and receipt of interest in all forms as understood in today’s business world. The term “Islamic finance,” which is a relatively new term and has emerged in only the last two to three decades, is often reduced to a system where “interest” is prohibited. However, this simple description is not only inaccurate, but is also a source of further confusion. The most significant implication of this prohibition is the removal of pure “debt-based” contracts from financial transactions. There is no doubt that the most critical and distinguishing feature of such a system is the prohibition of riba (interest). The Islamic financial system also encourages risk sharing, innovation, and entrepreneurship, and emphasizes “materiality” by which we mean that it endorses a strong linkage between the real and the financial sector and promotes asset-based financing as opposed to pure lending-based financing. Islamic scholars have argued that when the notions of economic justice and risk sharing are combined with other fundamental principles of Islam, it can lead to a financial system that is inclusive, efficient, and stable, and which promotes economic development.

Distinct intermediation raises two concerns. First, Islamic banks’ assets are dominated by short-term trade and leasing-based financial instruments. These instruments tend to be of short-term maturity and are not highly liquid assets. This poses a serious problem for Islamic banks that are unable to transfer illiquid assets in the secondary markets, and because of this illiquidity, Islamic banks tend to shy away from medium-to-long-term financial instruments. Second, Islamic banks are often characterized by their small size, in terms of assets and capitalization. Several studies have suggested that the industry should seriously consider consolidating smaller banks to reap the benefits of economies of scale and scope. However the larger the institution, the greater the risk of financial contagion in the case of institutional failure.

Globally, Muslims are part of diverse cultures, socioeconomic classes, and ethnicities. They comprise the second most populous religious demographic in the world. The topic of globalization has both intensely positive and negative connotations in the Muslim world. For those residing in traditionally Third World or economically underdeveloped nations seeking a middle path between capitalism and communism, the road to economic development and success can be an arduous one. Obstacles such as education and technology have posed problems when facing international institutions and perceived Western dominance.

At the same time, globalization has given many Muslim populations access to greater knowledge and increased communication. Foreign aid has also benefited the less fortunate in
areas of health and society. But for some, globalization can mean raising the ghosts of the past; for the underdeveloped nations, colonialism is all too fresh in their memories. With no unified structure or leader, the Muslim community (ummah) grapples with coinciding its traditional faith with modernity and progress. Muslims face concerns about health, education, and the cultural ramifications of globalization in addition to those economic and developmental issues.

3.11.1. GLOBALIZATION AND TRADE LIBERALIZATION

Embracing liberalization and the new globalization presented Muslim states and societies with two major challenges. First, reform was liable to destabilize local economies as markets were liberalized, industries were privatized, state spending was cut, and currencies floated. Second, economic reform was designed to engage with foreign capital and global markets; apart from the direct impact on economic life, liberalization opened societies to the culture of the market as well as the individualism and consumerism that went with it. Global culture tended to homogenize societies along the lines of a Western model that did not always sit easily with local cultures.

1. Technology and innovation:

For decades now, Muslim countries have struggled with appreciating the value of scientific and technological research, and in many cases, have become blind consumers of western technology. They have failed to develop scientific and technological capacity and infrastructures which has in turn resulted in weak agricultural and industrial capabilities. They have thus remained dependent on the West for not only the technical infrastructure (machinery, high-technology equipment, medicines etc.) but also high quality consumer and luxury goods, a fact that virtually guarantees them continued dependence and hence a lower status in the development ladder for years and years to come.

2. Muslims, democracy, and the west:

There is the cultural dimension of globalization which Muslims are very conscious of. They feel that the sort of values and ideas, notions of living which are emanating from the West and beginning to penetrate their societies, influencing their young in particular that these are harmful; at least some of the more obvious aspects linked to music and dance forms and films and so on. They see these things as injurious to their own culture and identity. They’re also conscious of the fact that the global political system is dominated by the United States, to a great extent, and some of the other big powers. And somehow there is perhaps wittingly, perhaps unwittingly, the exclusion of Islam from the global process.
3. Diversity amongst Muslim cultures and communities:

Globalization is prompting a reformulation of the common Muslim belief that Islam is not only a religion but also a complete way of life, which in Islamic discourse is known as the ‘one religion, one culture’ paradigm. Instantaneous and worldwide communication links are now allowing Muslims and non-Muslims to experience the reality of different Islamic cultures. Such experiences reveal not only what is common among Muslims but also what is different.

Islam is a globalized world in and of itself. It is an international community that includes some of the richest and poorest countries in the world. Globalization presents both these winners and losers with challenges, much as it does non-Muslim countries. By and large, however, few Muslim countries appear to have made notable contributions to the current field of information technology. One reason is because the basic components of a viable and fertile economy a good investment climate, inexpensive manufacturing, and market availability are often missing in the Muslim world. To compete economically, it is hoped that the Muslim world will renew its golden age of scientific progress and enlightenment (during which women were educated and joined the workforce).

