London Metropolitan University

Islamic Banking: Issues of Governance, Transparency And Standardization

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Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Industry
BCCI	Bank of Credit and Commerce International
BMA	Bahrain Monetary Agency
FSA	Financial Services Authority
GCC	Gulf Co-operation Council
IAIB	Association of Islamic Banks
IDB	Islamic Development Bank
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IOSCO	International Organization for Securities Commission
IMF	International Monetary Fund
IRI	Islamic Research Institute
IRTI	Islamic Research and Training Institute
OECD	The organization for Economic Co-operation and Development
OIC	Organization of Islamic Countries
PLS	Profit and Loss Sharing
PBUH	Peace be Upon Him
UK	United Kingdom
USA	United States of America
WB	World Bank

Glossary of Arabic Terms

Bai/ Bay'	Sale; commonly used as a prefix for different types of sale
Bay' al-Arbun	Sale; based on down payment with agreed conditions. This is mostly used for option contracts where the final contract is concluded with full payment. The buyer have the option to cancel the sale but then he loses the down payment.
Bay' al-Istisna	Sale; this is against advance order to manufacture.
Bay' al-Ina	Sale usually on credit; Refers to back to back sale, sale and repurchase, usually selling at a higher price and buying back at a lower price.
Bay' al-Muajjal	Sale; based on deferred payment, in a lump sum or instalments. This is used for Sale on credit.
Bay' al-Salam	Sale; based on immediate payment against future delivery.
Fatawas	Plural of *Fatwa* Religious verdicts by Islamic jurists.
Gharar	Risk of uncertainty.
Hadith	Saying , Deeds and endorsement of Prophet Muhammad (pbuh).
Hajj	Pilgrimage to *Makkah.*
Halal	Things or activities permitted by Islamic Law.
Hanafi	A School of Islamic Jurisprudence named after *Imam abu Hanifa.*
Hanbali	A School of Islamic Jurisprudence named after *Imam Ahmed bin Hanbal.*
Haram	Things or activities prohibited by Islamic law.
Hilah	A legal device to avoid imposition of a law in a particular case.
Hawala	Transfer of debt from one debtor to another.
Ijara	Leasing, Sale of usufruct of an asset.
Ijma	Consensus on legal opinion.
Ijtihad	Jurists inference.

Illah	Reason/Characteristics behind a *Shariah* ruling is found in another instances.
Maliki	A school of Islamic jurisprudence named after *Imam Malik ibn Anas*
Mudarabah	Silent partnership wher financial loss is borne by the financier.
Mudarib	Investment manager in *Mudarabah* contract.
Murabahah	A cost plus sale contract.
Musharakah	A partnership contract sharing profit and losses. Profit in agreed ratio but losses based on share in the capital.
Mysir	Gambling or any game of chance.
Qard-e-Hasna	Charitable loan with no interest.
Quran	The Holy book of Muslims.
Riba	Literally means increase or addition. It refers to premium(interest) that must be paid by the borrower to the lender along with principal sum as a condition for the loan or loan extension.
Riba al fadal	*Riba* in a hand to hand barter exchange.
Ribal al Naisah	*Riba* in a loan contract.
Shariah	Islamic Law.
Sakuk	Certificates of Debt.
Sunnah	Practice of Prophet *Muhammad* (pbuh).
Takaful	Insurance contract.
Wadia	Deposit for safe keeping with permission to use it without the intention of receiving any return on i.
Wikala	Representation, agency.
Zakat	The amount payable by Muslim on his net worth. This is a religious obligation mainly for the benefit of the poor and the needy.

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Dedication

I dedicate this thesis in memory of my father who was my teacher as well as my guardian. It was he who taught me morality, ethics and religious values. His moral teachings and guidance enabled me to remain focused on core religious values.

Abstract

This dissertation explores the corporate and *Shariah* governance of Islamic banks and the utility function of customers. The core requirement of Islamic banks is to provide financial services in accordance to Islamic *Shariah* Law. However, the fact that Islamic banks are also able to offer any financial services, which conventional banks are also offering, raises the question of their compliances to *Shariah* law and their transparency.

A mixed method of research, combining a case study approach in addition to customers' survey, was adopted to examine the banking services and investigate customer satisfaction. Three major Islamic banks in Bangladesh were selected in order to examine their practices, and a total of over four hundred customers of various Islamic banks in Bangladesh participated in the study by responding to questionnaires. Customers' surveys were also conducted in Malaysia, Dubai and in the United Kingdom with nearly six hundred returned samples from all four countries being analysed.

To determine the factors which are associated with the 'Satisfaction of Islamic banking services' (dependent variable), crosstabulation (bivariate), multiple logistic regression and ordered (ordinal) multiple logistic regression analyses were employed. The results of multiple logistic regression and ordinal logistic regression express the likelihood of satisfaction, adjusting for all significant variables included in the model.

The results from logistic regression analysis showed that 'satisfied with Islamic products and transparency' had relatively strong associations with the 'satisfaction of Islamic banking services'. The logistic regression coefficients indicate that customers satisfied on 'Islamic products and services' hold a belief that these banks are transparent and are likely to be satisfied with Islamic banking services compared to others. The results show that the risk of non compliance to *Shariah* law is very high and that customers are very sensitive to this issue.

Chapter 1

Introduction

Islamic banking and finance is a relatively new[1] concept and has only progressed during the last three decades. It now has growing prominence in the financial market, practiced universally and developing faster than any other financial sector (El-Qorchi 2005, Agarwall 2000). The Islamic banking system is based on principles outlined by *Shariah* Law and is also known as 'profit and loss sharing' (PLS) banking. Islamic banks must not deal with interest which is strictly forbidden in the *Quran.* These concepts demand that Islamic financial institutions must be fully transparent due to the complex environment which results from the mixture of religion and finance. These institutions must also uphold the basic tenet of Islamic *Shariah* law and should not be rent seeking on customers' religious beliefs (Suleiman 2000, El-Gamal 2006, International Organisation for Securities Commission 2004).

The literature reviews indicate that there are criticisms about the practices of Islamic banks, raising questions of the compliance to *Shariah* and the transparency of their operations. There are doubts among grass-root Muslims that Islamic financial instructions are in fact running an alternative banking system with similar outcomes to those of conventional banks. There has also not been significant research to examine these concerns of current Islamic banking practices. This is partly due to the fact that the system is relatively new and present understanding of this system

[1] Established first in 1963 in Egypt and thereafter expanded from 1973 onwards with the creation of Islamic Development Bank (IDB)

has not yet caught up with market development. Further more, western universities have yet to develop active research institutes for Islamic economics and Islamic finance research.

Previous studies in this area carried out by international organisations such as World Bank (WB), International Monetary Fund (IMF), Islamic Development Bank (IDB), International Organisation for Securities Commission (IOSCO), have not been able to address the core issue of Islamic banks' compliances to *Shariah* law. There have not been many studies that look into *Shariah* compliances and customers' satisfaction. While a number of previous studies have explored the supply side of the Islamic finance, i.e. its efficiency and profitability (Gerrald & Cunningham 1997, Metawa & Almossawi 1998, Ebrahim and Joo 2001, Darrat 2000, Yudistira 2003, Hassan 1999), thus far there has not been a study to examine the overall satisfaction of Islamic banking services and *Shariah* compliances.

1.1 Research background

It has always been perceived that the modern form of interest based banking institutions were not compatible with Islam. As such there has not been any attempt, until recently, to look at Islamic banking institutions as an alternative to conventional banking. The political dominance of western countries in the Islamic world is also responsible for the creation of an atmosphere in which an Islamic banking system was not enabled to develop in. From the mid-nineteen century, with the creation of Islamic states, the demand for a genuinely Islamic economic system gained momentum. Therefore, Islamic banking was established to provide financial services in conformity to Islamic Law *(Shariah)*. It took nearly half a century for Islamic banking to be considered a credible and acceptable form of banking. Yet there has not been any considerable study to look at the system from a perspective of the demand side of the banking system.

For centuries Muslims around the world have integrated their religious beliefs with everyday activities. From medieval times venture capital and micro economic activities were successfully carried out within Islamic principles throughout Muslim societies. The *Quran* provided the blueprint that the poor within society should not be exploited; rather they should be treated more fairly. According to *Quranic* principles wealth should circulate top down from the rich to the poor. The economy of poverty was dominant throughout Islamic history. The *Quran* is against immoral kinds of circulation, such as hoarding and usurious practices and instead demands that wealth circulates in a more ethical manner. Muslims, who have wealth, should give charity and *Zakat* and thus Islam has always called for a more socially just economic order. Islam encourages trade and Islamic religion is more favourable for trading and for earning ones living in the best possible way without harming the poor, needy and those who face difficulties. These forms of economic activities were very successful throughout the early days of Islam.

There are five tenets in Islamic finance, which are the avoidance of *Riba* (interest), *Gharar* (Uncertainty), *Mysur* (gambling), *Haram* (prohibited) and sale of items not owned or possessed. The main challenge for Islamic bankers is to provide banking and financial services avoiding *Usury* (interest) and *Gharar* (excessive uncertainty). The time preference value of money in the form of interest is strictly forbidden in

Islam. Similarly Islamic Law prohibits elements of uncertainty and speculative dealings in the interests of fairness and ethics to discourage unjustified enrichment (Omar and Haq 1996 :xii). These terms are interpreted differently by various schools of thought, as there are differences in interpretation among the major *Sunni* and *Shia'* sects. These differences combined with the positions of governments in various Islamic countries hinder the development of unified Islamic financial contracts and products.

There is a widespread consensus among Muslims in all regions that Islamic banking must develop in conformation with Islamic *Shariah* Law, thereby avoiding *Riba* and *Gharar* and complying with other prohibitions. The piecemeal development of Islamic banking in various regions on differential methods and numerous *Fatawas* (Islamic rulings) does not help in building confidence in the international financial and capital markets (Nomani 2003). Due to these differences in opinions and controversies, the corporate governances of the Islamic financial institutions attempt to benefit from the system and thus they adopt secrecy and non-transparency. However for the development of an internationally acceptable, unified Islamic banking sector, would require consensus among Islamic scholars and an enabling environment from the regulators and the central banks across the Muslim countries and the western world where Islamic banks are having a significant presence and impact (El-Gamal[2] 2006).

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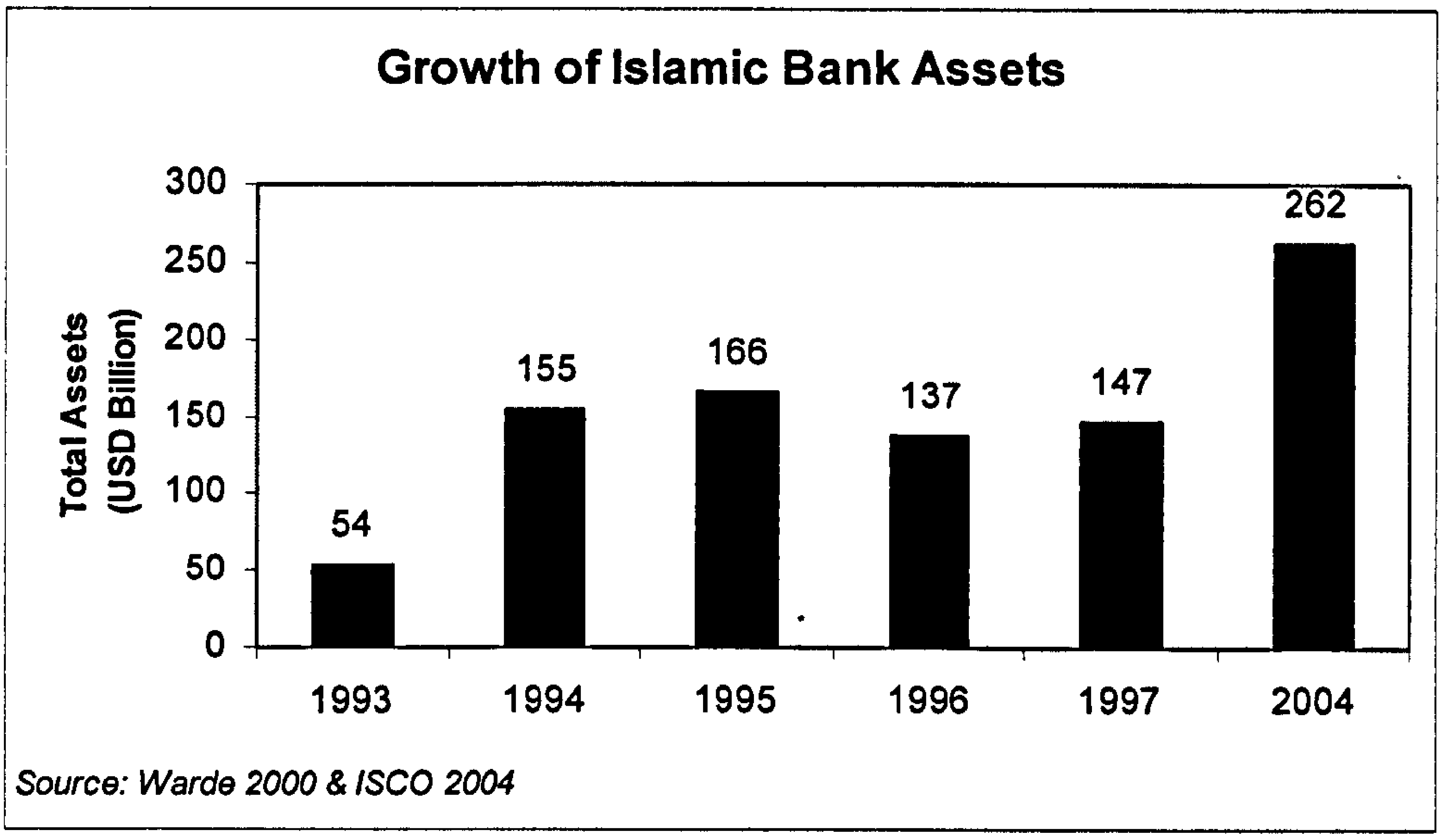
[2] Professor Mahmoud El-Gamal holds the endowed Chair in Islamic Economics at Rice University. He served in the Middle East Department of the International Monetary Fund and was the first scholar in residence on Islamic Finance at the US Department of Treasury in 2004. He wrote extensively on Islamic finance.

Islamic banking has seen rapid growth during the last two decades. There are many contributory factors for such growth, most notable of which is: the liberalization of financial regulation; globalization of financial markets; changes in technology; product innovation; birth of several new Islamic States; and a growing Islamic presence in the west. Product innovations have helped economists and religious scholars to bring new products in almost all areas of banking and insurance, which were previously thought to be extremely controversial (Warde 2000). There is no however accurate data on the exact extent and volume of Islamic banking.

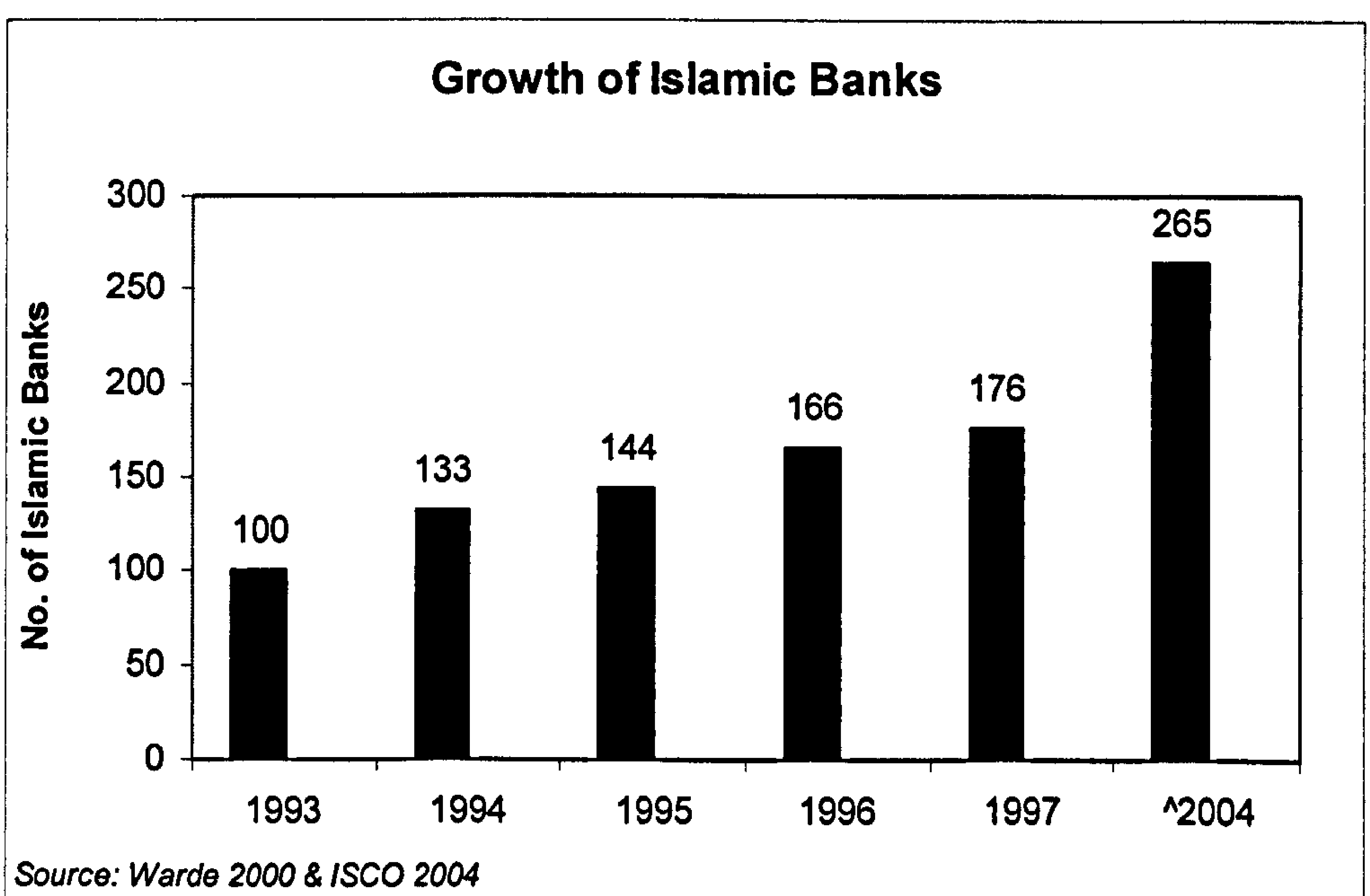
It is currently estimated that Islamic banks' assets are between USD250 Billion to USD800 Billion and there are nearly 300 Islamic financial institutions worldwide, including the "Islamic Windows" of conventional banks. Islamic *Sukuk* (Bond) is the fastest growing product estimated at USD30 Billion outstanding (Skully 2005, El-Qorchi 2005). In Pakistan and Malaysia, *Shariah* compliant funds have exceeded over 50% of total market capitalization (Ali 2005).

