

# Islamic Banking and Finance Revisited after Forty Years: Some Global Challenges

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## Abstract

After experiencing phenomenal growth over the last forty years, the Islamic banking and finance industry (IBF) faces some difficult challenges which are addressed in this paper. We argue that the industry has moved away from pursuing ideals conveyed by its brand-name products towards a convergence to the conventional banking and discuss the reasons behind this trend. We suggest that the dictates of the economic and financial theory might be at conflict with the IBF market niche strategy. Additionally, we highlight operational challenges facing the industry in deploying risk management techniques and regulatory compliance.

## I. Islamic Finance Industry Growth

The Islamic banking and finance (IBF) industry, a phenomenon of the last four decades has, according to estimates by Ernst and Young (2012), grown to more than 1.8 trillion dollars in total assets from scratch, though it remains still relatively small in comparison to the global banking industry; according to the Banker (2013), there were 14 banks worldwide each with total assets of more than two trillion dollars. Yet the IBF continues to grow at a rate of over 10% annually according to an HSBC (2012) report, which projects the potential size of the Islamic Finance industry at USD 4.4 trillion in 2020. The growing demand for Islamic finance products has led to the development of innovative products and to the increasing number of Islamic financial institutions globally. There has been concurrent strengthening of legal and regulatory frameworks which positively feeds back into the growth in the industry.

Though the bulk of the industry still lies in Southeast Asia (Malaysia) and the Middle East (Saudi Arabia, Gulf Cooperation Council, GCC) besides Iran, the IBF has generated widespread interest in the West as well. Major international banks, for example, Citibank, UBS, HSBC, Barclay and Standard Chartered, have started offering Islamic products to meet the demand for Islamic financial instruments in the U.S. and Europe. In 2004 HSBC realizing that 25% of the world's Muslims live where it operates created 'HSBC Amanah', a separate Islamic banking unit, to co-brand financial products targeting the Muslims. In Malaysia, HSBC Amanah has become the largest foreign provider of Islamic banking and in 2006 the division accounted for some 10% of HSBC's net income. In the immediate aftermath of the Global Financial Crisis (GFC) some have suggested that Islamic finance may be an effective alternative in forestalling systemic risks. For example, in a statement by the Vatican (Middle East Online, 2009) it was suggested that banks should look at the rules of Islamic finance to restore confidence amongst their clients which has been lost during the current global economic crisis; "*The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.*" Other have claimed that "those who have been in Islamic banking for a long time now feel vindicated," (Ambah, 2008).

While there has been a tremendous expansion in the balance sheets of IBF institutions in the last four decades, going forward there are difficult challenges in sustaining the growth rates and realizing its the ideals which have been further exacerbated by the GFC. This paper seeks to address some of such challenges and examines strategic alternatives for dealing with these. First, we examine the asset/liability structure of Islamic banks and note some deviations from the

principles of Islamic finance. Using the recent data on Islamic banks from several countries, we demonstrate that IBF practices have followed the easy route, resorting to debt like products rather than profits sharing contracts. In following this practice, the industry has moved away from its *brand-name distinctive products* towards a *convergence to the conventional* banking products. We discuss the reasons behind this behavior and the pattern of financing. Second, we address the related question why is it so difficult to introduce Islamic retail products even in the most ardent Muslim countries. We suggest that the dictates of the economic and financial theory might be at conflict with the product development, positioning, and branding strategies called for by the market niche sought by the Islamic banks. Third, the paper highlights some other operational challenges facing the industry including pricing of Islamic products, higher transaction costs, and constraints in deploying risk management techniques. Fourth, we discuss the challenges in complying with the regulatory requirements in risk management which necessitates the use of modern financial products disdained by the *sharia* scholars. Finally, we address marketing strategy challenges when competing with the mature conventional banking industry which has been evolving over the past five centuries.