3.11.2. FACING CHALLENGES AND FINDING SOLUTIONS IN THE MUSLIM WORLD IN GLOBALIZATION AND MODERNIZATION:

The Islamic world is at the centre of a raging world struggle, which makes it targeted from all sides and exposed to dangers from all contending parties on the international scene. As a result, the challenges facing Muslim countries assume greater proportions in a manner that deeply affects public life and reflects badly on the development process as a whole.

The major challenges can be summarized as follows:

a) Cultural challenges, at the level of theory development, planning, and cultural action in all its fields, as well as interaction on an equal footing with the strong cultural currents coming both from the West and East, let alone the sweeping role of the media and informatics.

b) Economic challenges, at the level of options, reform, applications, adjustment to modern economic systems, integrating into the trend of globalization and world economics, dealing with international competition in all these fields, and also at the level of advancing in the process of a comprehensive reform, with a new thought and an open vision.

c) Social challenges, at the level of fighting the dangerous triad of poverty, ignorance and disease, resisting despair which threatens to drive youth to collapse, and reconciling modern patterns and systems of behaviour, on the one hand, and the preserving of cultural and civilizational fundamentals and particularities on which the social system is based, on the other.
d) Political challenges, at the level of government and administration systems and the extent to which these can meet the expectations of Muslim peoples and comply with the unchanging values of the Arab Islamic civilization in this area, most important are the principle of Shura (mutual consultation) and extending the scope of popular participation in political procedures and practices. These challenges also involve the nature of the relationship between citizens and the government authorities, as well as governance at large.

e) Development challenges, at the level of efforts made to remove obstacles to development, and the laying of foundations for developmental recovery in all fields, with a view to achieving sustainable development at present, while being mindful of potential benefits for the coming generations.

3.11.3. MUSLIM COUNTRIES ARE SUFFERING FROM IMMENSE CHALLENGES THAT MUST BE CONFRONTED AND CONQUERED. THE MAIN CHALLENGES ARE AS FOLLOWS:

a) Rapid progress in the fields of communication, information and digital technology, and the lack of the material, technical and academic means in Muslim countries to catch up with and adapt to this progress.

b) Adaptation of the education output to the growing needs of the job market.

c) Freedom of education, which is limited to the role vested in the State without affording the private sector and local community institutions, organizations and associations the opportunity to exercise the right to free thinking with a view to developing education. This state of affairs paralyzes potential, stifles ambition, and sows the seeds of despair over the usefulness of reform, which is completely at variance with the spirit of Arab Islamic civilization and heritage in this respect. Indeed, free intellectual sessions used to be held in mosques, where various Islamic ideas and views were discussed and solutions to problems and dilemmas facing society devised.

This does not mean, however, that there is no way these challenges can be surmounted and turn them into positive challenges that would foster work, stimulate motivation, and strengthen resolve. To achieve this level of thinking, management and practice, the scientific approach to planning and implementation must be adopted, within the framework of a true Islamic, cooperation, coordination and solidarity, since the burden is too big for a single state among the Islamic states to bear.

The stances of states normally express their choices and translate their policies. Each stance the state takes is an expression of its national sovereignty. Therefore, unifying stances towards a specific issue, with a view to turning them into a single unified stance, strictly speaking, and in the legal sense as well, requires a constitutional procedure to be taken by the state within the framework of exercising its sovereignty.
3.11.4. MUSLIM PERSPECTIVE ON THE POSITIVES AND NEGATIVES OF GLOBALIZATION:

A. Positive aspects of Globalization:

1. Foreign Direct Investment (FDI) has helped to reduce poverty by creating jobs and improving incomes.

2. The expansion of trade and foreign investment has accelerated social mobility and strengthened the middle class.

3. New communications and information technology have helped disseminate knowledge in many fields of study and disciplines. Communication is cheaper and easier. Costs of telephone calls as well as travel have fallen.

4. This makes it easier to understand one another. Communities although heterogeneous, can be more cooperative now that are more means of understanding each other.

5. Globalization makes it possible for humanity to have compassion for each other when calamities – natural or man-made – affect others.

6. Issues such as human rights and public accountability are brought to the fore.

7. The rights of women are highlighted and the problems many women face are now addressed. All of these are conducive to religious teachings.

B. Negative aspects of globalization

1. Environmental degradation due to unrestrained logging activities of transnational corporations whose sole aim is to multiply profits.

2. Although poverty has been reduced to a certain extent, new economic disparities have been created. There are stark regional disparities in poverty.

3. Basic necessities in life are set aside in favor of profits. Many countries in the South have been occupied with facilitating foreign investment in industries that are lucrative to foreign markets and forsaking the most fundamental needs of the people.

4. Globalization aids the removal of national controls over cross-border financial flows. Dramatic outflows of capital from one country to another have caused havoc in some currencies, particularly in Southeast Asia.

5. Advances in technology aggravated by the outflow of capital to low cost production sites in the South have caused growing unemployment in the North, which is an affront to human dignity.
6. Globalization has popularized the consumer culture. Consumerism has given birth to materialism where people are more interested in what they have rather than the essential aspects of humanity.