Figure 1.1



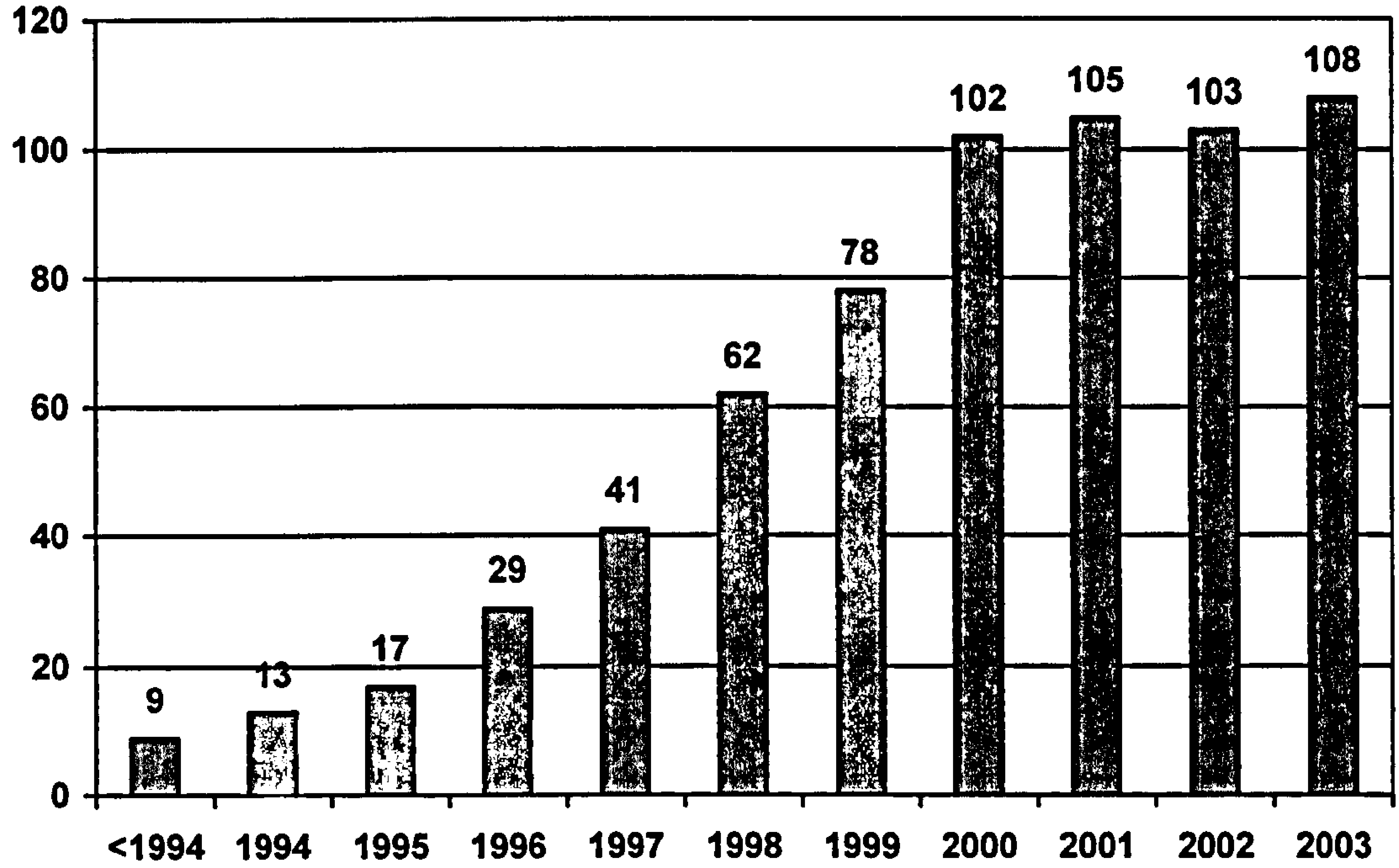
It is evident from the above graph that the Islamic banking assets have grown five fold in just over ten years.

Figure 1.2



This graph shows that during the same period the number of Islamic banking institutions have increased by nearly three fold.

Figure 1.3 Growths in the number of Islamic equity funds



Year of fund launch

(IOSCO 2004)

The above graph shows massive expansion of Islamic equity funds which has seen twelve fold increases within the same period.

Islamic banking has the dual attraction of being both Islamic and ethical. It is widely accepted that these banks and financial institutions avoid investments in harmful and sinful industries. Islamic banks do not invest in alcohol related industries, tobacco industries, armaments and pornographic industries. This ethical undertone has attracted customers from conventional markets as well as those who find that investment in this sector provides comparable return with ethical and moral standing. Some academics disagree with Islamic banks ethical claims and find that the Co-Operative bank in the United Kingdom can be considered more ethical and transparent (Wilson 2004). As Islamic banks lack transparency, customers are unsure how ethical their investments truly are. However, the Islamic *Sukuk* (Bond) has been taken up mostly by non-Muslim customers. For example 80% of recent Emirates *Sukuk* (Ferro 2005), 70% of Malaysian issues and 65% of Qatar Global issues were taken by non-Muslim customers (Green 2004). According to HSBC, Islamic commercial banking is also very popular to non-Muslim customers and nearly 40% of their Malaysian corporate customers are non-Muslims (Green 2004). According to El-Qorchi (2005) the German state of Saxony-Anhalt became the first non-Muslim issuer of global *Sukuk* and has raised Euro100Million in 2004 via *Sukuk* issue.

1.1.1 Rationality of this research

This thesis investigates the *Shariah* compliances of Islamic banks and customers' satisfaction. A review of literature shows that despite the growth of Islamic banking sectors, there have been few studies conducted in this area. The main motivation for conducting this study is to address this gap in current research and understanding. This thesis identifies and expands into the understanding of this field where there is presently a lack of extensive research carried out by researchers. Previous studies have been conducted by institutions connected with the sector such as Islamic Development bank, IMF and World Bank. These studies have focused solely on the supply side of Islamic banking and do not take into account all the elements of corporate and *Shariah* governances. They also fail to examine Islamic *Shariah* issues or conduct interviews with all stakeholders. Another limitation of existing literature arises from the fact that none of the research conducted have addressed all the elements of Islamic banks, their stakeholders, management including the *Shariah* Board and the regulatory authorities. Therefore, this thesis investigates an area which no other studies have significantly addressed so far. This research investigates the core element of Islamic finance.

The corporate governance in Islamic finance has an additional burden compared to that of conventional banking, as the relationship between the bank and the customers are not those of debtors and creditors. The bank assumes the role of trustees, agents, partners and managers. These roles are also swapped with customers depending on the nature of the transaction. When the Islamic bank receives the fund they assume the above role and when they invest the fund outwards these roles are then reversed. In addition to these complex relationships, banks need to ensure that depositors' funds are reinvested complying with Islamic *Shariah* Law as well as complying with all prudential regulations. Depositors need to ensure that their investments are sound and any resulting income is not corrupted and their need to derive *Halal* income is not compromised. The corporate governance of an Islamic bank needs to ensure that all stakeholders are properly and adequately protected and their status is not mitigated. Hence Islamic financial intermediaries, unlike their conventional counterparts, bear a heavy burden to ensuring that Islamic banks run their affairs with complete transparency. This ensures that customers are unaware that these financial institutions pay full regard to the above basic principles and that they do not outmanoeuvre and arouse suspicion amongst customers. A fully transparent system adds greater credibility to this sector and would lead to the healthy development. Once the institutions can rise to the challenge of creating system in order to gaining customer trust they show that they fulfil customers' religious and economic requirements. It is a heavy burden Islamic banks shoulder and it requires a pro active approach that displays that banks are open and ready to answer all stakeholders satisfactorily.

Islamic banking is the fastest growing and yet least understood sector (Archer & Karim 2002). In recent years it has become one of the most talked of subjects and has received widespread acceptance, yet it lacks transparency and standardization (Wilson 1997). In the 6th Harvard University Forum on Islamic Finance, (Taylor 2004), the United States Under Secretary of International Affairs acknowledged the shortcomings of Islamic *Shariah* Certification and the lack of transparency. He encouraged discussions to develop an internationally accepted regulatory framework. The participants in this forum acknowledged the need for further research to develop appropriate international standards to remove conflict in *"Fatwas"* (Islamic Rulings) and to find common ground (Taylor 2004).

There have been numerous academic articles highlighting the questions of transparency and secrecy surrounding Islamic banking and finance. There are many unanswered questions about the role of *Shariah* scholars whom banks employ to advise them and there is suspicion about Islamic banking at grassroots level (Dar 2004). So far there has not been any study which investigates the role of *Shariah* advisers in the overall conduct of the banking business. The Islamic banking corporate culture is not proactive and does not engage with customers. There are growing suspicions that Corporations hide behind Islamic *Shariah* boards and in practice are running a conventional style banking system. They find ways to outmanoeuvre *Shariah* recommendations and in practice marginalise the Islamic elements incorporating non-binding and conflicting legal terms in the financial agreements in order to achieve outcomes similar to conventional banking methods. It is therefore, a conflict in law terms between English and *Shariah* law in the same contract to show that it has been drawn to satisfy Islamic *Shariah* law requirements. However, these contracts have additional clauses for dispute resolution as per English law. The net effect of these terms is that the contracts are judged as per English law without giving any consideration to *Shariah* law clauses. These are therefore, non- binding terms designed to deprive customers of achieving Islamic *Shariah* judgements (Balz 2004). There is a further problem in that Islamic *Shariah* law is a religious law rather than a state law and therefore has no legal forum. English law clauses therefore are used for conveniences to get English law judgments. Institutions intentionally avoid drafting contracts which can result in obtaining Islamic *Shariah* law judgement to avoid being bound by such law. It is apparent that corporate governance of the institute does follow the objectives of their incorporation. It is unacceptable with regards to religion that in the financial world, borrowers are stuck with assets which have lost value but yet owe Islamic banks for the full loan along with a penalty interest rate through the implementation of 'classical contract form' coming in to effect in the event of a dispute (El-Gamal 2006). This practice goes against the core Islamic principles which demand that financial institutions share risks with borrowers. In practice, however, borrowers are made responsible for all losses, is achieved by inserting clauses in the contract which are not apparent the outset. This research endeavouring to investigate the

Shariah scholars' view with regards to this important area of Islamic finance, where the customers are not offered an Islamic dispute resolution mechanism.

According to Vogel and Hayes (1998), Islamic banks intentionally draft contracts in a way to achieve judgment towards local law with the sole intention to bypass Islamic law and penalize parties. These actions are not allowed under Islamic law. The Islamic banks have further modified their practices by incorporating commercial arbitration. In reality an arbitration award goes in line with local law because arbitration members are not qualified to give an Islamic law judgment. The roles of *Shariah* advisers are superficial as they have no control or position of authority. They advise the management about *Shariah* matters and corporate management obtain certificates from *Shariah* board which imply full *Shariah* compliance. However, in reality it is simply a cover to obtain legitimacy. In 'Islamic law contracts', violation would nullify the contract and would place the parties at a pre-contract position with compensation for the losing party. The differences of opinion of *Shariah* advisers have enabled the Islamic financial providers to use different products for different market segments and use price discrimination for greater rent seeking from more conservative customers.

The Islamic transaction involves the use of multiple contracts to avoid the Usury rules. This is done by linking the finance to an underlying asset sold and bought back- to -back. There is also a practice within the banks to seek juristic opinion on a single contract without explaining the whole financial structure and thus they manipulate the opinion of *Shariah* Boards to suit their purpose (El-Gamal 2006).

There are inherent risks in contracts which claimed to be Islamic as they are very superficial in nature. The existence of a full transparent contract would remove this

risk from corporations. Currently there is no regulatory requirement or pressure for an Islamic banks to be "Islamic" hence the present system is open for abuse. As Islamic banks have been granted licences by the regulatory authorities to call themselves "Islamic" banks, customers may take this on face value and assume that regulators have ensured that their activities comply to Islamic requirements. The United Kingdom Financial Services Authority (FSA) deflect the religious requirements to be applied through the bank's corporate governance as they do not wish to be religious regulators (Foot 2003). Financial Services Authorities must consider before granting licences, that these financial institutions are true to their objective and are transparent in all respects by placing a mechanism to ensure that this is complied with.

It is a common practice, as well as a regulatory requirement in certain regions, that Islamic banks have their own *Shariah* board to issue a *Fatwa* to the bank to legitimize their transactions. These *Fatawas* are often formed without further investigation. Such as not looking into the banking records by taking at face value the explanation given to them by the bank's management. This is an informal arrangement facilitating the banks corporate management to advance its own agenda without subject to further scrutiny. It is very important that regulators understand the main concerns of Muslim customers and ensure standardised products are offered by all banks through full disclosure, with the aid of a central *Shariah* certification agency with the authority powers to take action against non compliance. This research therefore, addresses these root concerns.

Innovations in Islamic finance have also changed the perception of risk. According to Merton (1995)

> *"less apparent understanding of new environment can create a sense of greater risk even if the objective level of risk in the system is unchanged or reduced".*

In line with Merton's observation, innovation in Islamic finance is generating concern of inherent risk and its spill over on to the rest of the financial system. The sector is growing rapidly whilst the understanding of the system is slower than its growth. Islamic financial institutions have greater risks than conventional banks because of their inability to avail all types of money market instruments for liquidity management due to their religious prohibition and they have fiduciary risk for noncompliance of Islamic *Shariah* and for negligence and misconduct. This noncompliance also increases the risk of failure due to the risk of loss of confidence (El-Hawary 2004, Khan & Ahmed 2001, Sunderjan & Errico 2002).

In the event of any Islamic bank facing liquidity crisis, there would be reverberating effects across the Islamic banking sector, which could eventually affect the conventional banking sector as well. These days, conventional and Islamic banks are intertwined and general loss of confidence in one sector could have a contagion effect to the other sector, leading to a proper disclosure being needed for the healthy development of the financial sector (Warde 2000). The late 1980 and early 1990s, were an early test for Islamic banks when most of the Islamic banks suffered heavy losses. There were several factors for the meltdown in Islamic banking industries; involving lax and insufficient government regulation, corruption, poor management and internal audit. Egypt suffered the most and some of the Islamic Financial institutions became beyond rescue wit owners fleeing the country and, as a consequence, Egypt's economy losing nearly 15% of its GNP and lost some USD3Billion. Many large Islamic financial institutions were rescued by the respective Central Banks; these include the International Islamic Bank for Investment and Development and the Dubai Islamic Bank. The collapse of the Bank of Credit and Commerce International (BCCI) has exposed the big black hole in Islamic investments. Banks managed to manipulate these losses by various unrecorded deposits and loans and the BCCI scandal further dented the image of Islamic banks (Warde 2000). Regulators need to draw lessons from history and work relentlessly for a more sound Islamic banking system. The current system is very new, only having been practiced mostly during the last 20 years, out of which the last five years are considered to be its prime time. This system is still in its infancy and has not faced any serious economic downturn. It is a concern within the industry that the sector lacks transparency and unification (Badawi 1996), and that regulators need to understand the system to form a dual regulatory framework. It also lacks adequate infrastructure to process information efficiently (Al-Jarhi 2004). In the United States, Harvard University Law School in association with Harvard Business School have established a number of programs and publications (Vogel & Hayes 1998) with the aid of major financial institutions, such as the National Commercial Bank, Islamic Development Bank, Goldman Sachs, Al- Rajhi Banking Corporation, Dubai Islamic Bank and others for the development of Islamic financial research.

Harvard has an active Islamic research centre and holds regular conferences on Islamic finances. The 7^{th} Harvard University Forum on Islamic finance held in April 2006 heavily focused on transparency and standardization and integration of Islamic finance to the mainstream banking sector (Harvard University IFP Project Data Bank, April 2006). This proves that research in this area is welcomed by the Islamic banking sector and this research would therefore be contributory to the development of the Islamic Financial industry.

1.2 Aims and Objectives

The overall aims and objectives of this research are to investigate the overall practices of Islamic banks including their customers' satisfaction. The research is critically looking at the roles of *Shariah* advisers and the management of the bank with a view to identify shortcomings and to advise and develop a set of standards to harmonize banking practices. It examines the role of external conventional Auditors' in *Shariah* audit as well as the conventional audit. The findings of this research will therefore assist regulators to bring necessary legislation and intergovernmental cooperation to improve transparency for the healthy development of the market for Islamic finance. Findings in relation to 'Standardization' will bring transparency and will also be useful to remove moral hazards and thus reduce the systemic effect. The customers' survey will provide guidance for the institutions to focus on customer's utilities and the factors that influences them most.

The overall aim of the present research is to explore –

- The extent the Islamic banks Corporate and *Shariah* Governance ensure *Shariah* compliance.

- The main utility functions of Islamic bank customers
- How the financial institutions can achieve greater transparency?

The specific objectives of the present research are as follows:

- to examine the utility function of Islamic bank customers
- to examine the nature and characteristics of Islamic Financial Products;
- to examine the market mechanism of their operations;
- to examine the *Shariah* compliance of these operations;
- to examine the implications for Customers and Regulators;
- to examine the policies of financial institutions;
- to examine theoretical model with practices;
- to examine their achievement in terms of the Islamic view point;
- to examine transparency; and
- to examine packages of measures for greater transparency and conformity.

Specifically, this research will examine the following research questions:

A) How far do the banks and financial institutions follow *Shariah* Board recommendations in the day to day business of banking?

B) To what extent do they engage with customers in explaining *Shariah* compliance and any shortcomings in operations?

C) What are the main utility functions of Islamic bank customers?

D) Is there any conflict in Corporate and *Shariah* governance?

E) Would central *Shariah* certification increase transparency and bring harmonization?

1.3 The main hypotheses of this thesis

To examine the above research questions following hypotheses have been identified can be tested to meet the broad objectives of this thesis:

Hypothesis 1 - Current Islamic banking practices are superficial, driven by market forces and not by religious convictions.

Hypothesis 2 - Existing environments is an obstacle for the Islamic banking to offer standardised products in a transparent way.

Hypothesis 3 - Regulatory shortcomings makes Islamic banking prone to systematic risks.

Hypothesis 4 - Practices of Islamic banking differ from their theoretical foundation and core objectives

Hypothesis 5 - Level of customers satisfaction of Islamic banking have association with clients socio-demographic characteristics and services provided by the bank.

The first four hypotheses have been explored through extensive literature review and the remaining hypotheses were tested based on empirical data collected at both client and Islamic banks' management level through structured questionnaire.

1.3.1 Assumptions

This study is based on the following assumptions:

- While Islam forbids *Riba* and *Gharar*, it encourages mutual trade.
- There is no distinction between the current form of bank interest and *Riba.*
- It allows making profit out of permissible activities but profiteering is not encouraged.
- It retains the right to property and their application subject to the principles of *Shariah.*
- It's Corporate social responsibilities also include society as a whole apart from its direct customers. Therefore, it has greater stakeholder groups than conventional banks.
- Islam discourages speculative dealings but accepts that firms' existence require making profit from acceptable dealings.
- It operates mostly in a non- Islamic regulatory atmosphere.

1.4 The structure of this thesis

The structures of this thesis are as follows:

Chapter two gives an overview of the Islamic mode of finance and the dilemma facing the Islamic banking sector and also outlining how the Islamic banking sector has developed within a very short period of time. It looks at the roots and sources of Jurisprudence for Islamic religious point of view and collates the verses from the *Quran* and the *Hadiths* relating to financial transactions, on *riba,* commitments and obligations and on speculation and gambling. This chapter brings together all *Shariah* issues relating to Islamic banking and the role of Islamic *fatawas* and also discusses concepts of Usury from the perspectives of Islamic and other major religions. It highlights the role of *zakat* in Islam and its possible impact in Islamic banking.

Chapter three attempts to review literature on Islamic finance for the last sixty years and examines them within the context of current development and practices. This chapter also collates together the legal and regulatory issues concerning *Shariah* compliances. It examines various Islamic banking products and also highlights the scholarly concern about the way the Islamic financial industry is rapidly expanding by trying to mimic the conventional banks in almost every area of banking. The chapter also deals with identifying the legal challenges on *shariah* issues in English and Malaysian High Courts. This chapter was designed to explore the hypotheses that - current Islamic banking practices are superficial, driven by market forces and not by religious convictions, existing environments is an obstacle for the Islamic banking to offer standardised products in a transparent way and regulatory shortcomings makes Islamic banking prone to systematic risks.

Chapter four investigates issues and concerns of corporate and *Shariah* governances and identifies regulatory shortcomings and arranged accordingly that practices of Islamic banking differ from their theoretical foundation and core objectives. It explains the effect on the Islamic banking sector during the 1980's recession which nearly wiped out this sector totally which was blamed on poor corporate governance and lax regulation. It outlines the moral hazards in Islamic banking, accounting auditing issues and accounting and accountabilities within the Islamic religious context and also explores the role of oversight by the international organisations and the efforts of Islamic Financial Services Board for regulation harmonisation.

Chapter five identifies the research paradigm and discusses methodologies used for site selection and data collection. It highlights the hypothesis within the Islamic paradigm with quotes from the *Quran* and *Hadith* and explains the Questionnaires used in this survey, their development and justification. It explored the data collection process, model specification, variables selection and data analysis using multiple logistic regression model.

Chapter six covers the Bangladesh case studies giving an overview of the Bangladesh banking sector and the role of Islamic banking in the overall development of its economy. Three major and diverse Islamic banks were selected for case studies and these are explained in this chapter. This chapter also outlines the survey results of the questionnaires sent to the regulators, *Shariah* board of Islamic financial institutions and to Islamic financial institutions.

Chapter seven analyses the data of customers' survey from the four regions, Bangladesh, Malaysia, Dubai and the U.K. and the data from the four regions are analysed treating them as separate and linked case studies. This section mainly deals with the hypothesis/assumption that the 'Level of customers satisfaction of Islamic banks have association with clients socio-demographic characteristics and services provided by the bank' and accordingly analytical and hypothetical frameworks were developed. Bivariate (cross tabular) analyses were used to test the above hypothesis.