## II. Islamic Banking and Finance (IBF) in Theory and Practice

The rationale behind IBF is that, like the historical prohibition of usury by the Church, Islamic law prohibits receiving and paying a predetermined fixed interest on borrowing; rather it prescribes that the financial transactions should be based on equity participation and profit-loss sharing (PLS) basis. The Islamic banking practices are creative methods of adopting Islamic principles to financial transactions for enhancing social welfare in Muslims societies. To some scholars (e.g. El-Gamal 1997, 2008), “Islamic law emphasizes issues of equity even more than issues of efficiency and growth at times.” Among the claimed advantages of IBF are:

- The risk-sharing nature of equity investment reduces the bankruptcy risks;
- Given the participatory risk relationship the financial institution may not be exposed to traditional credit risk;
- By integrating ethics and values into finance it leads to higher social welfare;
- “Many investors reportedly consider IBF to be more reliable than conventional financing, given the recent global credit crisis and fears of economic recession,” Apps (2008).

The proponents of Islamic banking claim that it is particularly advantageous for the developing countries for improving access to finance for traditional rural and agricultural sectors, small scale enterprises, disadvantaged groups, charities and social entrepreneurs. However, scholars have noted that, “Islamic finance has not appreciably furthered development goals. Nor has it served to prevent economic exploitation or promote economic justice; Cammack (2011). Another view is that, not only does Islam banking not negatively impact growth, but it could complement conventional banks and thereby help diversify systemic risk, and cover a niche that had so far not been served; Imam and Kpodar (2010).

An analysis of the actual practices of the Islamic Banks (IBs) suggests that these fall far short of the ideals of the Islamic finance. One of the objectives of Islamic law was the protection of the customer. However, the PLS instruments are likely to provide the customer with an equal or a more risky product and at a higher transaction cost. Critics have dubbed it as ‘creative financial engineering’ and/or ‘legal and regulatory (*sharia*) arbitrage’. Kuran (2004) has questioned the very nature of IBF, and ascribes the lack of economic development in the Middle East to the historic prohibition on debt. Others have questioned the role of *sharia* scholars and *Sharia Boards* for the lack of transparency in their relations with Islamic financial institutions (e.g., El-Gamal 2008). A number of studies, e.g., Metwally (1997) and Mangla and Uppal (2010a) have pointed out that Islamic banks mainly offer short-term and trade related financing, contrary to the predictions of the proponents of the IBF. Aggarwal and Yousef (2000) among others have noted that the IBF investments have been mainly concentrated in the *cost-plus* and *mark-up* type of investments, which only foster a rent seeking behavior, rather productive economic activities.

**Table 1: Islamic Bank Financing Structure - 2007**

Type of Financing	% of Total Assets	% of Total Financing
<i>Murabahah</i> (mark-up)	46.3%	67.8%
<i>Ijara</i> (leases)	8.0%	11.8%
<i>Istisna</i> (construction loans)	2.2%	3.2%
Deferred Sale	2.0%	3.0%
Sub-total ( <i>quasi debt</i> )	58.6%	85.7%
<i>Musharakah</i>	0.2%	0.3%
<i>Mudarabah</i>	1.0%	1.4%
Sub-total ( <i>PLS</i> )	1.2%	1.7%
Investment in properties	2.2%	3.2%
Others (net)	6.4%	9.4%
Total	68.3%	100.0%

*Authors' calculations for a sample of Islamic Banks*

Table 1 presents a summary of the asset side of a sample of Islamic banks. As can be seen only 1.2% of total assets and 1.7% of total financing consists of PLS based contracts. There is a pervasive pattern in the loan/advances portfolio of the Islamic banks, namely that there is a:

- Preference for debt-like instruments (mark-up based) over equity based PLS investments;
- Preference for short-term financing;
- Preference for investments in retail and trade sectors;
- Widespread use of collateral when providing financing.