7. Global consumerism is now forming a homogeneous global culture where indigenous cultures of the South are being replaced by Western cultures.

8. The global entertainment industry is propagating a superficial American pop culture, which titillates the senses and deadens the spirit.

9. Formal education systems are emphasizing technical and managerial skills responding to market demands and leaving aside traditional academic subjects. This means that education is nothing more than acquiring specific skills and techniques and less emphasis on moral education.

10. Although the IT boom has given rise to an expanse of information there is a lot of information that is useless and meaningless causing people to be pre-occupied with trivia.

11. Double standards are present in the human rights aspect of the present world where they are used as part of Western governments’ foreign policy but only when it suits them.

12. Globalization has internationalized crime of all kinds.

13. Like crime, disease is more rampant throughout the world making the spread difficult to control.

While the financial crisis poses challenges to Islamic financial institutions, it also offers opportunities to exploit. Depressed asset prices in the developed economies are attracting investors and Islamic financial institutions to make long-term investments. Such opportunities can become another venue for the introduction of Islamic finance in economies less familiar with this form of finance. Both developed and developing economies can tap into this market by understanding the requirements of Islamic finance and providing a level playing field at the legal and regulatory level. The future of Islamic finance in Muslim countries will depend in large part on the pace of economic growth in Organization of Islamic Countries (OIC), the success of privatization programs, the extent and quality of economic and financial reforms, oil price developments and the size of available investment funds in oil exporting countries, the quality of governance and supervision in Islamic countries, and the evolution of the global financial crisis that started in 2007 and continues unabated in 2009. As economic performance improves in OIC countries, as financial liberalization continues, as financial regulatory and supervisory administration of Islamic financial practices matures, as Muslims are afforded diverse and better opportunities to save and invest in accordance with their religion, and as the inherent stability of an Islamic financial system becomes acknowledged and accepted, the growth of Islamic finance should be more rapid than anything we have seen in the past.
3.11.5. CHALLENGES FACING THE GLOBALIZATION OF ISLAMIC FINANCE.

Islamic banks just tend to have weaker liquidity and weak accounting and disclosure framework, but against this backdrop of movement toward standardization, Muslim financiers are continually trying to come up with ways to mimic traditional western financial methods, including derivatives which are traditionally considered forbidden by Shariah. But the fact is there is still considerable dispute over the conventional and fairly simple financing models. In fact some believe that the fact that so many Muslim banks are providing Shariah compliant financing models is disingenuous, since the instruments are, arguably, little more than interest rate based financial instruments though they are called something else. Accordingly despite the efforts of the IFSB and even Basel II, one of the major stumbling blocks to the development of an internationally accepted Islamic banking industry is a lack of broadly accepted standards.

The Shariah board of a banking institution in Malaysia may approve a financial product as being Shariah compliant, but that same product may not be acceptable or approved in a country within the Gulf Cooperation Council. Malaysia, Pakistan, Sudan and Iran have set up Shariah boards for approving banking standards at the level of the central bank. In most other countries, the finance industry appoints its own Shariah board, which in many cases, is at the institutional level, that is, within each bank or finance house. Egypt and Malaysia have very liberal interpretations of Shariah law, while Saudi Arabia and Kuwait are quite strict. Dubai is somewhere in the middle. Then of course there is the lack of trained Islamic legal scholars with knowledge of the world of finance to set on banks’ Shariah boards. This puts the industry at a disadvantage. There are not even enough trained business people and economists who understand the Islamic financial industry to man the banks. A further obstacle is the lack of a secondary market for Shariah compliant financial instruments. The International Islamic Financial Market is attempting to develop such a secondary market.

3.11.6. ISLAMIC FINANCE AND INFLATION:

Inflation is one of the curses of mankind as inflationary period increases unemployment, reduces return on investment and purchase power, increases hoarding habit, slow down the business activity and increases social unrest. The decreasing purchasing power of money has been one of the most striking issues not only for the economists but also for the savers, lenders and consumers. As inflation poses a serious challenges to society, therefore policy maker try to curtail inflation as low as possible. Since the Second World War – II, economist fail to counter the inflation. This inflationary trend has convinced some economist for its existence along with economic development. Today most economists favor the low or steady inflation. But researchers are striving to have a system which put inflation at zero level. Revival of Islamic Financial System (IFS) creates a hope for them. IFS not only grow in Islamic countries but also in developed countries e.g. America, United Kingdom. The
resistance to current crisis and consistence growth of IFS during rescission has led to conclude that IFS could be a viable solution to the current financial ills. This paper aims to assess the potential of IFS to control inflation. The paper argues that IFS has an important role for socio-economic development for investor, lender and consumers. Furthermore, IFS has moral and ethical attributes that can effectively motivate the stake holders. The first part of this paper introduces the causes of inflation.

**A. CAUSES OF INFLATION:**

1. Over-expansion of money supply i.e. excess liquidity in the economy leads to inflation because “too many money would be chasing too few goods”.