Along with testing hypothesis this section also provided information on all four regions to better understand the utility function of Islamic banking customers and regional variations.

The eighth and ninth chapters further discussed and tested hypothesis on 'customers satisfaction of IB' (which has been mentioned in chapter seven) by applying multivariate techniques e.g. Multiple Logistic Regression Model and Ordinal Logistic Regression Model. The results of from Multiple regression and ordinal regression analysis is analysed and discussed in these two chapters.

The tenth chapter summarises the contribution of this study and policy implications. This chapter also discussed limitations of this study and suggests future study area.

Chapter 2

Islamic banking: concept of usury and sources of jurisprudence

2.1 Introduction

This chapter collates Islamic *Shariah* law and sources of jurisprudence relating to Islamic finance. It traces the roots of Islamic finance from the early days of Islam. The understanding of trade and business from the time of prophet [peach be upon him (pbuh)] and the understanding of Islamic *Shariah* issues relating to financial transactions shape the future direction of this research. There have been several scholarly writings on Islamic Jurisprudence and vast amounts of literature available on all other aspects of Islamic *Shariah* law. This chapter attempts to bring together all these *Shariah* issues its importance for the banking sector along with the role of *Fatwas* under one study so that the core requirements can be evaluated with current practices. This chapter therefore, sets a new direction to understand the issues and the concerns within the context of religion and finance. No other previous study has brought together all components, such as banking, accounting, corporate and *Shariah* governance from the Islamic jurisdiction point of view. This chapter is therefore arranged in a way to understand the controversy surrounding Islamic banking and finance within the Islamic religious environment.

2.2 An overview of the Islamic mode of finance

From the start of the decolonization of Muslim States, Islamic scholars have started thinking on how to develop a model which could provide alternative banking by avoiding interest and complying to all other aspects of Islamic Shariah law. This thinking has developed from the second half of the twentieth century. The revival of Islamic economic thought captured in the early writings can be traced to Quraishi (1946). Later in 1955, Uzair wrote a book titled "*An outline of Interestless Banking*" on the instruction of the Government of Pakistan to search for a banking framework within Islamic *Shariah* Law. The concept and the application of Islamic Banking in Malaysia and Pakistan have started around this period. However, the scholarly writings prior to 1980's are very few. Much of the writings started from the eighties (1980) and the workable Islamic banking concepts have also advanced from this period.

2.2.1. The roots of Islamic finance

The roots of Islamic finance have been traced to the life of Prophet Muhammad, (pbuh). There are numerous *Hadiths* on financial dealings and commerce and the Holy prophet (pbuh) always insisted on fair and transparent dealing. Islam calls for full disclosure, proper accounting and honestly in all dealing with full transparency. The holy prophet (pbuh) pleaded for leniency in a case of the debtor's hardship and simultaneously ordered that the able people to settle their debt in full as soon as possible as (the) God will not forgive on behalf of its subjects (Quran 2:280, 5:1, Obaidullah 2005).

Islamic banking was practiced throughout Islamic countries in the form of trade and finance and profit sharing. Muslim merchants had in the past dominated throughout Muslim and European countries. These functions were carried out by *"sarrafs"* (money exchangers). However, sarrafs were not banks in the strict sense with Udovitch calling them "bankers without banks" (Chapra & Khan 2000). The Islamic world had developed most of the framework of trade and investment from the late eight century and these later travelled to the west. The modern form of the corporation traces its origin to Islamic countries where people with finance joined together with those who possessed experience and shared the resultant profit. The original Islamic concept and techniques have found their places in modern day enterprise (Haq 2005). The English common law had its origin in Islamic law and recently John Makdisi (cited El-Gamal 2006) found similarities in British Contract Laws to those of Islamic origins.

The modern day concept of Islamic banking had taken off in the early 1960's from Egypt and Malaysia. Pakistan however, started in 1965 and attempted to change its entire banking system based on Islamic *Shariah*, with many legal challenges stalling this progress. However other countries progressed beyond Pakistan and Egypt. Sudan and Islamic Republic of Iran have adopted full Islamization of their banking sector. All other Muslim countries have a dual banking system (Dar 2004). The Islamic Financial Industry has accelerated towards the mainstream and London has become its western centre. The Middle East has become a hub for Islamic finance, with the creation of Accounting and Auditing Organisation for Islamic Finance Industries (AAOIFI) head quarters in Bahrain. Some major Islamic banks have their roots in the Middle East. The National Commercial Bank of Saudi Arabia is the largest Islamic bank. In fact the largest ten Islamic banks have their origins in the Middle East (Skully 2005). Pakistan was the first country to form specifically as an Islamic State and soon after they commissioned the feasibility of Islamic banking (Uzair 1955, Vogel and Hayes 1998, Chapra and Khan 2000, Archer and Karim 2002).

The current form of Islamic banks have their roots in Egypt where the earliest form of an Islamic Bank operated on a profit sharing basis establishing itself in the town of Mit Ghamr in 1963. Previously there had been two failed attempts in the mid 1940's in Malaysia and in late 1950's in Pakistan (Gafoor 1995). In Malaysia the Pilgrim Administration Fund (Tabug Hajji) was the first Government sponsor fund who used to process all Hajj (Pilgrimage to Mecca) applications. Tabug Hajji had a free hand to invest these funds to their own accord in Islamic *Shariah* modes in real estates and agricultural developments (Henry and Wilson 2003).

The first recognised interest free commercial bank was Naser Social Bank, established in Cairo in 1971. The next major step of Islamic Banking was the establishment of Islamic Development Bank (IDB) in 1975. The IDB was originally meant to be a financial backbone for the Muslim *Umma* (Nation) and not necessarily to be an Islamic bank, though in its founding agreement it state to abide by Islamic *Shariah*. At that point in time IDB had no idea how an Islamic *Shariah* based bank could operate. In 1976, IDB had its first *Murabaha* transaction with the Government of Algiers and until 2003 the IDB did not have an Islamic *Shariah* supervisory Board. Even the Dubai Islamic bank did not have a *Shariah* Supervisory Board until 1999 (Henry and Wilson 2003).

The leaders of Islamic movements were the modern thinkers of Islamic Economics, namely: *Abul Al ala Al Maududi, Syed Qutb and M. Baqir Al Sadr*. These modern thinkers wanted to establish an Islamic economic system and modern day Islamic banking has developed from their initial writings (El-Gamal 2005a). According to Ariff (1988), a framework of Islamic banking has extensively been documented by Siddiqi (1981), Khan (1986) and Karim Ali (1989). There was a vast literature in Islamic economics mostly written in Urdu, some of which has since been translated in English. The modern day Islamic banking concept developed from the writers in the 1950's, namely, Quershi (1946), Ahmad (1952) and Uzair (1955). These concepts were further taken forward by Chapra (1982), Mohsin (1982) and Al-Jarhi (1983). The International Monetary Fund (IMF) has conducted a study in 1987 (Iqbal and Mirakhor), which suggested the viability of Islamic banking in resource allocation. Recently there have been several studies on almost all major Islamic markets, including Bangladesh, Pakistan, Sudan and Malaysia. The International Organisation for Securities Commission (IOSCO) has conducted a major study of Islamic banking in 2004. This study has highlighted the extent of market developments and the challenges regulators need to address for the soundness of this sector (IOSCO 2004).

From the creation of IDB, Commercial Islamic Banking began to prosper and creation of numerous Islamic banking institutions soon followed thereafter. They spread from Muslim Countries to non-Muslim countries and now are a major force in the international capital market.

2.3 Islamic banking a dilemma

The dilemma for the Islamic banks is whether they should practice real Islamic banking and thus remain marginal or they should try to capture the wider market and become main stream Islamic bankers, which would require to some extent compromise with the principles. The further dilemma here is whether they should be frank and transparent about these compromises or they should claim to have found an Islamic solution to be engaged in activities, which are otherwise strictly forbidden in Islam. These are the central query of this thesis and it investigates this dilemma. There is a concern that the current system of innovative synthetic Islamic contracts will damage long term prospects for the Islamic banks (El-Gamal 2006, El-Diwany 2006)

Islamic banks are in the business of making profit by financial intermediation. They need to give attractive return to the providers of funds in order to attract them away from other banks. They cannot price their products cheaply which will bring unlimited demand and no supply and will create arbitrage opportunities at the expense of the Islamic Banks. Islamic bankers are required to focus on social justice in their operations. It is mentioned in the Quran (59:7) that –"*wealth do not circulate among the rich among you*". How can the bank be socially just and economically sound? How can they be lenient when the borrowers default? How can they give charitable loans without interest where they need to give fund providers a return? Answers to these questions in line with Islamic economic thought should have led us to the development of a pure Islamic banking system. However, banks have taken the economic justification and have found a way out to follow the conventional banking market in alternatives Islamic names. They have absolutely abandoned the spirit of Islam and tried to manipulate an outcome by which prohibited items appear to be allowed. They have formulated the Islamic banking products from sales-based transactions and they argue that in the *Quran* (2: 278) "*God allowed trade and forbids Riba*". This is a very simplistic notion as the Prophet (pbuh) further prohibited six commodities in order that the traders cannot hide the *Riba* in the contracts. In other words contracts should not be manufactured to circumvent the prohibition of Usury. There are considerable suspicions that Islamic banks are doing exactly what was forbidden, by hiding the *Riba* in the contracts. The intention in the *Quran* is to develop trade for economic prosperity where all stakeholders benefit. Instead of this however, Islamic banks developed trade like transactions known as "*synthetic trade*" in order to circumvent the prohibition of Usury. The great dilemma is whether they should develop Islamic banking or the should develop banking in a manipulative way which would allow them to capture a market which would otherwise not be engaged with modern banking (El-Gamal 2006)

Islam admits the existence of certain things but the followers of the Islamic religion were told in a clear cut language what is allowed and what is not. Islamic banking has devoted all of its efforts to develop a system by which it can practice the prohibited. It has not tried to develop a system on the basis of what is allowed. This is a great concern for the opponents of the current form of Islamic banking practices and for the Islamic banking product developers and this is still the main criticism and scepticism about the Islamic banks.

Islamic banks have captured a new market segment by this opportunity to avail of *Halal* (Islamically acceptable) profit by modern day Islamic bankers (El-Gamal

2006). However, Islamic banks remain very popular for their ethical investments and this ethical undertone has attracted vast number of non- Muslim customers (El – Qorchi 2005) to the Islamic banking sector and is satisfied with the level of return and risk category of this market segment. In many countries Islamic banks are emerging as a significant part of mainstream banking services. It is no longer considered as niche banking segment primarily targeting the Muslim customers. As the Islamic financial services are expanding rapidly, it can now re-address its core objectives in products are services to be more compliant to Shariah and develop some specific products to capture the segment of grass root Muslims who are now sceptical about Islamic banking (Dar 2004).

It can also address its greater corporate social responsibility by effective management of *Zakat* funds and also allocate a certain percentage of its funds for interest-free loans for financing the Mosques, social and cultural organisations. They should also allocate a certain percentage of its profit to help the needy sector and in educational and research projects. They should publish the above in their financial reports under social and corporate undertakings and promote the above principles by greater interaction with the customers and with the general public. This pro active attitude would fulfil its obligations to the community as a whole and to the Muslim *Umma* (community). This would improve their image and would in turn increase their customer base. The net result would be that both the banks and the society in general will be benefitted.

2.4 Islamic *shariah* issues - sources of Islamic jurisprudence

It is important to acknowledge briefly the sources of Islamic Jurisprudence. The better understanding of sources of Islamic *Shariah* Law would clarify certain controversial issues relating to the modern practices of Islamic banking. Most Islamic banking products were devised on the basis of Islamic jurisprudence, which includes the *Quran, Sunnah, Ijma, Al Qiyas, Al Istihsan, Al Masalih al Mursala, Saddudh Dharai,* Customs, *Sharman Qablana, Qawlus-Sahabi and Al Istishab;* explanation of these sources would clarify the role of jurisprudence in Islamic banking.

2.4.1 First source is the *Quran.*

In jurisprudence terms this is the primary source of Islamic *Shariah*. The *Quran* was full of commands with what is permissible and not permissible, and what is just and what is unjust. In *Quran* usurious transactions were disallowed and condemned in the strongest terms for everyone who has any kind of association with this form of transaction. However the *Quran* has allowed prosperity by mutual trade. So the Islamic banking industry, in theory, abandons the prohibition and develops products on the basis of mutual trade. The Islamic law of contract requires that in order for it to be valid, it must be lawful (permissible trade), the object is in existence deliverable and terms and conditions of the contract are precise and do not have elements of usury (Al-Omar & Haq 1996) (cited from Theory of Contracts in Islamic Law (Rayner 1991). All sources of unjustified richness are disallowed in Islam. The Quran dictates against acquiring each other's property wrongfully (Quran2:188, 4:29, 4:161, 9:34 , Al-Omar & Haq 1996).

In Islam, there are moral and legal constraints in acquiring and possessing wealth. There are also social obligations that come with the accumulation of wealth. Wealth must be acquired in a *Halal* (Islamically acceptable) way and not by *Haram* (forbidden) way. There is accountability as to how one acquires assets and how they are spent. Islamic *Shariah* is therefore a guide for Muslims to comply with these in their financial transactions.

Detailed sources from *Quran* regarding financial transactions, dealing with *Riba*, property transactions , honesty, transparency and accountabilities are to be found in Appendix Number-I-

2.4.2 The Second source is *Sunnah*

In jurisprudence term it refers to all Prophetic *hadith*, acts (include implicitly approved and the acts he did not object). According to *Hadith* (*Sahih* Muslim Cited *Kharoufa* 2000) Prophet Muhammad (pbuh) promises him "*who establishes a good sunnah to be rewarded for it as well as those who follow it until the Day of Judgment*". This authority has also been derived from the *Quran ,Sura An-Nisa* (Quran 4:59) " *O ye who believe! Obey Allah and obey the messenger*".

The relevance of *Sunnah* to the Islamic banking is that there are several *Hadith* which strongly prohibits *Riba* and all forms of transactions involving *Riba*. He also outlawed practices of trade where the *riba* was inbuilt in the transaction. Therefore, he outlawed any transactions involving six commodities which should be traded only at spot like for like so that acceptance of *riba* can not be manipulated for credit sale. Islamic banking in theory goes inline with this prohibition but does not go in the spirit of this *hadith* as they have invented commodities of value outside the prohibited six and developed trade like transactions for credit and for futures trade (El-Gamal 2006). The developments of this concept and its application to modern Islamic banking and finance and application have raised many jurisprudence issues which will be discussed through out this thesis.

There are small number of Islamic Scholars who would certify that the devised practices are in line with Islamic *Shariah* and these scholars are in the *Shariah* Board of multiple Islamic banks. The main stream Islamic Scholars would not accept that current innovative synthetic trade like transactions to be in line or sprit of Islamic *Shariah.* These issues will be discussed throughout this thesis.

Detailed texts from relevant *Hadiths* dealing with *Riba,* property, commitments, obligation, accountability, honesty and transparency are to be found in Appendix Number –I-

2.4.3 The third source is *Ijma* (consensus)

In jurisprudence terms it is called *Ijma* when Islamic scholars, following the death of Prophet (pbuh) are in agreement about a case according to principles of *Shariah.*

The relevance of *Ijma* in Islamic banking and finance is that the products are developed on the basis of consensus *(Ijma)* of Islamic scholars. There is a criticism for the Islamic banks that it is very easy to get consensus of a group of scholars who are on their payroll. This raises the issue of conflict of interest as the decision of the *Shariah* Board is final and cannot be subject to scrutiny of the outsiders. This practice raises the question of transparency and the question of compliances to *Shariah* remains doubtful. The critics of the Islamic banks argue that the wider public cannot feel comfortable for these in-house rulings which cannot be challenged. The financial institutions cover themselves by drafting their Memorandum and Articles of Association that for Islamic *Shariah* matters are concerned the *Fatwa* of their own *Shariah* committee is final and binding for the banks.

2.4.4 The fourth source *Al Qiyas* (analogical reasoning)

In Jurisprudence term *Al Qiyas* is described as follows :

> "*appending an incident, for which there is no text in the three higher sources to an incident for which there is a text and its ruling is assigned to the new incident. The reason for this being that both incidents are equal in the illah (rationalize judgment based on the fact of the case*"

(*Usul As-Sarakhsi* vol 2 cited *Kharoufa* 2000)

There are four pillars to *al qiyas* , conditions pertaining to original case, the new case whose ruling is sought by recourse to analogy, the effective cause *(illah)* which is an attribute of the original case and because of its presence, both the original and the new cases have become equivalent and thus the *Hukum*(ruling), the new *shariah* judgment. There are special rules attached to all of these pillars which are outside the scope of this thesis. Islamic Banking Scholars try to resolve many financial matter by *al qiyas* and *illah* the uses of some of them are very questionable. Here again the use of in- house *Shariah* Board is criticised for being to accommodating in granting the certificate to the Islamic banks to facilitate their business. These matters will be discussed further.

2.4.5 The fifth source is *Al Istihsan* (juristic preference)

In jurisprudence terms it is to deviate from apparent *qiyas* and apply an implicit *qiyas* or prefers an exceptional ruling. There are different schools of thought and most of them are not in agreement with this form of ruling.

2.4.6 The sixth is *Al Masalih al Mursala* (unrestricted interest)

This includes those interests for which no provisions have been expressly prescribed by Quran and *Sunnah* nor does there exist any evidence from *Shariah* to invalidate them. There are various categories and rules and regulation in each. The source of this jurisprudence comes from the Companions of the Prophet who used to base their judgement on the above principle and none of them denied the validity. Hence the majority of scholars are in agreement with this source of Islamic jurisprudence. (Islamic banking scholars draw parallel from the above in certain of their products.

2.4.7 The seventh source *is saddudh dharai* (blocking the means)

This is used to attain something forbidden by *Shariah*. According to *Ibn –al-Arabi "every act that has the appearance of being permissible, but leads to something forbidden"*. In general it a matter which in itself is not forbidden but may lead to something forbidden if committed. If it leads to something *Halal (acceptable in Islam)* then it is permissible otherwise not.

2.4.8 The eight source is customs

It could be a good or bad custom but it should not contradict Quran and *Sunnah*. It is cited as an example that usury was the custom and practices of many Islamic Countries but it should be abandoned as contrary to *shariah*.

2.4.9 The ninth source is *sharman Qablana* (revealed laws preceding the *shariah* of Islam) if not revoked by *Quran* and *Sunnah*.

These mostly refer to the Devine book which was revealed before to Prophet *Muhammad* to *Noah, Abraham, Moses* and *Jesus*. As for Islamic Banking it is recorded that interest was forbidden in all other major religions.

2.4.10 The tenth is *qawlus-sahabi* (the sayings of Prophet's companions).

These refer to four *Caliphs* , *abdul Ibn Abbas, Abdullah Inb Masud, Alias* and *Hudhayfa* among others .

2.4.11 The eleventh source is al *istishab* (presumption of continuity).

According to *Shaykh Abu Zarha* it means "applying evidence that exists and considering laws that are established and that have remained un-altered".

(The above jurisprudence sources were complied from *Kharoufa* 2000, *Kamali* 2003: *Nyazee* 1996, Vogel and Hayes 1998)

According to *Usmani* (2005) in the Islamic religion there are two sets of rule, one is based on the normal construction of Islamic jurisprudence and *Shariah* and the second based on living under constraint and hardship (in case of absolute necessity). In his opinion Islamic banking products were designed on the second set of rules, therefore, their activities are not in line with ideals of Islamic principles. However, he points out that Islamic bank are at their infancy and working within unfavourable legal and regulatory environments. As such they have invoked the concession allowed on the basis of need and necessity. For this reason it can be seen why grass root Muslims have such a negative view about the authenticity of "Islamic *Shariah*" in Islamic banking (Dar 2004)

2.5 Islamic jurisprudence the role of Islamic *fatawas*

The role of Islamic *Fatawa* (Islamic Ruling) is central for the development of Islamic banking and finance. The Islamic *Fiqh* Academy, a renowned organisation issues *Fatwa* on variety of Islamic issues. The Mufti of Egypt is also an Authority in issuing Islamic *Fatawas* on similar issues. According to the above jurisprudence sources these *Fatawas* can shape the future directions of Islamic banking and finance and can resolve the disputed matters and practices of Islamic banks. Initially the promoters of Islamic banks tried to obtain these highly accredited *Fatawas* for the development of Islamic banking. It was claimed that the banks were economic with facts when seeking their verdicts and their opinion were sought submitting a very limited number of documentation which did not give over all pictures. Now a days promoters of the Islamic banks do not take account of these *Fatawas* and are guided by their in- house *Shariah* board.