There is substantial empirical evidence that investment modes of PLS financing, known as *Musharakah* and *Mudarabah*, are least practiced. For example, Chong and Liu (2009) show that only a negligible portion of Islamic bank financing is strictly PLS based and that Islamic deposits are not interest-free, but are closely pegged to conventional deposits.” Khan and Bhatti (2008) concluded that, “the PLS system is not practiced in Islamic banking in either spirit or letter. The practice of *murabaha* financing grossly violates *sharia* principles.” Considering the disconnect between the claims and the practices of the Islamic banks, some have been led to the question “Is Islamic Banking a Reality or a Myth?” The general reservations as to Islamic banking are summarized in a quote from the Economist (2008): “*Growth is one thing, hyperbole another. The (IBF) industry remains minute on many measures: its total assets, assets managed by Islamic rules etc. The industry’s expansion is tempered by its need to address the tension between its two purposes: to serve God and to make as much money as it can.*”

The markup contracts are not considered strictly Islamic by many Islamic scholars. For example, on August, 29, 2008, a *fatwa* was issued by a group of religious scholars declaring the

present Islamic banking un-Islamic and inconsistent with the principles of *sharia*. *Murabahah* and *Ijarah* are considered mere legal devices (*heelah*) not real alternatives to the interest which are *Musharakah* and *Mudarabah*, Mansoori (2010). For such reasons in 2002 the Supreme Court of Pakistan declared the banking practices based on such instruments to be un-Islamic.

Equivalence between the mark-up mode of financing and interest has been pointed out by many main-stream economists since the inception of IBF. For example, Aggrawal and Yousaf (2000) argue that, “*the critical feature of markup contracts is that the bank retains ownership of the asset and can seize it in case of default.*” These control rights are equivalent to the control rights under debt contracts. This feature becomes critical as the PLS (equity based) contracts would be *incomplete* if the cash flows are not verifiable to a court in case of disputes or default.

*Convergence to Ideals or Financial Reality?* The fundamental problem remains that in all financial contracts, the problem of the asymmetry of information will arise, regardless of the mode of investments (loans or PLS finance). It is now becoming apparent that the IBs have not addressed the ubiquitous issues of moral hazard and adverse selection arising from asymmetric information, agency problem and incomplete contracts in any way different than that practiced by the conventional financial institutions. Rather the IBs have sought to address these fundamental issues in finance *through convergence to the conventional financial practices!* It has become more apparent in the issuance of *sukuk* or Islamic bonds which have become a dominant instrument of the IBF industry. However, these innovative products have generated various *sharia*, legal and economic issues and controversies. Critics point out that the focus of the Islamic capital market shall not be only on how to raise the funds and be acceptable to international financial institutions but to be *sharia* compliant first and foremost; Al-Bashir and Al-Amine (2008). El-Gamal (2003) finds this divergence between the fiction of Islamic finance and its facts paradoxical, noting that “Islamic finance quickly turned to mimicking the (interest-based) conventional finance it set out to replace.”

It is worth noting that the Islamic banking industry has arisen mostly in developing countries where the legal and regulatory framework necessary for enforcing financial contracts are still evolving. The financing pattern observed of the Islamic banking reflects the financial environment in which they operate, characterized by a high degree of imperfect information and moral hazard exacerbated by a high level of corruption and bureaucratic inefficiencies.

*Unique Risks in Islamic Banking:* In addition to the fundamental issues related to financial contracting, there are unique risks in Islamic banking.

- An ability of the depositors to switch between the two banking systems means that the IBs have to offer competitive deposit rates, or else be exposed to unexpected deposit withdrawals which means greater liquidity and interest rate risk, Bacha (2004).
- “Risk management has not been uppermost on the Islamic banking sector’s agenda in recent years.” Price-waterhouse-Cooper (2008)
- The ‘nuances and complexities’ associated with *sharia* compliant instruments “obscure the real risks.
- Differences of interpretation between *sharia* scholars about what is permissible and what is not open up the opportunities for *fatwa shopping*, or regulatory arbitrage. Malik et al. (2011) discuss *fatwa shopping* as a major threat to Islamic Finance.

- IB’s depositors (investment accounts) are contractually obliged to absorb losses; in practice banks may accept more downside risk in order to manage the customer relationship.
- Liquidity and market risk can also arise from thinness of the Islamic securities’ market; the sales of new *sukuk* (Islamic bonds), for example, dropped to about \$15 billion in 2008 from \$35 billion in 2007; Business Times (2009).