2. Expansion of bank credit rapid expansion of bank credit is also responsible for the inflationary trend in a country.

3. Deficit financing, the high doses of deficit financing which may cause reckless spending, may also contribute to the growth of the inflationary spiral in a country.

4. A high population growth leads to increase in demand and money income and cause a high price rise.

5. Excessive increase in the price of fuel or food products due to political, economic or natural reasons will lead to inflation for short- as well as long-term.

**B. EFFECTS OF INFLATION ON ECONOMY:**

1. Inflation is the increase in the price of general goods and service. Thus, food, commodities and other services become expensive for consumption. Inflation can cause both short-term and long-term damages to the economy; most importantly it causes slowdown in the economy.

2. People start consuming or buying less of these goods and services as their income is limited.

3. Banks will increase interest rates as inflation increases otherwise real interest rate will be negative.

4. Rising inflation can prompt trade unions to demand higher wages; to keep up with consumer prices. Rising wages in turn can help fuel inflation.

5. Inflation affects the productivity of companies. They add inefficiencies in the market, and make it difficult for companies to budget or plan long-term. Inflation can act as a drag on
productivity as companies are forced to shift resources away from products and services in order to focus on profit and losses from currency inflation.

6. Higher interest rates lead to shut down in the economy. Time value of money is the basis of interest. As per Islamic principles, time value of money is the problem for the investor to avoid keeping money idle and to avoid forgoing the use of money that may bring positive value to investment. However, it does not mean that the investor can demand an arbitrary increase as the cost of using money without taking the risk of a productive enterprise. As per Islamic principles, a financial investor has to undertake risk of productive enterprise by becoming self-entrepreneur or an investing entrepreneur as equity partner in others’ business to have any justifiable compensation out of the production process.

3.12. ISSUES AND CHALLENGES RELATED TO THE TRADITIONAL BELIEF.

The term “Islamic Shariah” (Arabic meaning, Path or a way) is the most sanctified and the most consecrated law of the religion Islam. Shariah law is not only a law but it is actually a complete code of Muslim life. Shariah provides guidance and assistance to all aspects of human life including daily routines, politics, clothing, food, sports, amusements, religious and familial obligations of a human and it also provides guideline for financial dealings as well. Traditional Muslim scholars believe that Islamic Law or Shariah expresses the most prestigious and the highest goals and moral values for other societies in the world as well.

The essence of Islam is that it derives its principles and values from the Qur’an and the Traditions of the Prophet Muhammad. The history of Islamic law begins with the revelation of the Qur’an which contains legal principles and injunctions dealing with subjects such as ritual, marriage, divorce, succession, commercial transactions and penal laws. In contrast, the Traditions of the Prophet Muhammad record the sayings, actions and tacit approvals of the Prophet Muhammad. The literature of the Traditions of the Prophet Muhammad covers a much wider range of topics than the legal verses in the Qur’an. Muslims believe that Islam starts from a given or self-evident premise, namely the revelation. It was with the aim of directing and guiding humanity to the realization of its moral potential and worldly worth that Islam undertook to create a system known as the Shariah. Shariah refers to commandments, prohibitions, guidance, and principles under Islam and is the clear path for believers to follow in order to obtain guidance in this world and deliverance in the next. The Shariah provides guidance in terms of belief, moral conduct and practical rulings or laws. According to Islam, a complete system of life is based on both legal prescriptions and moral and good conduct. Moral values have been incorporated as legal requirements in some specific contracts such as Amanah (honesty) in Murabahah (mark-up) financing. Other principles of moral values pertaining to commercial transactions include:
1. Timeliness in the payment of debt or delivery of an asset. The failure to observe this aspect might involve legal consequences.

2. Tolerance in terms of bargaining, where the parties are encouraged to be considerate to other’s requirements and circumstances.

3. Mutual revocation of a contract on request by one party if one party finds him or herself uncomfortable with the outcome of the transaction.

4. Honesty or Amanah in all statements, representations and warranties. These principles are not meant to be exhaustive but rather to highlight areas where, according to Islam, morality is relevant in commercial dealings.

Muslims from Africa, Asia, India, the Middle East and Eastern Europe follow a religion founded 1,400 years ago. Islamic law, or Shariah, is based on the Koran, the holy book of God, and the teachings of the Prophet Mohammed. It strongly influences Muslim life. Islamic law strictly forbids the giving or receiving of interest. Muslims believe in maintaining economic harmony in any financial transaction. It is not acceptable for a well-off person to benefit from lending money to someone less fortunate. Money is shared as a way to help the community prosper.

That belief can affect how Muslims finance a house, a car or an education, how they start a business, how they pay bills and how they use credit cards. The payment of interest is either a major or minor obstacle, depending on how orthodox a Muslim is. Many traditional Muslims in the Twin Cities don't own a house or have a bank savings account. If they have a savings account, they typically donate the interest to charity. Financing agreements acceptable under Islamic law include buy-sell and buy-lease agreements, interest-free loans, cost-plus-profit contracts, stock investments and partnerships. Muslim and financial leaders agree that it's not just a personal or religious issue; it's also a community and economic concern. They say a lack of acceptable financing has slowed Islamic entrepreneurial efforts and stunted business expansion. Some say the void has prevented Muslims from expanding their wealth, which has lessened their economic impact on the region.