A collection of *Fatawas* relevant for the understanding of Islamic banking and finance are to be found in Appendix Number -J-

From these *Fatawas* it is very clear that full disclosure and transparency in every respect is paramount to examine the authenticity of all transactions to conform to Islamic *Shariah*. The very natures of these transactions are complex and all transacting parties need full information to satisfy that these investments do not violate Islamic *Shariah* law.

2.6 The concept of r*iba* (usury) in Islam

There are numerous scholarly writings on *Riba* and literature review directs towards immorality of taking interest on money in all six major religions. The critics of Usury go back to ancient Indian times and all the religions had reservation about usury on moral grounds (El-Diwany 2003, Mills & Presley 1999).

Although *Riba* is universally condemned by the Muslims but in spite of this universal condemnation by the *Ulammas* (Islamic Scholars) there has not been great mobilization of Muslim masses against *Riba* slogans. Civil Codes in most Arab Countries forbid compound rates as they find this is closer to *Quranic* prohibition of doubling and redoubling of the debt. In Egypt Civil rates are lower than commercial rates and in Kuwait and Bahrain interest is authorized in commercial code but prohibited in civil code. In Saudi Arabian commercial regulations avoids use of interest and calls it profit and their central bank officially is barred from charging interest. In Iran and Pakistan banking laws prohibit *Riba* (interest) but many soft option were adopted to replace the terms in more acceptable ways. In most South East Asian Muslim countries banking regulations are secular and there are no substantive laws prohibiting *Riba* (Nomani 2003). There are unequivocal condemnation of *Riba* (usury) in the *Quran*. They appear in four places: Quran 2:275-81, 3:130-2, 4:161 and 30:39. The prohibition is clear cut without ambiguity.

Riba is an Arabic word which literally means increase, addition, expansion and growth. In Islamic *Shariah* it is used in two senses, *Riba al-naisa* and *Riba al-fadl*. The first term is associated with asking the borrowers to pay an increase in money terms for delay in payment. The second term is associated from commodities which derives from a *Hadith*, [saying of prophet (pbuh)] requiring if gold, silver, wheat, barley, dates and salt are exchanged against themselves they should be exchanged on the spot and be equal and alike (Al-Omar & Haq 1996).

2.7 Time value of money in Islam

Islamic *Shariah* does not recognise the time value of money at pre-determined fixed rate over a period. This is *Riba* in excess or increase in money against exchange of money. Islamic *Shariah* scholars are of the opinion that the credit price in relation to spot price, or advance payment in relation to spot price for a late delivery can be different. They have argued that *Bai Muajjal* (credit sale) and *Bai salam* (advance payment delivery later) are permissible modes in Islam. Therefore, Islamic *Shariah* recognises difference in value due to difference in time. Rent is also an element of time calculated on the basis of market demand which compensates for the monetary value of the asset. (Al-Omar & Haq 1996)

2.8 Role of *Zakat*

Zakat is one of the fundamental pillars of Islam and the second most important duty of a Muslim. The literal meaning of *Zakat* is purification, technically it means paying a proportion of wealth for use of the poor and the needy in order to purify the remainder of the property. There are 27 passages in the *Quran* ordering to pay *Zakat* and perform daily prayers. It is the final process of purification for the wealthy who must take account of their wealth at the end of the year. The rate of *Zakat* is the 2.5% of excess wealth above certain level which is to be paid to the people whose wealth is below the limit. (Metawally 1997).

Islamic banks must have a *Zakat* Fund which will promote social well being in line with Islamic social function in order to remove poverty. Most Islamic banks Articles of Association would require them to engage in social activities. Islamic Banks can work as an Agent for *Zakat* funds and collect such contribution from the

Shareholders. According to Accounting and Auditing Organization for Islamic Financial Industry (AAOIFI)'s FAS Number 9, an Islamic bank is obliged to pay *zakat* on behalf of its shareholders if the law or the charter of the bank require them to do so (Ahmed Eds Archer and Karim 2002). Bank can encourage their customers to contribute towards this fund. This will enhance the creditability and the image of Islamic banks to the Muslim Community. The *Zakat* is one of the core pillars of the Islamic foundation and every Muslim, rich or poor, is religiously and emotionally associated with it.

Besides religious values, *Zakat* has social and economic aspects in freeing the community from the blight of poverty (Zayas 2003). *Zakat* also plays a very important role in Islam, and therefore Islamic banks can play a very important role in Islamic Society if this issue is taken firmly and properly. This will enable Islamic Banks to reach out to all the Muslims and be seen as acting for social justice. Engaging with the poor in redistribution of *Zakat* obviously means that the rich in the Muslim society can more closely identify themselves with the Islamic Bank which will be seen as working for the just cause and performs a very important pillar of Islam.

Zakat has a double purpose to purify one's wealth from unknown wrong doing and to redistribute the wealth from the rich to needy to eradicate the poverty. It must not be confused with charity which one gives at one's discretion but *Zakat* is obligatory and must be paid with honest accounting between the person and his creator. He only knows if the person has honestly accounted and paid in full seeking God's forgiveness in an effort to purify his wealth.

It is due on both the individuals and the businesses. As such Islamic banks can play a very important role in the Muslim society by accounting honestly and paying the due amount to the needy in the society. This keeps the wealth circulating between the rich to the poor and can eradicate poverty. Islamic banks effort to purify their assets by giving *Zakat* should be encouraged. Banks can create a *Zakat* fund where customers can also contribute and thus this fund can be re distributed more constructively.

2.9 Conclusion

This chapter has brought together sources of jurisprudence from the *Quran, Sunnah* and customs from the early days of Islam. The concept of *Riba* (usury), has been explained within the context of Islam and other major religions, which has helped to understand why it is such a sensitive issue in Islam. The introduction of major *Fatawas* has strengthened this chapter and the role of *Zakat,* in wealth purification and its role for social welfare have been discussed within the context of Islamic banking and finance.

Chapter 3

Literature review

3.1 Introduction

This chapter attempts to review literature on Islamic finance for the last sixty years by bringing together relevant findings from previous studies. There are considerable amounts of literature introducing and explaining the innovation in the Islamic banking system. This chapter endeavours to explain these writings within the context of previous chapters and the context of this research. While the previous chapter dealt with Islamic *Shariah* and jurisprudence issues, this chapter examines these issues from scholarly writings and examines their practical application. This chapter thus allows previous literature to be looked at from the above perspectives. Combination of those two chapters shaped the exploration of this thesis to demonstrate why the transparency is paramount for the Islamic financial industry. This chapter also collates together the legal and regulatory issues concerning *Shariah* compliance of Islamic banking institutions as well as the Islamic banking current landscape and market practices.

The main purpose of this chapter was to explore the following hypotheses:

Hypothesis 1 - Current Islamic banking practices are superficial, driven by market forces and not by religious convictions.

Hypothesis 2 - Existing environments is an obstacle for the Islamic banks' to offer standardised products in a transparent way.

Hypothesis 3 - Regulatory shortcomings makes Islamic banks' prone to systematic risks.

3.2 Literature growth and scholarly concerns

The expansion of Islamic banking and product development throughout the world has been complemented by the parallel growth in the writing of scholarly articles on the subject. These writings can be classified as follows:

During the mid 1940's there was concern that there needed to be an Islamic banking system for Muslims. Islamic States were especially searching for ideas to formulate Islamic banking systems. These ideas did not materialize into any constructive Islamic banking framework. These concepts were taken further forward by Muslim Economists during the late 1960's and a framework of Islamic banking evolved during the early 1970's.

Most of this literature until the late 1980's was searching for a pure Islamic banking framework and such writings focused on the theoretical foundation for the formulation of Islamic banking. As the market has taken off academics have noticed that the development of the banking system lacks a sufficiently robust theoretical foundation. Further scholarly writings have positively encouraged Islamic banking and aided its development. According to Iqbal and Mirakhor (1999) Islamic Finance Development from 1950 to 1975 can be considered a period of developing conceptual framework and from 1975 to 1990 a period of experimentation and from 1990 onwards a period of recognition.

The writings produced during the 1990's were varied. There was a growing concern regarding the way the Islamic banking system progressed. The role of the *Shariah* Board has come in for heavy criticism. Products have also come under close examination. Corporate Governance was criticized for not being transparent and there were growing concerns that institutions had moved away from the founding principles of Islamic banking by getting the *Shariah* certification fixed to suit the conduct they wished to adopt. The *Shariah* board was also criticized for being too accommodative towards corporations and some would argue that they simply acted as a rubber stamp to give authenticity without any real effort to promote Islamic Banking.

These criticisms have helped to shift the banking concepts and technological developments have enabled banks in slicing and splicing the various components of a transaction to stand alone in isolation and still remain parts of the same body in an effort to hide the prohibitive elements. These are called new innovative Islamic banking products which are cleverly developed to compete in almost all conventional banking areas. These concepts and arguments are market driven and dynamic in thinking. These developments have given Islamic banking a new momentum and with the new boom in oil prices this sector is prospering and corporations Islamic or non –Islamic are tapping into Islamic money which promises positive return without being called Interest. These developments have shifted away funds from Islamic countries to the western countries resulting in the neglect of social development of the Islamic Countries economies. It defeats the whole object of Islamic economics to develop a system by which every stakeholder can benefit for long term. This led Islamic scholars to question the current advancement of Islamic banking with most of their current writings covering these areas of concern.

Scholars are frustrated about Islamic bankers' inability to develop a system based on the "substitute" of interest (Iqbal & Mirakhor 1999). It is a concern to academia that the credit risk assessment and benchmark interest rates are the same for both conventional and Islamic banks, structured differently to get the same outcome. Contracts are manufactured to facilitate loan on interest which classical rules do not allow (El-Gamal 2006). These are invented in modern interpretations to allow interest based loan in synthetic contracts which are the main criticism against the Islamic bankers. Islamic bankers have utilized Platinum based synthetic contracts to circumvent *Usury* rules. They argue that the Prophet (pbuh) prohibited trade in six *Ribawi* (Usurious) commodities other than trade in spot and in equal quantities and the Platinum is not one of them. Nomani (2003) argues that Prophet (pbuh) brought in six items in order to prevent circumvention of *Quranic* prohibition and the Islamic banks introduces other items to circumvent this rule. Islamic scholars argue that the principle extends to any commodities which are used to circumvent usury rules.

According to El- Gamal (2006) these unnecessary paper work adds to the costs and disadvantages the customer without helping the real promotion of Islamic banking. The current form of Islamic banking is simply rent seeking from a segment of the population which would otherwise not be involved in conventional from of finance. For this reason Islamic banking is not popular in Muslim and Arab Countries and it remains marginal. In Turkey despite its popularity and relaxed and favourable regulations for Islamic banks they did not capture even 4% of the market share. The failed *Ihlas* Financial House in 1995 has dented the confidence in Islamic banking which by now have overcome to some extent. In the Islamic world it has expanded relatively more in petroleum producing countries and indeed its birth was also credited to these countries which have contributed to the development of Islamic banking in early nineteen seventies from its limitless prosperity achieved in massive oil revenues. Islamic banks need a major structural reforms and long term Islamic finance depends on equity like instruments. Current forms of Islamic banks work as a conduit for Muslim Capital to find its way in overseas markets. (Henry and Wilson 2004)

There is now leniency in interpretations and it is now claimed by the Islamic financial institutions that the technological developments have enabled the market to structure the products and the conducts by means of multilayer transactional contracts and to eliminate the prohibitive by various cleansing methods. Most of the scholarly writing of this age questions such practice whilst others wrote sceptically about such developments. The scholarly field is now overcrowded with writings of concerns and questioning the transparency. The conventional economic theory of finance ran on "interest" as a price mechanism to stabilize the demand and supply of money. It suggests that with zero interest there would be infinite demand for money and no supply, a market failure scenario, and Islamic economics which only accepts time value of money in a real credit transaction as compared to cash transaction and in productive activities. It does not recognize the time value of money in isolation. It accepts that credit prices can be different from cash but should not be calculated at a pre determined rate. In Islamic law all financing is treated as loan once the principal is guaranteed whether nominal and or real terms (Al-Omar and Haq 1996). The conventional theory yields a guaranteed return whereas in the Islamic system there is no such guarantee that the economic activities would yield a positive return. This is precisely the Islamic view point to bring social justice in risk sharing and for sustainable social and economical development and not for a boom and bust system. Currently the scholars are arguing for more openness and that transparency would help to improve the image of Islamic banking.

3.3 Market development

There are over One Billion Muslims in the world (Ferro 2005), 20 Million of which are in the European Union. 6-12 Million Muslims can be found in the United States of America and a further 1.8 million Muslims live in the United Kingdom (Dar 2004, Green 2004). These figures illustrate the huge potential of Islamic Banking. It is predicted that Islamic Banks will control approximately half of the savings of the Islamic world by 2009/10 (*Zaher* and Hassan 2001, Warde 2000, Skully 2005). Literature reviews concerning this subject show that this is a fast growing sector and has increased 40 fold since 1982 and has been growing at a rate of 24-26% during 1996 and 1997 (Warde 2000). Currently the sector is growing at an even faster rate estimated to be in the region of 25 to 30% during the past 5 years (Ferro 2005). The average the growth of the sector is estimated to be within the region of10-20% (IOSCO 2004). Islamic Banking market share in Muslim Countries has risen from 2% (1970) to 15% (1999). The Malaysian government has set a target to attain 20% of their Banking system to reside within Islamic Banking by 2010 and has also started giving out licenses to foreign banks to open Islamic banks there. The Islamic banking phenomenon has been expanding rapidly from the Middle East to Australia, United States, African Continent and Soviet Union. It is prospering mostly in Malaysia and according to El-Qorchi (2005), Malaysian Islamic securities accounted for 42% total of outstanding private Debt by the end of 2004 and Islamic securities accounted for 25% of outstanding bonds. The Dow Jones Islamic indexes and Financial Times Stock exchange Global Islamic Indexes offers opportunities for Islamic and ethical investments, as these indexes monitor the corporations for *Shariah* compatibilities and adopts multiple screening processes. Religious scholars have reservations about the arbitrary screening methodologies they use in selecting the corporations for Islamic compatibilities and the various ratios they use in the process (IOSCO 2004).

There is considerable difficulty in obtaining up to date and accurate figures as most are based on estimation. It is currently estimated that Islamic Banks assets are between USD200 Billion to USD800 Billion. According to the last count there are nearly three hundred Islamic financial institutions including Western banks' "Islamic Windows" with Market Capitalization USD13 Billion. There are 30 Billion USD Islamic bonds outstanding and in total Islamic Investments are USD400 Billion. According to International Islamic Finance Forum, Muslims have some One Trillion USD potential in Deposits and Investments. To sustain the growth and expansion the Islamic financial institutions must highlight these social and economic benefits and must enhance knowledge on the association of Islamic finance and socio economic development. (Hijazi 2006). This is a fast developing sector and present research in this area is not keeping up with this expansion (Skully 2005).

3.4 Existing Islamic Banking System

In recent years Islamic banking products have reached a new level of sophistication. This is because of the involvement of heavyweight conventional banks in this sector. The Islamic financial industry is moving fast towards mainstream banking and London has become its Western Centre (Khan & Paracha 2005). Currently the fast growing segments are outside the mainstream banking products. Vast development and product innovation has taken place in an area which was previously very controversial, for example *Takaful* (Insurance) (Warde 2000).

Islamic banking products have taken a new shape (Iqbal and Khan 2005). They are now marketed as a socially responsible investment and non-Muslims are the largest customers for all *Sukuk* (Bond) issues as previously stated. Structural reforms and financial liberalizations of capital movements and global integration of financial markets have contributed to the expansion of Islamic Banking (Zaher & Hassan 2001). The PLS System of banking was profitable to start with but when certain banks reported losses banks changed to debt based financing (El-Gamal 2005a). Current Islamic banking is a supply driven elitist phenomenon and is not popular at a grass roots level. A survey in the United Kingdom found that 45% of Muslims have a positive attitude towards Islamic banking (Dar 2004). However the survey talks only about attitudes and does not give any data concerning the take-up rate of Islamic banking products among Muslims living in the U.K.

The involvement of conventional banks has changed the geography of Islamic finance. There are differences in opinion over whether conventional banks can offer Islamic products where their finances and objectives are non-Islamic. In a market economy Islamic banks are required to compete with some heavyweight conventional banks. As a result their margins are reduced. This development has disadvantaged Islamic banks as conventional banks are now able to benefit from both these sectors whilst Islamic banks are unable do both. Therefore Islamic banks have high agency costs and in order to reduce costs they compromise on principles. They are now in a race to catch up with conventional banks and are mimicking interest based conventional finance, the very system they originally set out to replace. Current form of Islamic banking is a prohibition driven industry that tries to financial engineer and manipulate transactions by ignoring the sprit of Islam. This form of *Shariah* arbitrage favours financial institutions who are attempting to acquire a captive market whose participants believe the authenticity of the products and services conforms to Islam with the *Shariah* certification by certain retained Islamic Scholars. This may do long-term harm to the cause of Islam and will handicap any thinking of developing a pure Islamic base product.

The fragmented rapid development of the Islamic banking and finance industry has been causing large concern for the regulators. They are in an urgent search for a greater understanding of *Shariah* based banking practices and its implication for the global finance industry (IOSCO 2004, El-Qorchi 2005). The current form of Islamic banking is operating in complete contrast to its core objectives of helping the poor and social re-generation. In fact it is now an elitist form of specialized alternative banking for the few who channel their vast wealth in western capitalist market and remain the main beneficiary of its development. According to El-Gamal:

"when Islamic finance is truly Islamic, rather than profit driven Shari'a

arbitrage, it should be a good finance at good price. At that point, the industry can proudly abandon the " Islamic" brand-name, to everyone's benefit" (El- Gamal 2005b).

3.4.1 Islamic banking in Malaysia

Malaysia is the second largest hub for Islamic banking with almost 12% of total banking sector with a recorded annual growth of 27% during last 10 years The Government of Malaysia have actively encouraged Islamic banking and have created an enabling environment by introducing the Islamic Banking Act 1983 and the Tax Act of 1984. They have looked into the tax changes by eliminating real property taxes on certain types of Islamic lending transactions and extended 10 year tax exemption for *Takaful* (insurance). The Malaysia Securities and Exchange Commission issued new guidelines on the issuance of Islamic securities and set up a special branch in the High Court to hear the cases relating to Islamic financial transactions. It also created Islamic interbank money market to provide liquidity to the Islamic banks. The *sukuk* and capital market flourished in Malaysis in 2001 and has since grown tremendously. It hosts the first international *Sukuk* centre with annual transactions over USD32 billion in 2006. It has Islamic unit trust fund, Islamic Index, managed fund (stock broker). Malaysian government has set a target of 20% market share by 2010. Other Islamic regions are critical of Malaysia for very liberal interpretation of *Shariah* over banking and finance affairs and these are not acceptable in other regions. Malaysian government has taken real and major steps forward for the creation of vibrant Islamic financial and capital (Rob: 2004, Khan & Bhatti 2008).

3.4.2 Islamic banking in GCC Countries

The largest concentration of Islamic banks are in the Gulf Cooperation Council G.C.C. countries which accounts for 36% of global Islamic finance market (Schmith 2008), yet it is only about 12% of its entire banking sector (Khan & Bhatti 2008).In the GCC Countries there is currently no distinctive regulatory environment. The GCC countries currently follow the Bank of International Settlements (BIS) standards and International Accounting Standards. Central monetary authorities are actively supervising and monitoring all financial institutions within the current regulatory framework. The regulatory authorities do not allow banks to invest in real estate on their own account. With the exception of Saudi Arabia most of them have a deposit protection scheme. The Accounting and Auditing Organization for Islamic Financial Institutions was established to review and develop Accounting and Auditing Standards for Islamic Banks (Islam 2003).