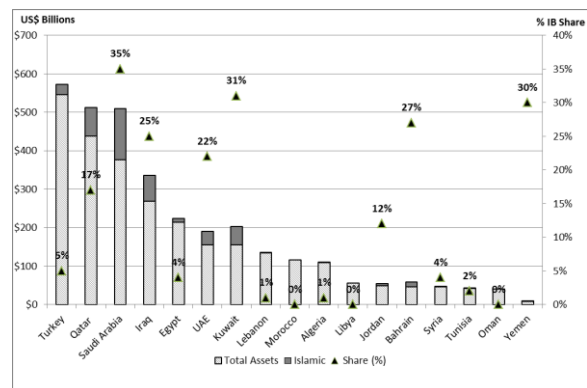
### III. Post GFC Challenges and Strategic implications

These risks came to surface in the aftermath of the Global Financial Crisis. It has been shown that not only the Islamic banks were not immune from the ravages of the GFC, but were also adversely affected by it to a greater extent than were the conventional banks; Uppal and Mangla (2010b). Though, IBs were not directly impacted by the GFC in its initial phase, the banks experienced the after-shocks of the GFC transmitted through indirect channels. The IBs were particularly exposed to the consumer and the real estate financing. Islamic banks also had substantial investment in the equities of both listed and unlisted companies, which exposed them to the severe correction in stock markets, as has been the case during the financial crisis. The *sukuk* market liquidity also evaporated and subjected the Islamic banks to liquidity pressures. However, this market is becoming more liquid as it reaches across border and becomes more global and grows in scale; Standard & Poor’s (2012).

The Islamic banks face a number of challenges in the post-GFC environment. These stem from four sources: (i) increasing competition, (ii) slowing growth rate giving early warning signs that IBs may have exhausted their “natural share” segment consisting of “IB loyalists,” (iii) eroding profitability of IBs, and (iv) asset/liability management. These challenges carry significant implication for chalking out strategies going forward. So far IBs have emulated the commercial banks (CBs); they may now have to be more innovative, reposition themselves and achieve higher efficiency across their value chain.

(i) *Competitive Environment:* Growth within the Muslim population countries has been the key driver behind increasing demand for Islamic financial services. A report by A.T. Kearney (2012) suggests that bank customers fall into three categories. “The first two include *Islamic Loyalists* and *conventional bank loyalists*, both with clear-cut preferences. The third and largest category is *floating mass* estimated at about 60 to 70 percent which typically make their banking decisions based on pricing and service quality, and will require an Islamic offering to be at least on par with a conventional one. This clientele is likely to be rate sensitive and represent hot money in pursuit of yields. *Sharia* compliant assets represent 14% share of Middle East and Northern Africa (MENA) banking market, and 26% in GCC (see Figure 1).

**Figure 1: Banking Assets (US\$ billion) and Islamic Banks’ Share (%) in 2010**



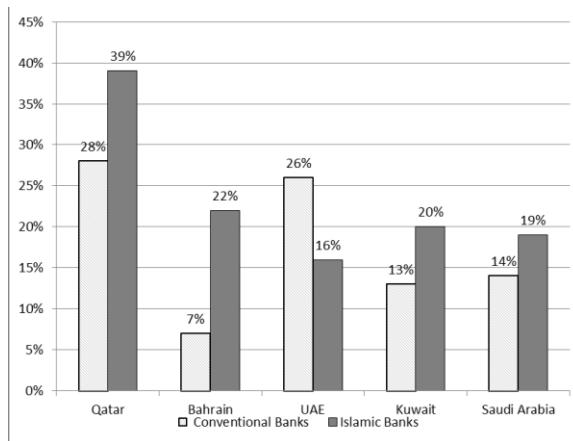
The market share of the Islamic banking may be reaching a saturation point. For further growth the banks may now have to compete in the conventional market. As they come in direct

competition with the conventional banks they will have to develop innovative competitive strategies. One factor which handicaps the IB's in this is their relatively small size. Despite the growth in the industry, the average size of an Islamic bank remains small, \$13bn average asset base which is a third of the conventional banks. Figure 1 shows that *sharia* compliant assets represent a significant portion of the total banking system assets of the region. However, the IFB share in total financial assets is quite varied, and tends to be related to the extent to which each country's political environment is *Islamized*.