Shariah, or Islamic law, is increasingly in the spotlight as its political and economic role expands in the Muslim world and even in the West. Shariah, or Islamic law, influences the legal code in most Muslim countries. A movement to allow sharia to govern personal status law, a set of regulations that pertain to marriage, divorce, inheritance, and custody, is even expanding into the West. "There are so many varying interpretations of what sharia actually means that in some places, it can be incorporated into political systems relatively easily,". Shariah’s influence on both personal status law and criminal law is highly controversial. Some interpretations are used to justify cruel punishments such as amputation and stoning, as well as unequal treatment of women in inheritance, dress, and independence. The debate is growing as to whether sharia can coexist with secularism, democracy, or even modernity, an idea that is being tested by several countries in the Middle East in the wake of popular uprisings and civil wars.
Shariah-compliant financial instruments can’t pay or collect interest, due to Islam’s proscription of usury; Islamic investments also can’t be associated with alcohol, pork, gambling, pornography, or other Muslim prohibitions. Islamic finance surged in recent decades by introducing products that mimic credit cards, savings accounts, and mortgages while avoiding interest. Islamic banks are growing rapidly in countries from Malaysia to Morocco, and even international lenders such as HSBC, CréditAgricole, and Standard Chartered have developed Islamic banking divisions. The growing pool of Shariah-compliant assets is fueling demand for Islamic bonds, or Sukuk, issued by corporations and governments, mainly in Muslim countries.

3.13. ISSUES AND CHALLENGES RELATED TO THE AVAILABILITY OF ISLAMIC EXPERT OPINION.

The rules governing Islamic Finance are derived from the Shariah. The Shariah is a framework of Islamic Jurisprudence derived from the primary sources: The Qur'an and the teachings of the Prophet Muhammad known as the Sunnah. In addition to which there is a dynamic secondary source of common law rulings and scholarly interpretations referred to as Fatwa’s. These fatwas are the results of human interpretation of the Shariah, of its texts, or its principles, or a combination of the two; they are not the word of God. Islamic law, it must be remembered, is more a process than a code, and the results of legal deliberations may differ when different methods are employed. Several fatwas are indicative of an acceptance on the part of Shariah Supervisory Boards of new realities in the marketplace and of their willingness to understand and work with these to the extent that Islamic religious and legal principles will allow. Such an attitude has ever characterized the best in Islamic legal thought.

In practice, the permissibility or otherwise of a transaction or business activity is governed by the Shariah, that provides the framework for a set of rules and laws, governing economic, social, political, and cultural aspects of Islamic societies.

The Islamic scholars and Shariah Supervisory Boards of different Islamic financial institutions have passed a large number of resolutions through collective Ijtihad (independent reasoning) interpreting the basic principles underlying Islamic transactions and the requirements of the Shariah with regard to different modes of financing, as well as some details of their practical implementation. This understanding is necessary to facilitate not only their compliance with the Shari’ah, but also helps Islamic financial institutions to use the new products in the light of Islamic principles. If an Islamic financial institution is not in compliance with Shariah precepts, there is nothing but its name to distinguish it from a conventional institution. One of the goals in publishing this work is to enhance the appreciation of practitioners for the importance of Shariah compliance and its significance for Muslims.

The central focus of Islamic finance is Shariah compliance. To ensure compliance a distinctive feature of Islamic finance is the establishment of a Shariah advisory or supervisory board to advise IFIs, Islamic insurance companies, Islamic funds and any other providers which offer Islamic financial products. The establishment of a board, the opinions of which are binding on all IFIs, is required to guide the institutions towards Shariah compliance. An institution cannot claim to be doing Islamic financial business until and unless it sets up a Shariah board (scholars) or committee consisting of qualified scholars who are of high reputation and who possess the necessary skills.
There are a number of issues that need to address. One is that, there is no single definition of what constitutes Islamic banking. Different institutions interpret the acceptability of Islamic banking products in their own way. Individual boards of Shariah advisers apparently have equal authority, so that in some jurisdictions there is no definitive answer as to the status of a particular Islamic banking product. This leads to uncertainty about what is, and what is not, the 'acceptable' way to do a particular business, which in turn can complicate assessment of risk both for the bank and its customers.

Muslims are very confused about the exact interpretation of Islamic finance, Islamic investment avenues therefore they are facing various issues and challenges regarding the availability of Islamic expert opinion related to expert opinion. As a result, it has become a common practice for Islamic banks to appoint their own board of Shariah scholars. Nevertheless, since expertise in these matters is still relatively scarce in some countries, different Islamic banks often share the same scholars. This phenomenon has the beneficial side-effect that it promotes consistency across the services and products offered by these institutions. Therefore, the first measure that an institution wishing to offer Islamic products must undertake, is to appoint a Shariah board or, at a very minimum, a Shariah counselor. This initial step is essential for the future operations of the institution, as it will help minimize Shariah risk, which is the risk that the terms agreed in a contract do not effectively comply with Islamic jurisprudence and thus are not valid under Islamic law. In consequence, the contract could be declared (partially) void in a Shariah court.