Bahrain is at the heart of the Islamic Banking industry, yet Bahrain does not have special Banking Acts specifically for Islamic Banks. Since March 2002 they have developed a Prudential Information and Regulatory Framework for Islamic Banks (PIRI) to use information contained in the return to monitor the operations. Bahrain Monetary Agency (BMA) has responsibilities to ensure that Islamic banks are adequately regulated. They have also accepted the recommendations for Capital Adequacy Ratio of The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Bahrain has created an enabling environment for the development of the Islamic banking Industry. There are also a considerable number of Islamic Banks and Supporting Organisations for the Islamic Banking Industries that have their head offices in Bahrain. These are AAOIFI, The International Islamic Rating agency, The General Council for Islamic Banks and Financial Institutions. They also host many training Institutions, that provide training for Islamic Banks (BMA 2002).

The first Islamic bank was established in 1978 and since it has grown tremendously. Now there are 33 Islamic banks and over 300 conventional banks. A large number of Islamic banks uses Bahrain as their base for operation in the gulf, European Union, USA and rest of the world. Dubai International Finance centre is renowned for trade in *Sukuk* at regional and international level .

In Kuwait with the establishment of Kuwait Finance House in 1977 the Islamic finance and *Takaful* activities have grown rapidly. It has the largest number of Islamic financial institutions and ranked as third most important centre for Islamic banking and finance with target of assets USD56 billion by the year 2010. The government of Kuwait is working for a proper regulatory framework for a *Sukuk* market. The Standard Chartered bank has introduced first Islamic derivatives contract in Kuwait. The central bank of Kuwait has introduced Islamic banking laws in 2003.

In Saudi Arabia there is no separate Islamic banking Act. There are two major Islamic banks in Saudia Arabia. These are *Al-Rajhi* Banking Corporation and Bank *AL-Jazira*. Conventional banks have also Islamic windows. There are increasing number of products absed on Islamic principles. Islamic *Sukuk* and *Shariah* compliant stocks are traded in Saudi Stock & Capital Market. Saudi Arabia hosts

Islamic Development Bank (IDB) which has the crucial role in promoting Islamic banking in Muslim world. (Khan & Bhatti 2008).

3.4.3 Islamic banking in Iran

In Iran following the revolution in 1979 the banking sectors were reformed several times to convert all banking activities in an Islamic *Shariah* format. Central banks have taken steps and introduced mechanisms for converting all existing banking accounts, contracts and loans etc. In 1982 Islamic Scholars had produced a draft law to bring entire banking operations according to Islamic *Shariah*. The law on interest free banking was passed in 1983 and became law in 1984. It gave banks a certain time frame within which to convert all banking systems to conform to Islamic *Shariah* Law. From 1986 the entire banking system was considered as an integral part of the Islamic Government as such a banking system had been used as an instrument for the restructuring of the economy (Makiyan 2003).

The government has introduced sector wise maximum ceiling of service charges and or profit. These rates vary between 4% to 24% with the lowest rate for the agricultural sector and highest charges for trade and services sector. The expected rate of return on bank loans were lower than inflation, therefore the lending operations were priced according to the need of the economy. The supply of loan is influenced by the intervention of the government rather than return on the banking system. From 1997 Iranian central banks issued licences to a number of credit operatives, interest free *Qardul Hasan* centres and non bank credit institutions. Private sector banking started from the beginning of 2001 and government also denationalised certain banks to enhance diversity of private banking sector. Foreign banks operate from the designated free trade zones. (Khan & Bahatti 2008).

The Iranian form of Islamic banking is exclusively practiced in Iran and this model did not form part of a wider form of international Islamic finance. In Iran banks are allowed to accept deposits without having to pay any return, but it permits the bank to offer incentives, coupons, and prizes. Terms deposit profit is determined on the basis of the profit of the bank. On the investment side they have profit sharing on civil or equity partnership. Commercial transactions are carried on *Musharakah, Mudarabah and jo'ala* , lease purchase and instalment sales basis. Personal consumptions are also based on instalment sales and *Qardul Hasan* (Lewis & Algould 2001)

3.4.4 Islamic banking in Bangladesh

There are both conventional and Islamic banking practices that operate in Bangladesh. There are several Islamic banks operating in Bangladesh, the most prominent of which is Islamic Bank Bangladesh Limited. It is a joint venture with Multinational banks owing nearly two thirds of its equity. In Bangladesh there is also the Islamic Bankers Association as well as an Institution for Islamic Economic Research called the Islamic Economic and Research Bureau who provide training and guidance as well as organise seminars. Supervision of Islamic banks is the responsibility of the central bank. There is no separate Islamic banking Act therefore these are supervised within the current regulatory framework with more emphasis on in house control and *Shariah* supervisory advisory boards.

Bangladesh has a vibrant Islamic banking which accounts for 17% of total banking sector. There are six Islamic banks with branches across the country. Islamic banking practices in Bangladesh share the experiences of International Islamic banking market and their modes of finances are *Murabaha, Musharaka, Mudarabah* and *Qardul Hasan.* They are mostly for trade finance on *Murabaha* (cost plus) basis and long term *Musharaka* and *Mudarabah* finances are negligible. There are no *Sukuk* market as yet developed in Bangladesh and no Islamic shares traded in the stock market.

3.4.5 Islamic banking in Pakistan

Despite being the pioneer in Islamic banking and potential of the market, it is legging behind with only market share of 2.2% of the total banking sector (Khan & Bhatti 2008). There are six Islamic banks with only 52 branches throughout the country. Under the recent directives of the State Bank of Pakistan, all conventional banks must open Islamic banking "windows" (Khan & Bhatti 2008). Recently Islamic *Sukuk were* issued for nearly one billion US dollars for development projects by Pakistani government as well as private sector. The Islamic equity index has also been launched in the stock exchange.

In Pakistan there is no special Islamic Banking Act and the banks are supervised by the central bank. Major financial transformation to comply with Islamic *Shariah* called for by the Supreme Court of Pakistan and Financial Services Transformation Committee has been established by the State Bank of Pakistan. The concept of

Shariah Board does not exist but there are *Mudarabahh* Companies Law to monitor the firm offering Islamic finances and investments on *Mudarabah* basis. In 1984 State Bank of Pakistan has laid down three permissible mode of financing, *Qard Hasan* (zero interest), mark up *(Murabaha)* trade related financing and share and equity participation *(Musharaka)* (Lewis & Argould 2001). The Pakistani government has taken new initiative to revive the *Mudarabah* companies. The Regulation in the rest of the countries offering Islamic banking are inbuilt within the mechanism of Central bank and Basel core practices (Chapra and Khan 2000). The public do not have much confidence in Islamic banking that their products comply to Islamic *Shariah* which the regulators need to address this issue for Islamic banks to prosper in this densely populated Islamic country (Khan & Bhatti 2008).

Following table of comparative structure of Islamic banks shows the market share, market concentration and divergence of products practices in various regions.

Table 3.1: COMPARATIVE STRUCTURE OF ISLAMIC BANKING

Region	Share of Islamic Banking	Banking System	Comparative Modes of Finance				
			Murabaha	Musharaka	Mudaraba	Ijara	Others including Equities
	%		%	%	%	%	%
Gulf countries	**12**	Islamic/Conventional	59	10	2	6	23
Middle East	**10**	Islamic/Conventional	34	51	13	1	1
Sudan	**100**	Islamic	50	23	4	1	22
Iran	**100**	Islamic	1	25	17	10	47
Pakistan	**3**	Islamic/Conventional	25	1	2	2	70
Bangladesh	**17**	Islamic/Conventional	33	2	11	19	35
South East Asia	**10**	Islamic/Conventional	3	1	1	12	83
Africa	-	Conventional	40	25	1	15	19
Western Countries	-	Conventional	12	51	1	6	30

World Market Share of Islamic Banking	%
GCC Countries	36
Non-GCC Countries	35
Asia	24
Rest of the World	5

REMARKS	
Gulf countries	Fully efficient Islamic banking market, No special banking Regulation, Monetary authorities issues guidelines
Middle East	Dual banking system, Islamic banking gaining popularity
Sudan	Islamic banking system, Basel Core Adapted under different risk weighing
Iran	Differential rates for various sectors, banking system unique from rest of the world, Western conventional banks operate from free zones
Pakistan	Dual banking system, All banks require to have Islamic windows, Not popular at grass root level, doubtful about Shariah compliances
Bangladesh	Islamic banking very popular, No special banking Act, Central bank have special monitoring Department.
South East Asia	Malaysia have about 12% Islamic banking market, regulations and legal infrastructures adapted to suit Islamic banking, lenient about shariah
Africa	Conventional regulation
Western Countries	UK allowed concession from double taxation rule for land registration, several Islamic banks received licences, authorities do not monitor Shariah

Sources:(Lewis & Algould 2001, Warde 2000, Khan & Bhatti 2008, Makiyan 2003, Schmith 2008)

3.5 What is Islamic banking

According to Association of Islamic Banks (IAIB)

> *"The Islamic bank is a banking establishment that solicits funds and employs them in accordance with the Islamic Shariah, for the purpose of building Islamic Solidarity and ensuring justice of distribution and employment of funds in accordance with Islamic principles"* (Banaga 1994).

Islamic banking has been developed to offer banking and financial services eliminating "*Riba*" and has developed many products based on Profit and Loss Sharing; service charges, hybrid of rent and other charges as opposed to interest. Most of the Islamic Scholars are unified in their opinion that the current form of "interest" excess over capital sum is *"Riba"* which is strictly forbidden in Islam. There are scholars who are mostly on Islamic banks *Shariah* Committee and Government appointed official Muftis and Government influenced religious scholars that justify that the current form of bank interest is not *Quranic Riba* (Henry and Wilson 2004). In fact this concept advanced by the famous Fatwa of Al-Azhar University (El-Gamal 2005a & b) who declared that current form of bank interest did not bear much resemblance with the *Riba* which existed in early period of Islam where the debt would rapidly multiply at an exorbitant rate. There was universal condemnation against this Fatwa which was seen by the majority of Islamic Scholars as a very mis-conceived opinion

In general Islamic Banks are characterised by the following features:

a. *"Transactions that are free from payment and receipt of a fixed or predetermined rate of interest.*

b. *Transactions that are based on profit and loss (PLS) arrangements where the rate of return is not fixed prior to the undertaking of the transactions.*

c. *Business activities and investments that are undertaken on the basis of permissible activities.*

d. *Transactions that are free from elements of gharar (unreasonable uncertainty).*

e. *Payment of Zakat(alms or taxes)by the bank*

f. *Transactions that operate through shariah-compliant modes of financing"*

(IOSCO 2004)

The Islamic Development Bank (IDB) is an inter-governmental bank owned by Muslim countries and established in 1975. According to Articles of Agreement the purpose of the bank is as follows:

> *"The purpose of Islamic development Bank (hereinafter called the Bank), Shall be to foster economic development and social progress of member Countries and Muslim Communities individually as well as jointly, in accordance withy the principles of Shariah"* (Banaga 1994).

According to Warde (2000) no definition of Islamic banking is entirely satisfactory. *Hamwi* and Aylward (1999) explain that Islamic banking must be consistent with the religious beliefs and the cultural characteristics of Muslim societies. According to Vogel and Hays (1998) the literal meaning of *Shariah* is the way, therefore, Islamic *Shariah* law means Law in an Islamic way which comprises the *Quran* (the divine revelation) , the *Hadith* (saying of the Prophet Muhammad pbuh) and the *Fiqh* (human effort to apprehend the law).

From the above definitions the distinctions between Islamic Banks and conventional banks is that the Islamic banking system is based on avoidance of interest and products are certified by their Shariah Board to be in compliance with Islamic Shariah Law. Depositors are treated as shareholders and the bank is treated as an Agent for depositors and resulting income is distributed in pro rata to their investments. On the other hand conventional banking is purely based on interest and Debtor and creditor relationship exists between the banks and their customers (Al-Jarhi and Iqbal 2001).

The corporate Governance of Islamic banks therefore can easily manoeuvre the practical application to achieve the outcome they wish to pursue. If Islamic banks unite behind a central certification Agency and follow the same standardized products and practices across the region similar to the conventional banks, this would give credentials to the Islamic financial institutions' and the general public will be able to grow confidence in the system. Current differential practices are the greater hurdle to overcome this stigma.

There is a need to simplify these differences and adopt a unified and standardized practice around which the banking practices should evolve. To become successful in a secondary market and to attract joint and syndicated investments in addition to build consumer confidences Islamic banks needs greater uniformity and full disclosure. Current banking practices are cumbersome with respect to their institutional arrangements and insufficient risk management which hinders their future market development (Vogel and Hayes 1998).

3.6 Politics of Islamic banking

The concept of Islamic Banking has developed from Islamic political movements. During the last century many Muslim States gained their independence from western rulers which gathered momentum for the economic system to be rebuilt around Islamic thinking. The combination of changes within the political geography together with finding of oil resources in the Middle East and booming prices have enabled Islamic Scholars to focus on development of the Islamic banking system.

The international organizations such as the International Monetary Fund (IMF) and the World Bank have encouraged the governments of Muslim states to adopt financial liberalization and thus created an enabling atmosphere to develop a financial system in line with religious and cultural beliefs (Henry and Wilson 2004).

Most Islamic financial Institutions grab these concepts rapidly and recognized the opportunities in this segment and thus rushed- in formulating financial products which can conform to Islamic *Shariah.* Market pressure did not allow or permit them time to develop more acceptable Islamic Modes of finance. Therefore, the role of these institutions did not become political in many countries while they remained marginal. Only in the Sudan did Islamic Institutions become significant political players. The Muslim brotherhood had control of Faisal Islamic Bank created in 1978 and also had a joint venture with a short-lived bank called Islamic *Al-Shamal* Bank, an organization co-owned by *Osama Bin Laden and Hassan al- tubari* of Muslim Brotherhood Movement (Henry and Wilson 2004).

3.7 Evolution of Islamic banking products

The earliest forms of Islamic Products were mostly *Murabaha* based products. It was claimed that 90% of banking was in this form. *Musharaka* and *Mudarabah* Forms of Financings though were theoretically in existence but these were hardly practiced. During the Nineties the banks heavily lost from these products and academics also questioned the validity of the *Shariah* certifications of such products. Many court cases in the west as well as in Pakistan have resulted in strong criticism of such products. The combined effect of these losses and criticisms is that the banks have found ways to develop debt based products claimed to be in conformity with Islamic *Shariah* Law. These banks can now offer almost all banking products in alternative Islamic names. Academics argue that the net results of the products are *Riba* which is strictly prohibited in Islam. It is therefore argued that banks have moved away from their core objectives and, instead of trying to develop a different Islamic economic and banking system, they have embarked to take on the big conventional banks and compete in the same markets using alternative Islamic names. It is therefore still a highly controversial area with grass root Muslim customers who look on with suspicion. Islamic banking financial calculations to compute present and future value of financial instruments are exactly the same as a conventional bank. Their investments are mostly (80-95%) are on fixed rate returns and very minimal contracts are on PLS based (less than 10%).

Aggarwall and Yusef (1996) have surveyed 22 Islamic banking corporations and found that 57% of their financing are on short term and only 2.6% on long and Medium Term, 21% liquid assets and 19% in other investments. In Egypt 90% of Islamic Banking activities are trade and retail financing related.

The *Fiqh* Academy of Jeddah in 1988 issued *Fatwa* against the use of artificial *Murabaha* contracts where bank never owned the asset and even to date Islamic bankers have failed to move away from this artificial or synthetic contracts manufactured only to facilitate loan (Henry and Wilson 2004).

3.7.1 Current Islamic Banking products

Islamic banking products give some alternative to Interest Free finance. These are the outcome of various Islamic Economists research as detailed above.

As for outward investments, Islamic financial products are grouped into three main categories: Debt Instruments; Quasi debt instruments; Profit and Loss Sharing Instruments. These instruments are conceptually very simple but extremely complicated in practice (El-Qorchi 2005).

3.7.1.1 Debt instruments

These are *Murabaha,* a mark up transaction with an inbuilt purchase and resale contract with predetermined mark up with a deferred payment. This is known as cost plus or mark up and various other products have innovated in this line. These are mainly *Salam,* a purchase contract with deferred delivery of goods, *Istinsa,* a deferred-delivery finance with instalment or deferred payment options and *Qard al-Hasan* (Benevolent loan). These types of instruments account for 80-95% of Islamic bank financing (Warde 2000). This type of contract with a pre-determined mark up has been challenged and Islamic scholars do not agree the model that banks use in their application. Banks do not assume any risk and make the customer or in this case borrower responsible for all events that have been ruled out by a *Shariah* Court in Pakistan (*Usmani* 1998). These forms of transactions are also considered purely as interest bearing loan in the High Court in London. (Balz 2004). There is much concern among religious scholars for banks adopting a synthetic *Murabaha* transaction without taking possession of goods or assuming any responsibilities for the same.

The provision of a charging penalty instead of interest for late payments or defaults can be considered usurious as this equates to higher mark-up interest rate normally use by conventional banks to cover the extra risk premium. In strict interpretations of the application of theoretical models the Islamic banks are themselves labelled as usurious practices by Islamic Scholars. (Vogel and Hayes 1998). Because of these criticism banks are moving away from traditional *Murabaha* transactions and have replaced them with multilayer contracts with outcomes that are equivalent to interest. El-Gamal (2006) argues that these add to transaction costs without necessarily making them Islamic. He argues that fully transparent models within the substantive spirit of Islamic law and in line with English Common Law can be the answer for long term sustainability.

3.7.1.2 Quasi debt instruments

These include *Ijara,* a leasing contract whereby customers lease an asset for rent payment. The constructions of these lease contracts are similar to conventional lease contracts (with a few notable exceptions). It is known as a lease purchase contract whereby at the expiration of the lease, the customer becomes the owner of the assets. The Islamic mode of construction of the contract must conform to *Shariah* rules, whereby the responsibilities of the repairs and insurance must not fall totally on the customer as the benefits belong to both the parties. The final sale price cannot be predetermined and lessees must have the option to cancel. This must be free from *Riba* and *gharar* (uncertainty). It is an acceptable instrument to most Islamic Scholars. This allows financial intermediation on flexible terms and this system has further been developed into home mortgage and car finance and household needs.

3.7.1.3 Profit and loss sharing instruments

These include *Musarakah* and *Mudarabah. Musharaka* is an equity participation contract under which the bank and client contribute jointly to a pro-rata ownership. On the other hand *Mudarabah* is a Trustee type contract where one party provides the fund for the project and the other party provides labour and know-how. Profit is shared as agreed and losses are down to the provider of the funds except in cases of misconduct, negligence or violation of conditions agreed upon by the bank. From the above concept the diminishing *Musharaka* modes of finance were developed to cater for Islamic house purchase mortgages or hire purchase agreements. These are also applied for any other form of trade and commerce where ratio or mode of partnership can be applied.

A study of Financial Instruments used by the Islamic banks found that these PLS contracts are debt like in nature (Aggarwal & Yusef 2000). Management Control imbalances are blamed for the lack of an appropriate PLS system to be in place, however this system can play a very important and efficient economic function. The Islamic *Shariah* position has been clarified by this famous maxim "*Profit is based on the agreement of the Parties, but loss is always subject to ratio of investment*". (Usmani 2005). Islamic banking PLS contracts lack loss sharing and thus these are debt like contracts in a PLS format.

3.7.2 The Islamic capital market

3.7.2.1 Islamic bond

Under the conventional system the Bond is a Loan document with a fixed value and period and periodic interest. This is therefore a pure *Ribawi* product and strongly rejected by Islamic *Fiqh* Academy who have prohibited all forms of Bonds with periodic payments and or prizes and or Zero coupons. However they considered that *Mudarah* Bond (*sukuk)* pertaining to a project or to a specified investment activity can be permitted provided some strict rules and regulations are followed. This ruling has lead many Islamic countries to issue *Sukuk* for infrastructure developments. On the same principle the *muqaradah* bond issued by private corporations to support their project finance has been has been approved. This development has lifted the volume of Islamic banking in *Sukuk* participations as investors found that state owned Islamic *sukuk* is a very good way of investing for acceptable level of return for good causes (Iqbal and Khan 2005, Adam and Thomas 2004). These are structured mostly on *Ijara* (lease) where a special purpose vehicle is created to enable taking the Lease and issuing the bond on Lease backed securities and then distributing the income generated from leased assets. At the end of the lease period, lessors buys back the securities at pre-agreed prices and the special purpose vehicle company pay the bondholders.