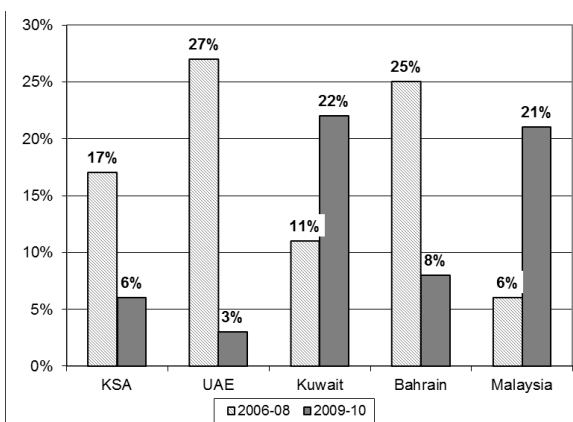
(ii) *Slowdown in Growth Rate:* The strong historical growth has mainly been driven by core Islamic segment; Chong and Liu (2009) suggest that the rapid growth in Islamic banking is largely driven by the Islamic resurgence worldwide rather than by the advantages of the PLS paradigm. Ali (2011) investigates the factors that drive the growth of Islamic banking and finds that, "it is strong regulatory support and political will that stand out even more than demand for Islamic finance for the growth of Islamic banking in the MENA region." Going forward the Islamic banks will, however, begin to compete for mainstream customers who are open to Islamic or conventional banking, resulting in slower comparative growth rates, as can be seen in Figures 2 and 3. The Islamic banking may still offer ample growth opportunities considering the dynamics of the market. These opportunities could arise from increasing market share within existing markets, penetrating untapped markets with potential, or sharing in the general expansion of the bank sectors in some developing markets as economic development leads to financial sector growth. However, it is expected that the future may see slower growth rates and the industry may need to reexamine growth strategies.

(iii) *Declining Profitability:* Figure 4 provides a comparison for some key income and expense ratios. In the past, Islamic banks have been able to generate higher financing margins because of their stronger retail focus. The IBs have also benefited from a higher proportion of free deposits from their core customers. Average cost of

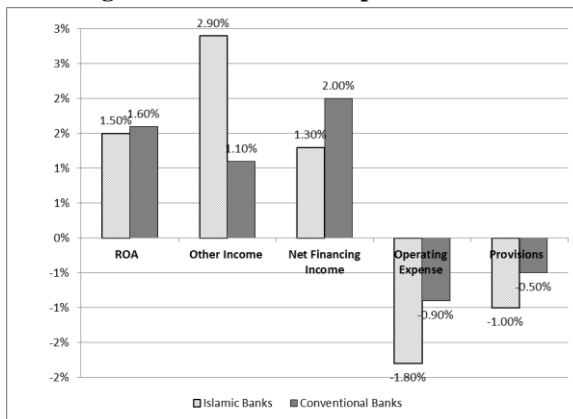
**Figure 2: Compound Annual Growth Rate in Assets – 2006-2010**



**Figure 3: Banking Asset Growth Differential**



**Figure 4: Income and Expenses - 2010**



customer funds is lower for Islamic banks, primarily due to high share of free deposits in the deposit mix. However, these deposits are typically also of a short term tenure.

Table 2 presents a summary of the key financial ratios indicating performance of Islamic banks operating in the Middle East and Northern Africa (MENA) region as compared to the conventional banks for the two years, 2006 and 2010; these two mark the year before and after the Global Financial Crisis. The table also contains brief observations with respect to each ratio. As the observations noted in the table indicate, there has been a notable relative decline in the performance of the Islamic banks as compared with the conventional banks over the years.

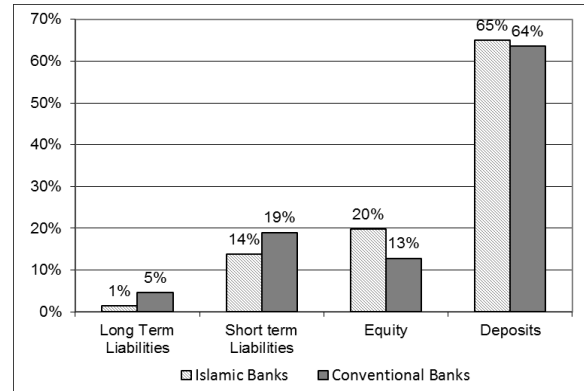
**Table 2: Key Financial Ratios  
Islamic and Conventional Banks – MENA Region**