Financial regulators should also appoint their own Shariah experts, which would provide advice on the instruments and services offered by the institutions in their jurisdiction. Consultation with these experts would be crucial to ascertain whether the regulations issued by the supervisor with regard to Islamic institutions, as well as the licensing of different activities, are compatible with Islamic principles.

3.14. ISSUES AND CHALLENGES RELATED TO THE AVAILABILITY OF ISLAMIC BANKS.

Islamic financial markets are operating far below their potential because Islamic banking by itself cannot take root in the absence of the other necessary components of an Islamic financial system. A number of limitations will have to be addressed before any long-term strategy can be formulated:

1. Legal and Regulatory risk:

A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets.
2. Compatibility Risk:

There is no single, sizeable, and organized financial center that can claim to be functioning in accordance with Islamic principles. Although stock markets in emerging Islamic countries such as Egypt, Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles. Moreover, the secondary market for Islamic products is extremely shallow and illiquid, and money markets are almost nonexistent, since viable instruments are not currently available. The development of an interbank market is another challenge.

3. Undeveloped Financial Market Risk:

The pace of innovation is slow. For years, the market has offered the same traditional instruments geared toward short and medium-term maturities, but it has not yet come up with the necessary instruments to handle maturities at the extremes. There is a need for risk-management tools to equip clients with instruments to hedge against the high volatility in currency and commodities markets. In addition, the market lacks the necessary instruments to provide viable alternatives for public debt financing.

4. No specific Accounting Standards:

An Islamic financial system needs sound accounting procedures and standards. Western accounting procedures are not adequate because of the different nature and treatment of financial instruments. Well-defined procedures and standards are crucial for information disclosure, building investors’ confidence, and monitoring and surveillance. Proper standards will also help the integration of Islamic financial markets with international markets. Islamic institutions have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles. Only a limited number of Islamic institutions can afford to train their staffs and deploy resources in product development.

5. Lack of Uniformity:

There is lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious boards for guidance. Islamic banks have to consult their respective religious boards, or Shariah advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. This problem can be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.
Islamic banks are essentially governed by their Shariah boards – the religious scholars that deem a product Shariah-compliant. But the challenge is that there is no central authority promulgating Shariah law, and the understanding of what is hence permissible and what is not varies among Islamic scholars and jurisdictions. The rapid growth of Islamic banking over the years has resulted in the introduction of complex banking products and structures, which now require Shariah harmonization at a global level. At present, that harmonization is lacking. For example, the Islamic contract of Tawwaruq (Islamic financial product) or Commodity Murabaha (principal-agent financing) is only allowed by certain scholars. Similarly Bai-al-dain, or sale of debt, although disallowed by the majority of Muslim scholars, is allowed by some scholars in Malaysia. Recently, a prominent Shariah scholar concluded that approximately 85% of Sukuks (Islamic bonds) in the market fall short of basic Shariah principles.

While conventional banks have harmonized and approved regulatory standards that banks around the world follow, making it easier for them to expand and conduct operations in different countries, there are no approved standards per se for Islamic banks; they follow the conventional banking regulations. But because Islamic banking differs from conventional banking, it is difficult for Islamic banks to completely follow these global conventional standards. For instance, the capital structure in Islamic banks is different from that of conventional banks.

Because of the prohibition of interest, Islamic banks mobilize and utilize funds using Shariah-compliant instruments or contracts that are not used by conventional banks and hence their capital structure primarily consists of Tier 1 capital only, while only a handful of Islamic banks have Tier- II capital. Another differentiation between the two banking models is the bank’s ownership of the asset: in Islamic banking contracts like Murabaha (principal-agent financing), Islamic banks have to own the asset for a period of time, a practice that is not required in conventional banking practices.

Hence because of these issues and challenges Muslim salaried people is facing several issues and challenges regarding the availability of Islamic banks in India.