The Islamic *Sukuk* (bond) is very popular and a fast developing instrument. Recently Islamic Scholars raised question mark on the *Shariah* compliances authenticity of 85% of *sukuk* issued so far. This has resulted in heavy loss of confidence in the *sukuk* market and takes up rate of new issues reduced by over 50%. (Gulf News. Com. Sept.15, 2008)

3.7.2.2 Islamic funds

There are many types of Islamic Investment Fund currently managed in Islamic *Shariah* modes where investors' funds are pooled together like a mutual fund. These are Equity fund, Hedge Fund, Commodities Fund, *Murabahah* Fund, *Ijara* Fund. These Islamic funds are gaining popularity because there is an opportunities to earn *Halal* profit (Islamically acceptable). Fund mangers employ *Shariah* advisers and the mangers employ Islamically acceptable screening method. There are strict investment and re-investment criteria where the total activities of a firm is assessed fully to screen out the level of unacceptable activities and measure their proportionality to remain with acceptable limit.

The principles behind this fund are more or less the same as for the above titled Islamic products. Only the scale and modus operandi is different. These Islamic Funds run in parallel to conventional Funds with the exception that these are ethically screened and profit earning in accordance with acceptable activities.

3.7.3 Derivatives in Islamic banking

Commodities Derivatives: The sale of a pure right is one of the most debated product of Islamic banking. Derivatives instruments are mostly used by the conventional banks for risk management. Islamic *Fiqh* Academy though acknowledges the benefit in risk management, it stresses that this benefit derives out of the forbidden transactions in Islam such as gambling, exploitation, monopoly and price distortion . Also it goes against the principle laid down in *Hadith* of the selling of what one does not own. The Organisation of *Fiqh* Academy Conferences in 1991 and 1993 passed resolutions to the effect that the subject matter of the options as they are traded are not *mall* (wealth), *Manafah* (usufruct) or *Haqq mali* (pecuniary right), therefore these cannot be Islamically legally traded as such these are illegal contracts.

Forward contracts it was also decided to be illegal both the counter values are deferred. Other Islamic scholars compare the option equivalent to gambling. Some scholars are of the oinion that on the basis of *Salam, Istisna* or *bay al sifah, bay al arbun, khiyar al shart* and carefully worded contract with subject matter specially mentioned should comply with Islamic *Shariah* for forward and option contracts (Iqbal & Khan 2005). According to Shikder (2007) Islamic finance industry must accept that all forms of conventional instruments such as options, future and derivatives cannot be made *Shariah* compliance. Therefore, trading in derivatives remain very controversial for Islamic financial industry.

3.7.4 Options and futures trade including currency futures

Option contracts, gives one party in the contract rights without any obligation to buy or sell products. This can be structured on any commodities, stock and currencies. It is developed on the basis of *"urban"* sale (down payment). This down payment can be considered from a potential buyer to a potential seller. If the potential buyer decided to complete the sale, the *urban* is counted towards the total price. If the buyer did not complete the sale, he forfeited the down payment which he considers a gift from the counter party. Most of the classical jurists are of the opinion that options are not allowed on the basis of excessive *Gharar*. The *Fiqh* Academy of Organisation of Islamic Conference in their eighth session in Brunei 1993 ruled that down payment sales are acceptable (El-Gamal 2006).

For currencies trading, Islamic scholars are unified in their opinion that the currencies of different countries can be exchanged at spot value only. Trading in currency futures are forbidden on the basis of excessive *Gharar* (uncertainty). Islamic bankers have devised a system by which either or both the parties in the transaction delay their obligation at a future date. Some of these scholars would agree to this form of deferred settlement but the majority would say this is the equivalent to future trading with inbuilt *riba- al-naisa* (Obaidullah 2005).

Following table shows the Islamic products and their Shariah position.

Table 3.2	ISLAMIC BANKING PRODUCTS AND SHARIAH POSITION			
TYPE OF PRODUCT	NAME OF THE PRODUCT	CHARACTERISTICS	METHODS OF OPERATION	SHARIAH POSITION
DEBT INSTRUMENT	MURABAHA	Mark-Up(Costs Plus)	Goods acquired by the bank on behalf of	Acceptable if bank acquires ownership before
			Customers and sold to the customer on	re-sell
			credit at a predetermined Mark -up	
	SALAM	Advance Payment, deliver later	These contracts facilitates Loan	Acceptable for Agricultural Sector
	ISTINSA	Advance order to manufacture	Instalment/part-advance/or deferred payment	
	QARD HASAN	Benevolent loan with	Loan granted without interest but service	Acceptable
		Service Charge	Charges are levied to recover costs	
QUASI DEBT INSTRUMENT	IJARA	Leasing Contracts	Hybrid of Rent and service charges	Allowed if meets with Islamic Leasing Contracts
			works out on the basis of contribution	
PROFIT AND LOSS SHARING	MUSHARAKA, MUDARABAH	Equity Partnership and or	Bank grants Loan on projects	Allowed, Profit can be shared on agreed ratio
		Project Management	Repayments are worked out	Losses must be shared on the ratio of Capital
			Based on base plus Margin	Project Manger should not suffer Losses
		House Purchase	Uses diminishing Musharaka	Acceptable
		Hire Purchase		
CAPITAL MARKET PRODUCTS	SUKUK	loan (ownership) Certificate	investors receives rent instead interest	Allowed if ownership transferred
		with periodic payments		to the investors
	ISLAMIC FUND	Fund invested in acceptable	Receives dividend plus Capital Gain(loss)	Allowed if the corporation generate income in
		Corporations		Islamically acceptable way
DERIVATIVES	OPTIONS	Option to buy/sell with no	Forfeits the premium if option not	Mixed ruling, some consider down payment
		obligation	not exercised	sales are allowed, other consider excessive uncertainty
	FUTURES	Similar to any future trade	Islamic futures are done at spot	Not allowed,
	CURRENCY FUTURES		with both counter parties deferring execution	

Sources: (Literature review)

3.8 Islamic banking accounts

As for Inward Investments, banks offer Current Accounts, Savings Account, General Investment Accounts, Special Investment Accounts, Fund Management, Corresponding Banking Services and other miscellaneous retail banking services buying and selling of foreign currencies, remittances and transfers, safe custody , Trustees and Nominee services.

Deposits are accepted into Current accounts on the basis of *al wadiah* (trust). Banks retain the permission to use the fund while holding them on trust. Customers are allowed to withdraw all or part whenever they need to. The profit banks can generate from such liquid cash holdings are to be retained by the bank.

Savings Accounts are also maintained on the above principle except that by agreement there are withdrawal restrictions and as such banks would share some of the profit they earn with the depositors. As for Investment Accounts, banks become entrepreneurs and accept funds for different maturities on *Mudarabah* principles where similarly to outward investments profit and losses are shared.

The above principle also extends to Special investment Accounts for Large deposits where the distribution of profit can be at a higher ratio with some more restrictions for withdrawals.

Bank offer a variety of Investment opportunities to their customers to be involved with Mutual Funds, Bond Holdings and other Equities.

In corresponding banking services banks take the role of facilitating the services of other branches of the same bank or different banks by advancing the fund from the accounts of the customers and earn commission fees for such services. They also facilitate opening of letters of Credit and facilitate imports and exports (Al-Omar and Haq 1996).

Therefore, Islamic banks can perform all forms of inward and outward banking services in Islamic modes. The main criticism against Islamic Banks is that they do not perform their activities within the spirit of the religion or try to abide by its prohibition. They in fact run interest-based systems embedded in synthetic trade contracts and do not run those affairs as proper Trustees or Agents or entrepreneurs.

3.9 Islamic contracts legality challenged.

The analysis from the court judgments (these are to be found in Appendix-K-) reveals that the Islamic baking contracts are very complex. They are drafted in a way that the defendants cannot get an Islamic *Shariah* outcome. The court considered them as loan agreements in line with conventional banking loans and did not acknowledge any effect of non binding *Shariah* terms in the agreements. This therefore raises the question of transparency and the compliances to Islamic *Shariah*. These landmarks court cases prove that in Islamic banking system, they yet to accommodate *Shariah* based dispute resolution mechanism within the agreements.

3.10 Conclusion

This chapter reviewed literature regarding the issues and concerns of Islamic banking and questioned its rapid development and its compliances to *Shariah*. The initial section highlighted the growth of scholarly writing questioning the *Shariah* compliances of the Islamic banks. The later chapter explained Islamic banking, concepts market, products, development and the political influence that shaped current day Islamic finance. This chapter attempted to bring together all the issues to from the literature reviews and have demonstrated the legal challenges faced by the Islamic banks. The non-availability of Islamic *Shariah* based contract dispute resolutions raises the question of transparency and compliances to *Shariah*. This chapter, therefore, addressed the issues which are the core concerns for the customers of Islamic banks.

Based on existing literature presented in this chapter is sufficient to justify that 'Current Islamic banking practices are superficial, driven by market forces and not by religious convictions'. Also the 'existing environments is an obstacle for the Islamic banks to offer standardised products in a transparent way'. The information in this chapter further highlights that the 'Regulatory shortcomings makes Islamic banks prone to systematic risks'.

No other of the previous study has investigated these issues from the perspective of Islamic jurisprudence, regulatory and legal challenges. This chapter has therefore contributed to the understanding the practices and the core concerns of the Muslim community.

Chapter 4

Corporate and *shariah* governance for Islamic banks

4.1 Introduction

This chapter is an extension of the literature review highlighting the issues of corporate and *Shariah* governances of Islamic banks, Principal and Agent problems which are the central theme of this thesis. To examine the hypothesis that 'Practices of Islamic banks differ from their theoretical foundation and core objectives' this chapter investigates the conflicting nature of transactions within in Islamic banking and finance which is a hindrance on good corporate and *Shariah* governance. While previous studies in corporate and *Shariah* governance although critical about the current practices, did not investigate the contributory factors behind this. This core chapter brings together all issues of concern such as accounting, regulatory and *Shariah* issues which need further examination to understand the governance practices of Islamic banks. Currently Islamic banks are not required to follow any particular regulation or guidelines and are not required to be members of any organisation which are established to address the special needs of the Islamic banks. This chapter, therefore, identifies the regulatory shortcomings which contribute to poor corporate governance.

4.2 Issues of corporate governance in Islamic banks

Good corporate governance is a pre-requisite for sound regulation and supervision. It helps to contribute towards market confidence by strengthening transparency and accountability. Good corporate governance needs good corporate practices at all levels of the operations within the organization. In the Islamic religion accountability and transparency are very much a part of religion. It calls for fairness and justice and equitable distribution of wealth. Therefore for Islamic banking institutions good corporate governance is a religious pre- requisite (Azia 2004:3)

Islamic Financial Services Board (IFSB) Exposure draft in December 2006 identifies that for Islamic bank's *Shariah* noncompliance may make the bank vulnerable to loss of income, loss of reputation and could eventually lead to possible insolvency. As such good corporate governance and adequate supervision is essential to monitor practices to identify any shortcomings. It acknowledges that there is no single model of corporate governance that works well in every institution in every country. It is up to the supervisory board to review the controls and the quality of the internal governances that had been put by the Islamic banks to ensure proper adherence to the regulatory requirements (IFSB Exposure draft 5). It is the responsibility of ISFB to examine all areas of concern and develop appropriate guidelines and mechanisms to ensure that these are followed properly.

There is no set definition of "corporate governance". It has been defined in different ways depending on the areas of concern being addressed. However, The Organization for Economic Co-operation and Development (OECD) has defined it as the *" set of relationships between a company's management, its board, its shareholders and other stakeholders"*. The World Bank ex-President Mr. Wolfensohn calls it *"fairness, transparency and accountability"* (Chapra & Ahmed

2002). Therefore, it is to ensure fairness through greater transparency and accountability.

The corporate governance of the banking sector has been analyzed mostly in the context of the conventional banking market to examine their various conflicting roles. The corporate governance roles in the Islamic banks are different to those of conventional banks. Despite the growing presence of Islamic banks internationally over last three decades very little has been written about the corporate governance of Islamic banks. There are different categories of stakeholders in Islamic banks in addition to their normal conventional banking counter parts.

Conventional banks run on the basis of depositors and borrowers plus other fund managers and general stakeholders including shareholders and corporate social responsibilities. In Islamic banks because the modus operandi requires the bank to work as equity participants and as agents for savers and borrowers, the role of profit maximization for the shareholders and the conflicting interest of working on PLS based for certain investment types makes the issue of corporate governance a major headache and dilemma. In additional to complying with the conventional rules and regulations the Islamic banks are also required to adhere to Islamic Law. These various modes require them to keep the fund segregated as well as not expose the fund to excessive risks to avert the general losses which may jeopardize the returns of various other modes of finance. They are also required to have a *Shariah* Advisory Board that would ensure that the banks activities do not violate Islamic *Shariah* law, corporate governance on the other hand needs to ensure that these compliances do not expose the banks to losses (Suleiman 2000) This agenda sometimes conflicts with religious sanction which they can neither comply with nor ignore.

From the above analysis it is clear that principal and agent problem dominant in Islamic banking. Currently there are unsatisfactory contract arrangements in existence to safeguard the interest of all stakeholders, principal and or agents. These are further complicated for the fact that the position of principal and agent changes with the nature of transaction. The corporate governance of Islamic banking is a shareholder model of, where shareholder out to have control and managers to have fiduciary duty towards shareholders and objectives to the firm is to maximise shareholders wealth. In efficient corporate governance system there should be sound monitoring structure solving the moral hazards and adverse selection problems (Iqbal and Mirakhor 2007). Therefore, Islamic banking system can only improve once above issues are taken into account in contract arrangements and it displays full transparency.

The Bahrain Monetary Agency (BMA) believes that three fundamental steps are required for effective corporate governance and they have directed the banks accordingly. In this banks are required to employ qualified and experienced personnel for key positions. Structural transparency with clearly delineated with reporting lines fully visible with the Proactive Board of Directors who are responsible for overseeing the implementation and the appointment of audit committee (BMA 2002).

The principal and agent problem is much more dominant in Islamic banks compared to Conventional banks as the bank and the depositors swap their role depending on the mode of finance being applied for in individual cases. This calls for the segregation of funds and in many cases the total disclosures of earning and investments.

The contract structures in Islamic Banks are very superficial and nominal. These are not designed to be very robust because of the nature of the relationship. It may not be feasible to draw a satisfactory contract arrangement because of asymmetric information and different and conflicting roles bank and their customers need to undertake. The substantial monitoring expenses will make these products unworkable. The supervisory authorities can take greater role in ensuring that checks and balances are in place to ensure fairness and honesty and the parties operate within the spirit of the contract. There must be a heavy sanction if these are violated. They must ensure market mechanisms are in place to create an enabling atmosphere. The corporate governance of Islamic banks does need to stand up to the scrutiny. One of the pioneers of Islamic Banks, *Sheikh Saleh Kamel* quoted that he preferred to use the word partner to the term customer. According to him:

> "*Those people who place their money in Al-Baraka bank or any other Islamic bank are considered shareholders of these banks. This means if these banks prosper so will they*".

Contrary to this statement, the depositors of Islamic banks are not shareholders. They do not get a share of any profit and nor they are treated as partners (El Gamal

2004 cited from The Daily Star August 15, 2005). Therefore, current form of Islamic banking do not have enough safeguard to protect the interest of the agents and the stakeholders in general.

The corporate governance of Islamic banks is particularly weak in developing countries. There are many contributory factors to this weakness such as poor and inefficient regulation, corruption, weak judiciary, political instability, inadequate disclosures and not comparable accounting and disclosures standards. Banking institutions worldwide, conventional or Islamic are subject to rapid and unexpected volatility in the foreign exchange and securities market. Financial institutions over the last couple of decades have experienced a series of crises which led to the call for a new international financial architectural system which emphasizes improved corporate governance. Islamic banks were not immune from these crises as such without effective corporate governance it will not be possible to strengthen their role internationally (Chapra and Ahmed 2002). To address the principal and agents problems Islamic banks need to improve contract structure and modify products and services in a way that can mitigate these problems.

The Ten Year (2006-2015) Master Plan of IFSB (draft) made 11 recommendations , these included:

- Adequate capitalization, well performing and resilient to enhance efficiency;
- Enhance the effectiveness of *Shariah* and corporate governance and accountability;
- Develop specialized pool of highly competent human capital;

- Promote and develop standardized products;
- Comply with international prudential, accounting and auditing standards applicable to the IFSI;
- Develop appropriate legal, regulatory and supervisory framework;
- Develop sophisticated comprehensive inter bank, capital and derivatives market Infrastructures;
- Promote Public awareness;
- Strengthen international Islamic financial infrastructure institutions and enhance collaboration;
- Foster collaboration among countries offering Islamic financial services; and
- Conduct initiatives and enhance financial linkages to integrate domestic IFSI's with regional and international financial markets.

To achieve the above objectives Islamic financial institutions need to be more pro active, open and transparent at the same time try to adhere Islamic principles in true sense.

4.3 Moral hazards in Islamic banking corporate and *shariah* governance

Islamic Financial Institutions' financial reporting differs considerably from their theoretical models. All assets are treated as co-mingled assets, despite being accepted on different premises. There are significant deviations in asset and liabilities structures. The Islamic banks do not have any firewalls to separate their commercial and investment banking. PLS transactions in practice differ considerably from their theoretical model. There is a danger that losses are not apportioned properly resulting in other funds absorbing these losses. Investment account holders, large or small do not have any governance rights and are not part of any monitoring processes. Income distributions to various classes of stake holders are not consistent.

Islamic Banks operate in a mixed system and pay their investment account holders good and attractive rates irrespective of their profitability and thus other equity holder's returns are displaced. They pay higher returns to their investment account holders irrespective of their income potential to avoid withdrawal risk. These practices raise the question of transparency and information disclosures of Islamic financial institutions. Increased transparency would help robust risk management which would give authentic foundation to Islamic financial intermediation (El-Hawary et al 2004).

The Basel Committee on Banking 1998 have heavily emphasised transparency.

> *"the public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk management practices".*

Therefore transparency is a necessary pre-condition for minimising risk in investment decisions. Errico & Farahbaksh have conducted a study in 1998 on behalf of IMF which highlighted the concern of interest rate mismatch of Islamic banks and that their prudential standards are much neglected. With greater transparency the principal and agents problems can be reduced.

Market competition drives the leniency of *Shariah* boards. There is now a new economic order that has emerged and the world of finance has become unrecognizable. Malaysia has adopted great leniency in interpreting Islamic *Shariah* law. They have taken a dynamic approach on the basis of *Ijtihad* (Islamic reasoning, literally meaning effort) to generate new ideas. A number of research centres were established to generate new ideas and develop new products to tap into unlimited modern finance in the international capital market. In particular the Malaysian *Sukuk* model is very controversial among Muslim scholars from the Middle East who blame Malaysia for abandoning core Islamic values in developing Islamic products.

Islamic financial Institutions have abandoned truly differential products and Profit and Loss (PLS) segment have been abandoned by majority of Islamic institutions. The above discussion shows there is a race to tap into Islamic finances and that the system is prone to Islamic moral hazard. In order to promote systemic stability and economic development Islamic banks must adopt international best practice and resolve unresolved *Shariah* issues and create proper enabling environment (Chapra & Khan 2000, Capra & Ahmed 2002).

There remains a conflict of interest between the bank and their customers. Banks try to find faithful customers and do not assess their creditability and suitability. Religion has been used to justify lending. This then encourages the officials to make connected lending and being an Islamic (religious) financial institutions borrowers try to escape from their obligation pleading hardship and urge banks to forgo their capital. This moral hazard means that payment to an Islamic bank appears at the bottom of their priority. PLS system in late eighties and early nineties proved disastrous as banks trusted people who did not deserve trust. Islamic banking customers had bitter experiences and suffered from the collapse of Bank of Credit and Commerce and Kuwait Stock Exchange during this period and now trades cautiously (Vogel and Hayes 1998).