Financial Ratio (percent)	Type	2006	2010
<b>Net Income / Equity:</b> <i>a decline in IBs' profitability over recent years</i>	IB	23.0	13.0
	CB	23.0	10.0
<b>Net Financing Income / Financing Assets:</b> <i>higher IBs' financing margins</i>	IB	4.3	3.7
	CB	3.0	2.8
<b>Net income / Assets:</b> <i>decline in IBs' ROA to lower level than the conventional banks</i>	IB	4.0	1.5
	CB	3.0	1.6
<b>Operating Cost / Operating Income:</b> <i>Increasing operating costs for IBs</i>	IB	29.0	35.0
	CB	26.0	40.0
<b>Staff Cost / Operating Expenses:</b> <i>higher IBs' staff cost</i>	IB	58.0	60.0
	CB	57.0	54.0
<b>Operating Cost / Asset:</b> <i>higher operating costs for IBs</i>	IB	2.2	2.1
	CB	1.3	1.5
<b>Provisioning / Operating Income:</b> <i>increase in IBs, loan loss provisions</i>	IB	3.0	20.0
	CB	6.0	21.0
<b>Return Paid on Investment Accounts / Deposits:</b> <i>IBs average cost of funds is lower</i>	IB	3.0	1.3
	CB	3.8	1.8

Source: Ernst and Young, 2011

Comparing the 2006 and 2010 financial ratios, the Islamic banks have experienced relatively steeper decline in profitability over global financial crisis period, though their profitability ratios now appear to be stabilizing. It is remarkable that both Islamic and conventional banks (CBs) had experience a sharp increase in the provisions to income ratio; however, in case of IBs the increase has been seven fold (20% from 3%) compared with three-fold increase for the conventional banks (21% from 6%). The return on assets ratio (ROA) for the Islamic banks stood lower in 2010 than for the conventional banks. Operating costs, particularly staff costs, are also impacting Islamic banks unfavorably across the region. Operating costs have contributed to the decline in profitability of Islamic banks.

**Figure 5: Liabilities and Equity**



Percentages do not add up to 100% due to rounding

(iv) *Balance-Sheet Structure:* Figures 5 provides a comparison between the liabilities and equity structures for the two banking sectors based on 2006-10 averages. As the figure shows the Islamic banks carry higher levels of equities but they also carry relatively less long term liabilities, due to limited availability of *sharia* compliant funding. On the asset side, as the Figures 6 shows, there is no significant difference between the two banking sectors as far as broad composition of assets is concerned. The Global Financial Crisis (GFC) led to sharp correction in investment asset values, particularly in the real estate, and to significant change in the asset mix. Still, the Islamic banks hold a much higher percentage of real estate related assets. Islamic banks continue to hold

relatively more liquid assets but, as Figure 5 shows, their use of long term liabilities has also been limited. Therefore, like typical conventional banks, IBs have a negative liquidity gap over short term maturities.

#### IV. Strategic Choices

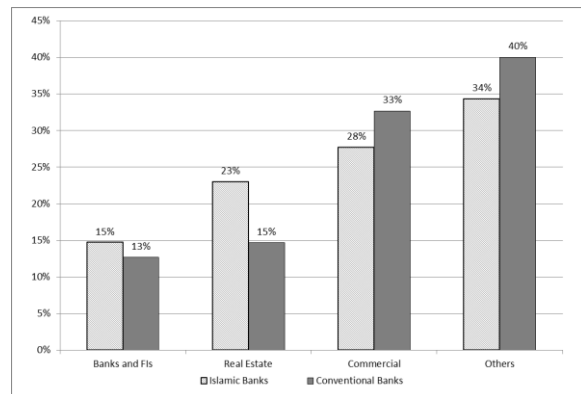
In view of the emerging challenges the Islamic banks face a number of strategic options. A.T. Kearney (2012) categorizes these as either following a *head-on competitive* or a *niche market* strategy. These two broad strategic choices are discussed below.