3.15. ISSUES AND CHALLENGES RELATED TO THE LARGE FAMILY SIZE.

Education is the instrument of change and development for the society. It trained and develops the manpower resources, transforms the society as well as change the status of a person from one status to another in social hierarchy. Education according to Indian tradition is not merely a means of earning a living; nor is it only a nursery of thought or a school for citizenship. It is initiation into the life of spirit and training of human souls in the pursuit of truth and the practice of virtue. In contemporary world particularly in developing countries modern education is seen as a means and goal for modernization. Growth of education is considered as a sign of human growth and development.
India has one of the largest Muslim populations in the world about 156 million constituting about 12 per cent of total population. It is observable phenomenon that the educational status of Indian Muslims is very low. The status of Indian Muslims has a poor human development status because of widespread illiteracy, low income, irregular employment, high incidence of poverty. In this country the communities like Parsees, Christians and Hindus, had an earlier start in the educational field, while the Muslims entered into this field at a much later stage. Education is an indispensable means for helping the Muslims out of their economic misery because economic dependency is the major factor contributing to the low status of Muslims. Indian Muslims are far behind in achieving the literacy status because of their economic conditions, no availability of schools, more drop-outs, less likely to survive educationally, lack of resources in the available schools and low level of interest in education, lack of honest leadership in the community. It has also been reported that the dropout of the Muslim Students from schools and other educational institutions is of higher rate. Female literacy among the Muslims is also significantly low and this is one of the important reasons of ignorance and illiteracy in Muslim community. Again the adult education among the Muslims (both male and female) is significantly lacking. Beside formal education, the learning of new skills and technology is also not very satisfactory among the Muslim community. All these facts have shown that the ignorance and illiteracy are the characteristics of the Muslim society in India.

Muslims are the largest minority in India, majority of this community is far lag behind with respect to all material benefits, particularly in education and employment. There are many reasons which are responsible for lower literacy among Muslims but the main cause is the vision of Muslims towards modern education. It is observed that the Muslims do not enthusiastically provide education to their children especially their daughters. The educational backwardness of Muslim community is generally attributed to their religious orthodoxy coupled with their emphasis on the theological education with little effort to change the traditional education system and acquire the knowledge relevant to the needs of changing world. Indian Muslims are not having positive attitude towards modern commercial education. It is universally accepted fact that education is the most potent and effective tool to achieve any section of society. Although it is right that socio-economic condition also makes a significant contribution in this regard, but the positive attitude towards education ensures the development of confidence and self –worth. Economic well-being can also be elevated naturally by development of level of education. Employment is also closely linked with the status of education. Muslim students do not have access to quality education thus end up with low paid jobs and less remunerative employment. Muslims are not only the victims of poverty; rather have accepted inequality and discrimination as their inevitable fate. They also suffer from recurring insecurity, because of devastating episode of mass communal violence. Thus they should take education as a matter of highest priority in order to improve their pathetic state of life. Majority of Muslims are leading life at periphery of well-being.

Economic development of any nation is contingent upon the saving potential and consumption pattern of its people. While, the channelization of savings in productive investment avenues leads to increased capital formation, the rise in consumption expenditure
leads to higher aggregate demand and elevated economic growth of a country. Most of the existing studies are of the view that family size affects both the savings and consumption expenses of the individual, but in opposing direction. With increase in the size of the household, the income is diverted away from the savings and consequently the saving income ratio of the individual is lowered. However, because of the presence of relatively large number of economically active members, there is a possibility of average savings of large sized families being more than that of the low member family groups. Nevertheless, the empirical findings of majority of studies suggest that family size has a negative effect on savings, as increased number of family members draw down the savings, thereby resulting in reduced propensity to save of an individual.

Large family size is the biggest obstacle of Muslim salaried people in the path of investment. Hence Muslims facing more problems in saving and investment of money due to large family size.

3.16. ISSUES AND CHALLENGES RELATED TO THE LEGAL SYSTEM.

Islamic banking is lack of effective supervisory framework and it is one of the weaknesses of the prevailing system and deserves serious attention. The roles of both the Shariah advisory boards and the Central banks need to be streamlined and strengthened. Islamic banks have devised their own practices and procedures to accomplish their banking activities. However, commercial banking and company laws appropriate for implementation of Islamic banking and financial contracts do not exist. Hence that depend the problem of tax discrimination, Islamic banking contracts are treated as buying and selling properties and hence are taxed twice.

The commercial, banking and company laws contain provisions that are narrowly defined and prohibit the scope of Islamic banking activities within conventional limits. It is necessary that special laws for the introduction and practice of Islamic banking be put in place. Governance issues are equally important for Islamic banks, investors, regulators, and other stakeholders. The role of Shariah boards brings unique challenges to the governance of Islamic financial institutions.

3.16.1. The legal framework of Islamic banking and finances might include the following:

i. Islamic banking courts:

The disputed cases of the Islamic banks are subject to the same legal system and are dealt with the same court and judge as the conventional one while the nature of the legal system of Islam is totally different. To ensure a proper, speedy and supporting Islamic legal system, amendments in existing laws, which are repugnant to injunctions of Islam, are required to promulgate Shariah compliant law for resolution of disputes through special courts.
ii. Islamic banking law:

In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra costs and effort. Therefore, banking and companies’ laws in several countries require suitable modifications to provide a level playing field for Islamic banks. Furthermore, international acceptance of Islamic financial contracts requires them to be Shariah compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

iii. Amendment of existing laws:

Islamic banking has some laws and regulations that as similar as universal banking, therefore, laws and regulations have to be amended accordingly to accommodate this new concept such as section 7 (forms of business in which the banking company can engage) and 9 (prohibition of trade) of the Banking Companies Ordinance 1962 while Islamic banks are big or wholesale traders in reality.