The Dubai Islamic Bank lost USD50 Million by two employees who granted loans without complying credit terms. When the news spread there was a bank run on Dubai bank and in a single day customers withdrew USD138 Million which was 7% of their total deposit. The central bank then had to come to their rescue. Similar incidents occurred at their West African branch where managers gave USD242 Million in unauthorised loans (Warde 2000). Some consider that Islamic financial activities are immune to scrutiny. The multi-layer legal system has not been developed as yet. There are fragmented Islamic banks across the world and there is a lack of adequate infrastructure for the soundness of Islamic banking. They lack industry wide norms and there are no truly secondary markets to provide urgent liquidity. When banks deal with real estate and work as fund managers and stakeholders for their depositors, this system allows the bank to manipulate financial reporting by inflating profit or hiding the losses. Islamic banks can easily face liquidity crises as their assets are not quickly realizable and discounting would look like *Riba* (interest). Trading in derivatives is very risky and due to lack of investment opportunities banks are resorting to commodities futures and derivatives. These are the products responsible for large losses for both Islamic and conventional banks. The biggest challenge for the regulators is to develop a framework for supervising and regulating the fragmented Islamic banking industry. They need to work urgently for building confidence for market stability and remove fragility El-Qorchi (2005). According to HSBC (Green 2004) Islamic banking is still at a very early stage. It requires maturity sophistication and transparency. He said that:

> *"Islamic Banking is still at early state, there is a mountain to climb and we are at the valley and the road ahead is clear".*

The Harvard Forum of Islamic Finance (2004) 6th Forum called for greater transparency and for standardization of products with uniformity in *Shariah* certification. The main concern within the industry is that it is difficult to compare Islamic banks across the regions. There are no standards in reporting and on *Shariah* certifications. Banks use their in-house advisers which therefore raises the question of conflict of interest. The Accounting and Auditing Organization for Islamic Finance Industries have issued a number of accounting standards but these are not mandatory and not being adopted by the banks. They have been in discussions with regulatory authorities to ensure that the Islamic banks follow a set of standardized procedures but so far have made no progress. The matter has been further complicated by Malaysian Accounting boards which are developing different sets of standards.

The theoretical model of Islamic Banking has developed on the basis of profit and loss sharing. Banks accept depositors' funds as an agents and employ those funds in ventures which should be economically sound. As an intermediary for the funds banks have the knowledge and expertise to choose those business projects which would bring them positive results. On the investment side, banks advance money on a profit and loss sharing mode as well, but the contract terms with the customers are drawn requiring thee customer to give to the bank positive guaranteed returns , even though the customer may be losing on the investments. Therefore the practical deployment of the funds does not have the same characteristics. There is further concern that all ventures do not end up yielding positive return. There are losses and customers defaults resulting in losses for the banks. However, irrespective of the return from the customers on their investments, banks always give a positive return to their account holders. In Islamic finance, especially in *Mudaraba* (silent partnership) contracts the provider of a fund cannot expect both a fixed profit and guarantee of return of the capital. In the case of the customers joining the bank giving them a deposit in terms of Islamic *Mudarabah*, they should not have the guarantee of full return. In strict terms if the venture goes wrong they should lose their capital. However, if this theoretical mode was strictly applied in practice, customers would not bring the fund to the bank. They are coming to the Islamic banks for guaranteed profit and guaranteed return of the capital. Islamic banks must come into the open and engage in a full debate in addition to researching how to overcome this hurdle. A healthy debate and transparency would give them all the credentials they need. Otherwise according to El-Gamal (2006) Islamic banks will remain as a footnote in the history of finance.

There is mismatch as the asset side does not always mirror the liabilities side. Losses are hidden in the system which may give rise to systemic failures. Regulators' do not have enough understanding of these religious requirements to tackle the Islamic banking system head on. In fact in a conference in Dubai 22nd Sept 2003, Michael

Foot the Managing Director of the UK Financial Services Authority (FSA) made it clear that they did not have the ability or the desire to monitor a bank's *Shariah* compliance. He further stressed that the modus operandi of investment account holders should not leave the account holders to take a share of any loss. Bank must guarantee that depositors get full refund of deposited money. They want an outcome equivalent to conventional banking (Foot 2003). This is totally against the Islamic core principal that in order to gain reward, one must also assume risk of loss. The inability of the FSA to monitor the bank for *Shariah* compliance does not help in confidence building by the Muslims are leaving the system open for further abuse . It also shows unwillingness of the regulators to prosper Islamic banking taking into care its core objectives.

Islamic banks are always one step behind conventional banks (El-Gamal 2006) and attempt to mimic conventional banking products in Islamic names. Islamic banking customers, mainly depositors, bring their funds on the ground of faith. If those customers start losing trust in the integrity of Islamic banks there would be systemic and rapid withdrawal of funds resulting in bank runs and a general loss of faith in the sector. For the sake of stability regulators must develop a system to ensure that Islamic banks truly develop this niche market and do not become over ambitious in offering all banking products in Islamic names.

It is noted (Vogel and Hayes 1998) that apart from the fact that Islamic banks mimic conventional banks in their return, these return are always nearer to 5% bench mark which raises doubt as to their theoretical foundation. In developing countries, Islamic banks returns are always mimicking conventional banks base rates and they attract fund by higher bidding. It is a concern that banks use multiple contracts, and their intermediary roles become the buying and selling of goods showing the delivery in the paper work, in reality their connections with goods are theoretical. The mismatch between the theoretical foundation and practical application are a major concern as these go against the core principal of the foundation of Islamic faith and Islamic banks. Islamic banks should not confuse mark-up contract as a profits mark-ups, and should rather list it as interest because it is capped whereas profit is potentially unlimited and not capped (El-Gamal 2006). Islamic scholars have long identified that only in three areas Islamic banks can truthfully operate on the basis of pure Islamic *Shariah* modes and earn profit instead of interest. These are 'trading', 'leasing' and 'direct financing in profit and loss contracts'. These must be real and *Shariah* conformity business and not synthetic notional contracts.

The core foundation of Islamic banking is to offer financial services in conformity to Islamic *Shariah* law. However innovations in the field have shifted the concept from "conformity" to loosely termed "Islamic based" products (The Times Supplement, U.K. April 2006). This is a major shift from the principles of Islamic banking. If the product is based only on Islamic *Shariah* law it implies that it is not necessarily in conformity. There may be certain elements drawn from the Islamic principles. If there is transparency and frank discussion about this, then there will be question of authenticity about the current products if these can be considered Islamic. There may be some good elements in these contracts and such will be more appropriate to call as Islamic Value Banking or banking with Islamic values. It is more suitable to call it ethical and alternative banking, not because it circumvents interest and gives fixed or notional profit to their customers, but rather as it does not get involved in sin and harmful industries. There are also question marks about Islamic banks derivatives activities and whether or not these are ethical as they can be a cause of great uncertainty which have elements of *Gharar*, uncertainty strictly forbidden in Islam and does not form a part of ethical investments. Islamic banks acquires fund from the Current account holders on the basis of Trustees with the permission to use the fund at their discretion without giving any benefit to the account holders. The use of these funds in derivatives increases the principal and agents problems as these are highly speculative transactions, where bank may lose to the extent that they are not able to refund the depositors. The agents have no control or check and balance towards the principal.

Islamic banking should stand for social development and move away from current form of greed banking. If it is to advance money for social development its impact would benefit future generations. Islamic banks should reinvent themselves and move away from the current greed banking and invest in disadvantaged fields which would re-generate society and would give the banks incremental and ethical returns. Current forms of Islamic research are market driven and bankers are busy in devising systems quickly to follow conventional banking products as soon as any new product is launched. Islamic banks should encourage research for the development of pure *Riba* free Islamic banking alternatives instead of trying to circumvent the prohibitions. They should actively consider promoting on the basis of permissibility and not to promote the prohibited and offer alternatives to those prohibitions. If Islamic bankers are able to devise such a system transparent in every respect, most of the Muslim community would be attracted towards Islamic banking. The potential for such a system would be huge and would be long lasting and sustainable in every respect. The current poor take up of Islamic banking by the Muslim customers proves that the current form of Islamic banking is considered by the grass-root Muslims as being a system devised for rent seeking in the name of religion by *Shariah* arbitrage.

Grameen Bank in Bangladesh does not claim to be Islamic or interest free but its structure of small scale lending to the customers who are not credit worthy but otherwise enterprising has revolutionized the micro credit field. Its founder has been awarded the 2006 Nobel Prize for peace for its achievements of social re-generation in removing poverty which has attributed as an achievement of peace. The Nobel Committee recognized the impact this had in reducing hunger and thus attributed it to peace, as there can be no peace if there is hunger. Similarly Islamic banks can find its way to micro-lending for social advances which will be both ethical and Islamic because it can truly charge profit instead of interest and will not have be linked to base rate returns. They can develop products on equity participation and can move away from current questionable type of products to a product which would more closely resemble Islamic ideas and spirit. A study by Alam (2003) of small cottage industries in Bangladesh found that there remains tremendous opportunities for the Islamic banks to develop saving habits as well as a mobilization of funds in Islamic mode of finance for social re generation at the lower end of the enterprise. His study showed that Islamic banks current activities in this sector lack enthusiasm and current participation is at very scant level and presently there remains no mechanism for savings for small scale customers. For this reason most of the small and cottage industries customers to borrow from local money lenders at very high rate of interest. This research shows that investments in small and cottage industries sector can be a way forward for Islamic banks. From these findings it can be argued that currently customers pay a very a high rate of interest to local money lenders they will be very encouraged to a more just and equitable investment from Islamic banks on profit and loss sharing modes. This will go in line with the vision of an Islamic scholar Al- Gazzali nearly a millennium ago who argued for development through social justice (Mehmet 1997).

4.4 Accounting and auditing issues

The functions of conventional accounting and Islamic accounting differ quite considerably due to the fact that the conventional accounting model was developed on Anglo-American accounting practices which deal with the identifying, recording, classifying and interpreting of economic data to permit users to make informed decisions. There are different criteria of measurement and recognitions set out by the Accounting and Auditing Standards. Islamic accounting also deals with the above function in addition to classifying financial data they need to ensure that the transactions are recorded and reported within the boundaries of Islamic *Shariah* law. The recognition and measurements of this data have different objectives and the stakeholders of the Islamic financial institutions are also vastly different from those of conventional banks. As such Islamic accounting is a process which must address the requirements of all the different stakeholders group and to have due regard to principal and agent problem. They further need to ensure that their reporting standards are in line with other financial institutions and regulatory requirements. These requirements are which are mostly conflicting within the core objectives of Islam as such Islamic accounting is complex and therefore, it is challenging to produce financial reports in the dual regulatory atmosphere. Accounting principles and standards were developed on the basis of conventional debtors and creditors principle; therefore, these principles do not suit the requirements of Islamic Financial Institutions. In Islamic banks, the relationship between customers and the banks varies. For most of the deposit accounts the relationship is one of a trustee and agent relationship. For loans, depending on the type of loan, the relationship can be partnership, trustee or agents, entrepreneurs, managers etc. Therefore, normal debtor and creditor relationships are not appropriate. These types of debtors and creditors relationship distort the core principles of Islamic finance and give rise to principal and agents problem. The development of an Islamic Accounting Standards is required for accurate reporting of the financial affairs in order to reflect proper "true and fair value" of the Islamic financial institutions within the boundaries of Islam. This would give investors the proper tools to analyse the strengths and weaknesses and thus can improve transparency and confidence and mitigate principal and agents problem.

At the initiative of IDB, Accounting and Auditing Organisations for Islamic Financial Institutions (AAOIFI) was established in Bahrain in 1991. By the end of 2002 it had issued 18 financial accounting standards. It has also issued guidelines for the calculation of the Capital Adequacy Ratio for Islamic banks. It has also issued 13 *Shariah* Standards (IOSCO 2004). These standards are not mandatory for the Islamic banks which creates an arbitrage opportunity and does not help in standardisation and or transparency. AAOIFI's standards were adopted by Bahrain and Sudan. However Qatar's central bank issued local accounting standards based on AAOIFI's pronouncements and in Saudi Arabia supervisory authorities issued circular for the Islamic banks to be guided by AAOIFI's standards (Ahmed Eds Archer and Karim 2002). The Malaysian Accounting Standards Board has produced an Islamic Accounting Standard for the presentation of Financial Statements. They have also issued an exposure draft relating to a *Ijarah* (Islamic Leasing) (Rob and Mannix 2004). These are quite significant steps towards developing suitable standards to eradicate conflicting reporting as their operations do not reflect their reporting accurately. If Islamic banks continue to report in a conventional reporting standard their purpose will be defeated and they will turn into a conventional bank. This is a very pressing task that bankers and regulators must address quickly to ensure greater transparency and long term sustained stability.

4.4.1 Accounting and accountabilities issues in the Islamic religious context

Accounting is central in Islam because the Islamic faith reminds its followers that one has to give full accounts of ones activities to God. Many parts in the *Quran* and numerous *Hadith* refer to the requirement to give full measure and not deprive others. In fact in the Quran *Sura* (11:85) command to give full measure and weight. Reliable information must also be presented correctly and fully including the details of all the transactions undertaken (Lewis 2001). It is therefore central that truth, honesty, accountability and transparency form the core principles of Islam. In fact the *Quran* dictates that the transactions are recorded fully and properly. This would thus enable every party to have all their rights and obligations clearly understood and not forgotten or to avoid doubt and disputes.

There are six verses in the Holy Quran that refer to full disclosures (2:71) " *now you have brought the truth*" (4:135) " *Be maintainers of justice*" Payment of *Zakat* need full accounting disclosures of assets and liabilities. With respect to contract law the Quran Dictates " *O you who believe, fulfil all obligations*" (5:1). Therefore, Islam is a religion where accountability and transparency matters.

> *"believers , when you contract a debt for a fixed period, put it in writing. Let a scribe write it down fairly.... And let the debtor dictate, not diminishing the sum he owes"* (*Quran* 2:282) .

> *"never get bored with recording it, however small or large up to its maturity date, for this is seen by Allah as closer to justice, more supportive to testimony and more resolving to doubt".* (*Quran* 2:282)

The current lack of full disclosure, and mismatch in reporting standards will give rise to principal and agents problem.

4.5 Risks in Islamic investments

Islamic investors have higher risk tolerances compared to conventional diversified investments. This is due to the fact that the investors enter into new and innovative products without much of a track record. Secondly most Islamic countries have similar risk factors for example they are politically unstable, have high corruption, weak currencies etc therefore these do not give them well balanced diversification.

Thirdly due to lack of standardised products and the lack of efficient secondary markets the Islamic stocks are mostly buy and hold, they do not offer much liquidity or quick get out options (Hamwi and Aylward 1999). In recent days Middle Eastern credit risks are becoming more appealing for European investors. They find modern Islamic *Sukuk* risk-wise more acceptable and conventional customers are the largest subscribers along with fund managers and institutional investors (Box 2005) International energy projects are turning towards Islamic finance in *Sukuk* structure which are favoured for long term infrastructure developments easier to adapt in *Shariah* style of underlying assets generating profit instead of interest (Gordon 2005). There should be adequate safeguard to ensure that the *sukuk* Special Purpose Vehicle (SPV) do not become worthless in economic down turn while the users of the fund are immune from losses by the multi layer contract mechanism. This mechanism allows the speedy liquidations of SPV without effecting the parent company. In such a situation *Sukuk* participants stand to lose out without recourse to the principal.

4.6 Risk management and regulatory issues

Due to the special nature of Islamic bank's transactions which are needed to be *Shariah* compliance, the nature of these transactions is varied. There is virtually an unlimited number of ways Islamic banks can provide funds in any modes of finance, PLS and otherwise. These pose special challenges for regulators identification, the measurement of risks and the control of underlying risks. There are issues that are needed to be addressed by the regulators in respect for income recognition, adequacy of collateral, and disclosure standards. Islam encourages PLS modes of finance but this form of finance has been identified as most vulnerable for the banks. It is difficult to assess recognizable defaults until contracts expire. The default of a PLS contract means that the project has failed with many consequences to address. In the case of *Mudarabah*, the bank is only entitled to receive capital back at the end of the stipulated period and only if there was profit. In the case of losses, the bank cannot recover its loan fully as the entrepreneur is not responsible for losses. In this type of contract a bank cannot control the business and can only see the end result. However in *Musaraka* contracts banks can control the business but such form of investments are negligible.

Financial contracts involving purchase with deferred delivery banks face both credit risks and commodities risk, being sold in advance to cover at future date. Banks also carry substantial risks in investment deposits whose capital value and rate of return is guaranteed. Unrestricted *Murabaha* contracts have moral hazards as banks are free to use the fund at their own discretion.

Banks are also constrained by *Shariah* regulation in risk hedging and thus Islamic banks are more vulnerable then their conventional counterparts. Regulators need to understand these risks and the many other risks that banks face in their overall operations. Regulators need to put into place proper internal controls and monitoring. They must also put in place a reliable *Shariah* litigation system to enforce defaults (Sundarajan and Errico 2002). The Basel Committee of Banking Supervision standards are thought to provide essential guidance but are not totally appropriate for governing Islamic banks. Prudential supervision of Islamic banks in the western countries pose additional problems because of the dominance of regulation focusing upon the traditional banking market. It is a further challenge that Islamic finances are growing faster in the west which is outside the traditional borders of Muslim countries (Errico and Farahbaksh 1998). The establishment of the AAOFI and IFS Boards can address the above issues and develop standards and ensure that these standards are complied with adequate transparency and accountability. The harmonisation of the products and practices would greatly assist the recognition and measurement and reporting standards of Islamic banks (Grais and Iqbal 2004).

4.7 Regulatory oversight

The following organisations are currently active in developing Islamic banking and finance structures to comply to Islamic *Shariah* law. They have developed various standards and they issue guidelines to the institutions. However, these are not binding on the Islamic banks as yet.

4.7.1 Auditing and accounting organisation for Islamic financial institutions (AAOIFI)

This was established in 1991 by major Islamic banks based in Bahrain. It was established to develop a core set of accounting and auditing, governance and *Shariah* standards. It is a self regulatory body which does not have the power to enforce its standards. Decisions are taken at national level whether or not to implement its standards by the Islamic banks. It has developed many standards as complementary to international accounting standards but not as a replacement of them aiming to fill the gap of convergence between conventional and *Shariah* recognition and reporting standards.

It is also working towards standardising the functions of *Shariah* boards and to develop and implement *Shariah* standards by harmonising the *Shariah* ruling across the world where Islamic baking being practiced (Iqbal & and Mirakhor Eds Archer and Karim 2002).

4.7.2 Islamic Financial Services Board (IFSB)

The IFSB was established by central bank governors where Islamic banking is practiced. It is based in Kuala Lumpur, Malaysia. It has the similar role of Basel Committee on banking for the regulation and supervision of Islamic banking. Its role is to promote uniform regulatory and transparency standards similar to Basel Committee standards. The establishment of IFSB is being encouraged as a right step for the sound development of Islamic banking (Bank of England, Iqbal & and Mirakhor Eds Archer and Karim 2002).

4.7.3 Islamic Development Bank (IDB)

This is a multilateral financial institution designed for economic development and social progress in its Muslim Member countries (OIC) and for Muslims in Non Muslim countries. The IDB provides financial assistance on Islamic modes as well as Interest Free Loans (grants) for projects and also assists in promotion of foreign trade among member countries. The IDB also established Islamic Research and

Training Institute (IRTI) to facilitate research in Islamic economics, finance and banking. The performances of the IDB have been below expectation. It is rather slow in recognising the need for investments into the development of infrastructure finance where some of its member countries are in desperate need of development projects (Iqbal and Mirakhor Eds Archer and Karim 2002).

4.7.4 The International Monetary Fund (IMF)

The IMF has contributed to some extent in the development of Islamic banking and finance. It took interest when in early 1980 Iran and Pakistan decided to change their banking system to Islamic *Shariah* basis. The IMF has initiated research concerning the foundation of Islamic finance, the operations of Islamic banking and the conduct of monetary policy within the Islamic system. They further initiated technical assistance and knowledge sharing with the central banks of Islamic countries where Islamic banking was practiced. Its efforts have resulted in Muslim countries establishing multilateral institutions to facilitate co-operation to develop the Islamic money market, Islamic capital market and international Islamic banking and financial supervisory and standard setting organisations.

4.7.5 The World Bank (WB)

In line with IMF the World Bank also took interest in the development of financial markets. The bank works closely with member countries where Islamic banks were practiced to share knowledge and experience to develop the legal, regulatory, accounting and supervisory infrastructure. The World Bank guaranteed the protection of foreign commercial interest in the event their claims become prejudiced by Islamic *Shariah* Convention. This was known as "*Shari'a* event" protection which played a major part in the mix conventional and Islamic financing in single project structure. The International Finance Corporation (IFC), a private sector arm of the World Bank is involved in financing some USD7 billion in infrastructure projects in developing countries (Malas, 1997 Hamwi & Aylward 1999 cited Iqbal & and Mirakhor Eds Archer and Karim 2002).