(i) *Head-on Competition:* The Islamic banks can go for head-on competition by offering competitive products. Following such path would only be successful if they can offer these products more cost effectively, or provide more efficient services. Imam and Kpodar (2010) find that Islamic banks and conventional banks appear to be complementary, suggesting that interest rates offered by the banks matter particularly to the less devout or nonreligious consumers. Product innovation is paramount for maintaining the Islamic brand. They may also have to develop more customer-centric approach, e.g., offering financial services in a more cultural-friendly environment.

The IBs face another challenge in following a head-on strategy as some modern finance products are not easily replicable as *sharia* compliant. For example, Islamic derivative are not generally acceptable as *sharia* compliant. However, some innovative products have been developed such as the *Tahawwut* (hedging) agreements, introduced in 2010, and the Islamic profit-rate SWAPs, introduced in 2005. However the key question is of the ability to offer competitive products with competitive operational efficiency; or are the products going to be cost effective? It appears that the Islamic banks will be playing a continuing game of catch-up.

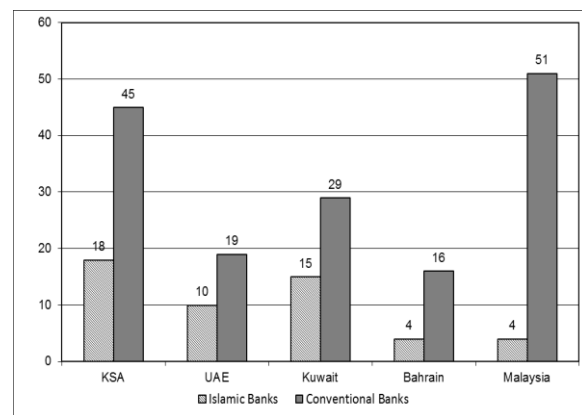
It is likely that the IBs will be competing for customers who are not driven by *sharia* considerations only, leading to a direct competition with the conventional banks. A particular, handicap the IBs face in this pursuit is their size (see Figure 7); IBs are considerably smaller than CBs; there are only four banks with assets greater than \$20 billion. Size does seem to matter in the banking field, at least in the countries where IBs operate. Čihák and Hesse (2008) find that (i) small Islamic banks tend to be financially stronger than small commercial banks; (ii) large commercial banks tend to be financially stronger than large Islamic banks; and (iii) small Islamic banks tend to be financially stronger than large Islamic banks, which may reflect challenges of credit risk management in large Islamic banks. At the same time, there is also increasing

Figure 6: Asset Structure



Percentages do not add up to 100% due to rounding

Figure 7: Average Asset Size - \$ billion, 2010





competition within the IB sector as the number of institutions offering Islamic products has also increased considerably.

There may be scope for improving operational efficiency, for example by adopting customer centric operating model, improved data management, embracing new technology etc. Some efficiency gains may be forthcoming as the industry moves either to specialize, putting emphasis on the core businesses, or through a process of consolidation and conversions within the industry. However, there does not seem to be any reason to believe that the Islamic banks enjoy a *competitive advantage vis-à-vis the conventional banks* in this regard.

(ii) *Niche Market Strategy*: Such a strategy will continue to emphasize targeting IB loyalists segments consisting of their traditional clientele. There may be some expansion potential in offering new products such as *halal* (or kosher) investments, *awqaf* (Islamic trust) asset management services for religious charities, and products meeting Muslim specific needs such as Hajj financing. However, the challenge remains as to how to implement true product differentiation, while in practice the Islamic banks' practices have tended to converge to the traditional banking products. As it becomes increasingly clear that the economic essence of the IB and conventional products is the same, the Islamic brand may be diluted and lose its differentiating prowess. El-Gamal (2003) finds that the Islamic jurists have supported their paradoxical stand of condemning conventional interest-based financing, while supporting and personally profiting from its "Islamic" twin, through excessively formalistic interpretation of the letter of the Law. He concludes that, "Islamic products differ from their conventional counterparts in the same manner that kosher water bottles differ from most other bottled water: certification by certain religious figures."