iv. Islamic banking balance sheet:

Islamic banks do not show out the assets financed through Al-Ijara (renting or leasing), Murabah (principal-agent financing), Wadiah (deposits of funds), Istitsna (construction or purchasing financing), Salam (Islamic contract) etc., on balance sheet because section 7 of Banking Ordinance 1962 does not allow a bank to own property or asset which section 9 prohibits to enter into any kind of trade. However, all the assets owned by Islamic banks be mentioned in their balance sheets only.

v. Monthly payment agreement:

The housing finance is executed on the basis of Diminishing Musharakah by the Islamic banks. Under this mode the house and property is jointly owned by the bank and the customer. The bank rents out its share to the customer on Ijarah (leasing or renting project) basis concept. The Islamic bank while executing Ijarah (leasing or renting project) with the partner or customer uses the term ‘Monthly Payment Agreement’ instead of having the Ijarah (leasing or renting project) agreement with the customer. It is so named as to safeguard the bank’s interest in case of refusal by the customer to pay rentals. There is no legal cover is provided to the Islamic banks to overcome the risk.

vi. PLS deposits:

Deposits in Islamic banks are usually based on principle of profit and loss (Musharakah-equity financing or Murabahah (principal-agent financing). The concept of profit-and-loss sharing in an enterprise, as a basis of financial transactions is a progressive one as it distinguishes good performance from the bad and the mediocre. If something happens and the bank suffers loss it has to be transferred to the depositor directly. This loss is the biggest barrier to deposit mobilization in Islamic banks. In some case, it leads to withdrawal of funds. The depositors should be provided with some kind of protection.
3.17. FUTURE GROWTH OF ISLAMIC FINANCE:

The further growth and development of the Islamic financial system will depend largely on the nature of innovations introduced in the market. The immediate need is to deploy human and financial resources to develop instruments to enhance liquidity; develop secondary, money, and interbank markets; perform asset/liability and risk management; and introduce public finance instruments. The Islamic financial system can also offer alternatives at the microfinance level. Securitization is a step in the right direction but even this requires more sophistication. The scope of securitization are the process of unbundling and repackaging a financial asset to enhance its marketability, negotiability, and liquidity in Islamic financial markets is very promising, because current market operations are restricted by the dearth of liquidity-enhancing products; secondary markets lack depth and breadth; and, more important, instruments for asset/liability management are simply nonexistent. With the expansion of securitization, the customer base of Islamic financial systems will grow as institutional investors, who have access to broader maturity structures, are attracted to the market; the secondary market will develop; and asset/liability management will become a reality. Other strong candidates for securitization include real estate, leasing, and trade receivables because of the collateralized nature of their cash flows.

Microfinance is another candidate for the application of Islamic finance. Islamic finance promotes entrepreneurship and risk sharing, and its expansion to the poor could be an effective development tool. The social benefits are obvious, since the poor currently are often exploited by lenders charging usurious rates. An Islamic financial system can play a vital role in the economic development of Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest-based financial channels and by facilitating the development of capital markets. At the same time, the development of such systems would enable savers and borrowers to choose financial instruments compatible with their business needs, social values, and religious beliefs.

3.18. SUMMARY OF THE STUDY:

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.

Islamic financial markets are operating far below their potential because Islamic banking by itself cannot take root in the absence of the other necessary components of an Islamic financial system. A number of limitations will have to be addressed before any long-term strategy can be formulated:

1. A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed. Existing banking regulations in Islamic countries are based on the Western banking model. Similarly, Islamic financial institutions face difficulties operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets.

2. There is no single, sizable, and organized financial center that can claim to be functioning in accordance with Islamic principles. Although stock markets in emerging Islamic countries such as Egypt, Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles. Moreover, the secondary market for Islamic products is extremely shallow and illiquid, and money markets are almost nonexistent, since viable instruments are not currently available. The development of an interbank market is another challenge.

3. The pace of innovation is slow. For years, the market has offered the same traditional instruments geared toward short and medium-term maturities, but it has not yet come up with the necessary instruments to handle maturities at the extremes. There is a need for risk-management tools to equip clients with instruments to hedge against the high volatility in currency and commodities markets. In addition, the market lacks the necessary instruments to provide viable alternatives for public debt financing.

4. An Islamic financial system needs sound accounting procedures and standards. Western accounting procedures are not adequate because of the different nature and treatment of financial instruments. Well-defined procedures and standards are crucial for information disclosure, building investors’ confidence, and monitoring and surveillance. Proper standards will also help the integration of Islamic financial markets with international markets. Islamic
institutions have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles. Only a limited number of Islamic institutions can afford to train their staffs and deploy resources in product development.

5. There is lack of uniformity in the religious principles applied in Islamic countries. In the absence of a universally accepted central religious authority, Islamic banks have formed their own religious boards for guidance. Islamic banks have to consult their respective religious boards, or Shariah advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. This problem can be addressed by forming a uniform council representing different schools of thought to define cohesive rules and to expedite the process of introducing new products.

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