Nevertheless, many consider Islamic banking as a question of developing appropriate marketing strategy; see for example, Yap (2011). Rice (2011) notes that "companies are discovering Muslims as consumers," and suggests that "when looking for opportunities, executives should observe that the Muslim market, just like the "Hispanic market" or the "gay market," is complex, dynamic, and diverse." Thus, the niche strategy poses new challenges in product innovation. Until now the IBs have followed a mimicking strategy, i.e., replicating the conventional financial products repackaged with *sharia* legalese and blessing of *muftis* and *imams* (religious scholar). It is yet to come up with a product that might be uniquely innovative and conform to the *true* spirit of Islam, while minimizing reputation, regulatory and commercial risk at the same time. At a more fundamental level the challenge is to deal with the fundamental economic and financial issues such as moral hazard and adverse selection.

A unique challenge in developing new products is that the risk and capital management tools, such as risk adjusted returns, fund transfer pricing, economic capital etc., need to be reconciled with the constraints on risk management practices imposed by *Sharia*. On the other hand the risk management practices are to comply with regulatory requirements. Therefore, in developing innovative products the compliance requirements imposed by the regulatory requirements on one hand and the *sharia* scholars on the other may be pulling the IB industry in different directions. In several Islamic markets financial infrastructure is weak which further exacerbates the challenges IBs face. An enabling infrastructure would necessitate development in legislative, regulatory, legal, accounting, tax, human capital, and *sharia* business framework.

Furthermore, Islamic finance standard setting institutions have limited geographic reach and national and international acceptant and enforceability remains a challenge.

The contrasting pictures of product brand vs. economic substance may emerge as a particularly thorny issue in non-Muslim majority countries. For example, consider the position of the US regulators vis-à-vis the Islamic banking. A 1997 Office of the Comptroller of Currency (OCC) interpretive letter while approving a residential net lease-to-own home finance product (*ijara wa iqtina*) determined it to be functionally equivalent to secured lending. In 1999 New York State Board approved a net lease product, holding it to be “functionally equivalent to or a logical outgrowth” of secured real estate lending. Similarly, in 1999 OCC approved *murabaha*-based financing and determined that the bank would be functioning as “riskless principal.” The position of the regulators thus recognizes the economic substance of the Islamic products as being same as debt financing, and throws it in sharp juxtaposition with the banding of the product. The marketing of the product as being *interest-free* may thus not only be considered unethical but may also be testing the limits of the “Truth in Lending” legislation. In addition, post 9/11, there are concerns in some quarters “about possible ties between Islamic finance and political agendas or terrorist financing and the use of Islamic finance to circumvent U.S. economic sanctions;” Ilias (2010).

## **V. Conclusions**

The growth of Islamic banking and finance over the last forth decades has been phenomenal. It has also generated widespread interest in the West and major international banks have started offering Islamic products. The mission of the IBF industry is to provide financial services and products based on equity participation and profit-loss sharing (PLS) basis in conformity with the Islamic law. However, the actual lending practices are predominantly based on a mark-ups thus implicitly charging interest. While the IBF industry has fallen short of the Islamic ideals greater challenges seem to lie ahead which have been brought to the fore by the Global Financial Crisis.

We identify specific areas of the challenges facing the IBF. We demonstrate that IBF practices have moved away in substance from their brand-image towards a convergence to the conventional banking. We argue that there are sound economic, financial and regulatory factors which lead to such convergence in the evolution of the IBF industry. We suggest that the gravity of the economic and financial reality will pose greater challenges to the product development, positioning, and branding strategies called for by the market niche sought by the Islamic banks. On the other hand increasing competition within the industry and with the conventional banks will further accentuate the conflict between their brand image and its economic substance. Additionally, we highlight operational challenges facing the industry in offering their products and services at competitive prices, in lowering transaction costs, and in risk management. Another set of challenges comes from conflicting demands of the regulatory bodies and the *sharia* scholars related to the use of modern financial products. With greater disclosure and transparency required by the regulators, the economic substance of the Islamic-branded products will increasingly be at odds with the claims of the IBF advocates and the demands of the *sharia* scholars. In short, in the future, there is likely to be a serious set of strategic and operational challenges facing the IBF industry in competition with a mature conventional banking industry.

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