The above organisations can play a very important role in sound development of Islamic banking by creating enabling atmosphere and by adapting regulations in which Islamic banks can prosper. The changes in regulation will aid the Islamic banks to reduce the conflicts between corporate and *Shariah* governance and reduce principal and agents problem. They must make it mandatory that these regulations are to be adhered with sanctions for no compliance. Such an oversight will bring public confidence and will, therefore, aid in developing a sound Islamic banking system.

4.8 The role of central bank in regulating Islamic banks

The Islamic banking regime falls under dual regulatory framework, Islamic and conventional even though Islamic banks' risk profile is quite different than conventional banks. They are subject to same prudential regulation as well as *Shariah* supervision in some Muslim countries, where central bank took additional role by creating special Islamic banking Act or by extending the current regulatory frame work under a special desk to deal with Islamic banks only. In the western countries, there are no special rule applies for the Islamic banks (Warde 2000). Islamic banks works on the principles of co-investors rather than providers of fund and the level of risks varies under different modes of finance, therefore, risk weighing under Basel Accord does not represent their risk category adequately. In Sudan, central bank effected certain adjustments to the accord to cater for the peculiarities of Islamic banking transactions with respect to capital adequacy and risk weighing (Hassaan 2004). Under Basel II Accord 2000 , the pillar 2 – Supervisory process, require close partnership between banks and their supervisors. Supervisors are required to be more familiar with the sophisticated techniques developed by the banks to assess and control their risks. Under this new accords the role of the supervisors are more challenging (Crouhy, Galali and Mark 2001) in understanding the risk of various instruments bank use. The recent banking crush worldwide suggests that the regulators have failed in understanding the sophisticated risks various banks were exposed to. Though during current banking crises the Islamic bank did not suffer as much as their conventional counterpart because their risk profiles are different. During the last recession Islamic banks suffered significantly more which were mostly blamed for lax regulation (Warde 2000). Therefore, regulators need to understand the Islamic banking risk profile adequately to cater necessary supervision techniques. The most popular Islamic banking investment instrument *Sukuk*, came under heavy *Shariah* scrutiny recently, as a result Islamic *Sukuk* market fell over 50% in a single year (Gulf News, 15th Sept. 2008). This is, therefore, a special area heavily intertwined with the conventional market, which need urgent attention by the regulators.

The role of the central banks is the prudential regulation ensuring that Islamic banks are sound; this would include the risk management of Islamic banks. Unlike conventional banks, the risk management of Islamic banks also include to examine the Shariah non compliances risks. All banks large or small rely on to the central banks as a lender to the last resort. Central banks can fulfil this obligation for the conventional banks without any difficulty by providing the liquidity needed. The Islamic banks cannot avail short term finances from central bank on interest or cannot discount the bills as both will look like involving in interest based activities. For this reason, in many regions, specially in Bangladesh, the central bank has created an un-official Islamic interbank money market to absorb additional money and or to inject necessary fund by means of Islamic *Murabaha* (costs plus) bond. This bond is administered by the central bank as such the question arises about the role of central bank in ensuring that the income from Islamic bond complies with Islamic Shariah law, to ensure that resultant income is *Halal* (Islamically acceptable). Therefore, in the regions where Islamic banks are significant part of the banking sector, regulators need to ensure that prudential regulation would include ensuring *Shariah* compliances by the bank to eliminate the systemic risk that can erode the confidence in this sector thus affecting the banking sector as a whole.

4.9 Conclusion

This chapter identified the core players in corporate and *Shariah* governance of Islamic banks and how their interaction would help improve governance. It highlighted the inherent principal and agent problem within the nature of Islamic banking transactions and the obstacle posed by accounting and reporting Standards, which follow ISA, developed for conventional banks. It also explained that a poor regulatory atmosphere in developing countries allow the Islamic banks to take regulatory arbitrage opportunities which increase the moral hazard. The Islamic banks asset and liabilities are not matching and as such these institutions are exposed to a greater impact of economic downturn, which by the analysis of the last economic downturn has proved effect Islamic banks in comparison to conventional banks. The information along with the literature presented in this chapter justify or conclude that "practices of Islamic banks differ from their theoretical foundation and core objectives" The accountabilities of honest management and reporting were highlighted in religious context.

This chapter concludes that current regulatory efforts need to be harmonised and regulatory agencies must create an enabling atmosphere for Islamic banks while also having enforcement powers. In the absence of such efforts, the banks would attempt to benefit from regulatory and *Shariah* arbitrage opportunities. Where such arbitrage opportunities prevail, banks would not be inclined for providing full transparency which will therefore, be an obstacle for good corporate and *Shariah* governance.

Chapter 5

Research methodology

5.1 Introduction

The literature review and the examination of other studies in Islamic banking and finance have shaped the research methodologies as well as the site selection for this research. This chapter discusses the methodologies used for the case studies and the data collection within the context of the Islamic banking environment. A mixed method research approach was adopted combining both case studies and customer surveys. Multiple Logistic Regression and Ordered Logistic Regression models were used for data analysis. No other previous research has used this techniques to analyse Islamic banking customers' satisfaction.

5.2 Statistical methods for data collection and analysis

Due to four different Schools of thought in Islamic jurisprudence, banking practices have developed along these religious lines. Because of the convenience of information collection and examination (or verifications) of existing and previous practices of Islamic Banking, four areas namely, Malaysia, Bangladesh, Dubai and UK have been selected as study sites for this thesis. Relevant information on each of the four study locations and financial institutes will be analyzed independently by treating them as separate but linked case studies.

Case study is one of the most popular methods used by researchers both within qualitative and quantitative paradigms for research projects. It is a very useful way to study phenomenon to examine the real world. A case study approach uses multiple means to collect data. It can focus on a single unit or multiple units. This way, researchers can try to study both the underlying process and the context in which they took place.

The Islamic Finance industry is quite a newly developed sector. This market has not reached maturity as yet. Therefore this research will take a multiple approach to present and compare the findings from four different locations on various levels. This research will employ both qualitative and quantitative and mixed methods research.

According to Creswell and Clark (2007)

> *"Mix methods research provides more comprehensive evidence for studying a research problem than either qualitative or quantitative research alone. Researchers are given permission to use all of the tools of data collection available rather than being restricted to the types of data collection typically associated with qualitative research or quantitative research. Mixed methods research helps answer questions that cannot be answered by qualitative or quantitative approaches alone."*

During the first stage of data analysis, all the collected information (both qualitative and quantitative) from four locations is presented in both an explanatory and descriptive format for each location. These case studies will assist in understanding the internal and external views of Islamic finance in respective contrasting regions or areas. During the second stage, summarized information on each of the case studies are compared to one another.

The validity of these studies is examined by triangulation methods (e.g. data triangulation, theory triangulation and methodological triangulation). According to Creswell (2003), Guion (2002) and Jick (1979) triangulation of both qualitative and quantitative studies improves validity by overcoming weakness. Researchers can overcome biases associated with any single method by applying mixed methods which neutralize the biases of the other methods.

During data triangulation (involving the use of different sources of data/information) each stakeholder group was interviewed to gain qualitative and quantitative information. This has assisted in gaining an insight of each stakeholder groups' perception and captures their uses of Islamic banking. Representatives of each stakeholder group were also interviewed separately. All this information and data are triangualised to establish and inform the thesis.

Theory triangulation (involving the use of multiple professional perspectives) takes a single set of data and it interprets it from different professional perspectives to find the similarities in the findings. This was used to support in further establishing the validity of this thesis.

Methodological triangulation (involving the use of multiple qualitative and/or quantitative methods) takes different methods, surveys, interviews, observations, document analysis or any other feasible method to be applied. If the conclusions for all these different methodologies are the same, validity will be established. Triangulation methods will also enable an understanding of the research problem from the numeric trend generated from quantitative research and the details obtained from qualitative research. In this research quantitative approaches will be used to obtain statistical results from samples and then follow up of those results for in depth study of the problem. First order facts are to be collected from field observations to enable an understanding of how elements of religion and culture effects financial decisions. Theoretical concepts will also assist in a better understanding of the data. This research will take a hermeneutic approach; therefore, data collection and analysis are intertwined which will shape each other in the progress of this research. The process of triangulation can be applied until a sufficient and better understanding is achieved by focusing on the research problem.

If any areas are found to be successful or failed in Islamic Banking, an exploratory analysis will be used to examine the contributing factors behind the success or failure of the identified institutions. Finally, this study will draw conclusions based on the findings from the case studies of the four locations and empirical data from the existing literature. It will also discuss organizational practice and culture.

This research is based on four sets of closed ended Questionnaires. According to (Davis 2002) :

"questionnaires survey provides the broad scope and the respondents may be more honest in answering due to anonymity and it has high external validity It provides accurate results due to large sample size. Typically it has very low response rate."

The advantages of using closed ended questionnaires are that this technique is easier and quicker for the respondents to answer. The answers of different respondents are also easier to compare. In addition to this the use of closed ended questionnaires are easier to code and statistically analyse (Neuman 2006:287). Questionnaires surveys are useful to target a selection of population and are the least expensive approach. Questionnaires survey allows the researchers to use questions which are multiple choice and numerical open end. The rating scales and agreement scales are two common types of questions researchers' use, as multiple choice question and others are treated as numerical questions.

To cover all the specific research questions, a series of structured questionnaires have been used for *Shariah* advisers, Bank Executives and their Marketing Department respectively. Leaders of the mosques and Islamic Centres at each site were asked about their perception of current Islamic banking and their view on how to improve the image of Islamic Banking and Finance. Questionnaires were designed to gather their views about the transparency of the system. All these questionnaires were designed with the co-operation of the supervisors and based on expert opinions in the relevant field. A further set of questionnaires were sent to all major Islamic banks in line with IOSCO 2004 (Questionnaires are presented in Appendices 5.1 to 5.4).

To cover the specific research questions four sets of questionnaires are designed. These are for the Customers of the Islamic banks, for the Members of the *Shariah* Board of the Islamic banks, for the Islamic banks and for the Regulators. These questionnaires were designed to investigate the issues and concerned addressed in this research. The questionnaires themes were drawn from other studies carried out by researchers previously in this area. These include *"Islamic Banking: a study of customers satisfaction and performances in Jordan*" Naser, Jamal & Al-Khatib (1999), Islamic Development Bank Occasional paper No 6 *"Corporate Governance in Islamic Financial Institutions"* Chapra & Ahmed (2002), *"Islamic Capital Market Fact Finding Report"* (IOSCO2004) and other studies carried out in in Bahrain (Metawa & Almossawi 1998), Bangladesh (Hassan 1999) and Singapore (Gerrard & Cunninhgham 1997).

The survey questionnaires were structured to cover the following areas:

- Regulatory frameworks concerning *Shariah* compliances and customers' protection.
- Investment return and services including bank deposits and bank finances, accounting and reporting framework.
- Customers' experiences and expectations on *Shariah* related matters and transparency.

These questionnaires addressed all the issues and concerns of this thesis concerning Islamic banking and finance. These questionnaires are in line with our overall aims and objectives and were structured in a way to allow analysis using logistic regression model and ordered logistic models.

A pilot study was conducted using Customers Surveys and the questionnaires were moderated accordingly. These questionnaires were further moderated by all of my supervisors. The views of Islamic scholars with experiences in Islamic banking were consulted. Their returned questionnaires were also included in the analysis.

5.3 Methodological justification

Due to four schools of thought in Islamic jurisprudence, the banking practices have developed along these religious lines. Therefore, this research undertook to collect samples to represent the four schools of thought and the region in which Islamic banking are developing faster. This research therefore; has considered Bangladesh, Malaysia, Dubai and U.K. to be important regions for study.

The term 'methodology' refers to following: a well defined path in order to achieve a given end. On a technical term it refers to the "technical procedures of a discipline" (Caws 167 cited Chapra 1996). The methodology process provides criteria for the acceptance and rejection of research programs (Blaug 1980 cited Chapra 1996).

This research would develop on the basis of methodological pluralism because it will be futile to look for a single method for accepting or rejecting a hypothesis.

(Cladwell 1982 cited Chapra 1996). This is because according to Klamer, (1984: 234 cited Chapra 1996) theoretical disagreements remain unsettled despite the accumulation of empirical evidence. According to Klamer (1984)

> *"Economics involves the art of persuasion. In the absence of uniform standards and clear cut empirical tests, economists have to rely on judgments and they argue to render their judgments persuasive. This process leaves room for non-rational elements such as personal commitment and style and social discipline".*

According to Siddiqui (1988 Cited Chapra 1996) :

> *"Islamic tradition in economics has been free of formalism, focusing on meaning and purpose with a flexible methodology"*

The Islamic paradigm is well defined by the Quran and *Sunnah.* However, everything has not been spelt out in the *Quran* and *Sunnah,* leaving room for *Ijtihad* (human reasoning) which is a part of Islamic *Shariah.* The formation of Islamic economics originates from understanding of *Quran* and *Sunnah,* therefore economists can make a great contribution by evaluating their hypothesis against Islamic *Shariah* and its reasoning. From the above reasoning emerges a second important methodology- to evaluate the hypothesis in the light of the rationale and the teachings of *Shariah* through logical reasoning. There is a serious rationale behind every value or institution in Islamic *Shariah* (Chapra 1996).

A third methodology is the testing of the various hypothesis derived against historical records and available data to the extent possible. Dr Naqvi (1994:xxi cited Chapra 1996) argued that:

> *"Muslim economists" should be ready to subject their theories to the toughest tests, and to discard old theories once enough contrary evidence a priori or empirical, becomes available. The aim should be scientific progress in Islamic economics"*

Another view forwarded by Zaqra (1986) is that Islamic economics need not hesitate to use the techniques of testing and tools of analysis of conventional economics and social sciences,. All of these may not necessarily have their roots in the secularist's paradigm (cited Siddiqui 1996). Islamic economists may also adopt conventional economic theories so long as they do not conflict with the logical structures of Islamic *Shariah*. Besides the divine revelation of *Quran* and *Sunnah* the experiences of the Muslims worldwide and the non-Muslims societies can be taken as well as logical deduction can be taken as a source (Chapra 199).

It is not against the Islamic faith to test hypothesis against the *Quran* and *Sunnah*. In fact the *Quran* itself emphasizes such testing. Even the Hypothesis that:

-The *Quran* is the word of God

is falsifiable because the Quran has it itself opened it to the falsification challenge by challenging mankind to produce something equivalent in terms of its linguistic beauty, force of logic and quality of teaching (*Quran* Chapter 2:23, 10:38, and 17:88). Even after 1400 years the challenge has not been met and the hypothesis remains un-falsified. In many places in the *Quran*, it asks human beings to look at the historical record of past civilizations which uphold the truth and positiveness of its normative theories. The *Quran* revealed (Chapter 3:137).

> *"Go then, around the world and see the ultimate fate of those who rejected the truth"*

Accordingly the *Quran* considers its normative theories to be testable against facts.

According to Ibn Khaldum (Mluquaddimah 1, 2 cited Chapra 1996):

> *"past resembles present just as water resembles water"*

He further asserted that:

> *"social phenomena seem to obey laws which, while not as absolute as those governing natural phenomena, are sufficiently constant to cause social events to follow regular, well defined patterns, and sequences. Hence a grasp of these laws enables the sociologists to understand the trend of events around".*

He further believed that:

"these laws can be discovered by gathering a large number of facts…… from records of past events and observation of present events"

(*Ibn Khaldun* Cited Chapra 1996).

According to Shah Waliyullah :

" cause and effect relationship that God has established in the universe as well as human life is a manifestation of His wisdom. It shows that he does not operate arbitrarily. He rather acts in a methodological and systematic manner that benefits His Wisdom."

The above is also supported by number of *Quranic* verses (Chapter 33:62 and 48:23)

"And you will never find a change in God's Sunnah or set pattern"

which shows the irreversibility of the cause and effect relationship established by God. This wisdom is reflected in all normative theories of Islamic *Shariah* (Chapra 1996:42).

5.4 Data collection

The data was collected between November 2007 and April 2008. For case study in Bangladesh three banks were selected, with each bank having a Head Offices in Dhaka. These banks were selected on the basis of their network coverage, age of the bank, its capital and customers base. These three different banks had three diverse backgrounds and histories. One bank is a very old established bank with local and foreign promoters from Islamic and Arab World. The second bank is a fully sponsored by the local investors and is in business for over a decade. The third bank selected has a good capital base and was converted from conventional to Islamic bank. This study has therefore benefited from the experiences of three different types of establishment with different corporate governance structures.

The Customers survey was drawn from randomly selected branches of these banks branches in Dhaka. The customers were approached as they were leaving the bank and on average one in five customers agreed to take part in the survey. Customers were hesitant to take part in the survey thinking they may be the target of Government Agencies. However after being shown credentials some customers agreed to take part in the study and have also agreed to provide their contact details in case there are further queries that may arise from the responses. The sample collection was undertaken with the help of a research company in Dhaka who assists various establishments from local organisations and abroad in collecting data in Bangladesh. The staff of the organisation mainly had post graduate qualifications. I met them over a few days to explain the research questions fully so that they were completely aware of the research's motives and objectives. I personally visited the interview site to monitor the progress and I was available for consultation during the survey process. After each day of interviews I met the interviewees again to discuss any issues and concerns raised by the respondents.

Similarly Malaysian samples were conducted through the offices of the same research company who has connection in Malaysia. The interviewees were students of Bangladeshi origin who were studying at post graduate level at various Universities in Kuala Lumpur. At first of all the interviews were attempted to be conducted outside the bank premises but problems arose as the bank authorities did not want the interviewees to ask any question to their customers outside the bank. Therefore, the interviewees have selected Mosques and Islamic centres for their interview and data collection.

The Dubai samples were collected with the help of a Dubai based Islamic Bank employee who asked the staff of the bank to fill the questionnaires. This is therefore a sample of the employees of an Islamic bank, rather than the samples of a population. This therefore has presented as a separate case study of bank employees. This provides the customers views who are also connected with the bank. This is quite unique as this reaches a different cluster of population which no other survey has previously been able to reach.

The U.K. survey was conducted by sending questionnaires to the Imams of various Islamic Centres throughout the Country to get responses from the peoples who come regularly to the Mosque to attend prayers and are customers of Islamic banks. A total of 207 questionnaires were sent during the same period and only 27 responses were received. This survey has, therefore, included the views of pious Muslims who represent a different but very important cluster of Islamic bank customers. These are also presented separately.

5.5 Data analysis

Statistical analyses were carried out using SPSS for Windows (Version 16.1). For entry purposes both SPSS and MS Excel were used. To check the inconsistency of the data (skip errors, missed answers, values out side the range), frequency distribution for all question items have been checked and corrected (if required). Some cross tabulations were also carried out particularly to look at 'skip questions'. Once all the errors had been corrected data were saved as new master file for statistical analyses. Univariate (frequency distribution), bivariate (cross-tabulations), multiple logistic regression and ordered logistic regression analyses were used to explore the association of socio-demographic characteristics and the satisfaction of Islamic banking related services. For the purpose of interpretation and to ensure meaningful results, some of the questionnaire items were grouped into broad categories (age, usual occupation, level of education, etc.). The results of univariate and bivariate analyses were expressed as percentage and chi-square tests were used to examine group differences.

Multiple logistic regression analysis and ordered logistic regression were used to explore the independent contribution of each potential explanatory variable on 'satisfaction of Islamic Banking services'. Adjusted odds ratios (OR) from logistic regression analysis with their associated 95% confidence intervals (95% CI) express the likelihood of satisfaction for each explanatory variable adjusted for the effects of other variables. Only those variables found significant in bivariate analyses were included in the logistic regression model. To avoid multi-colinearity, highly correlated variables were excluded from the logistic regression model. The details of multiple logistic regression and ordered logistic regression models are described in respective chapters.

5.6 Model specification and variables selection

One of the primary objectives of this study was to estimate a comprehensive model for the probability of satisfaction on Islamic bank related service. Following the analytical framework/literature discussed earlier, this section examined the association of socio-demographic characteristics and satisfaction of banking services. The dependent/outcome variable used in this study was 'Satisfaction on Islamic banking services' which is a dichotomous variable (takes two values e.g. 1 for 'satisfied' and 0 'not satisfied'), in this situation multiple logistic regression analysis has been commonly used to explore the independent contribution of each potential explanatory variable on dependent variable adjusting for other variables (Hosmer & Lemoshow 2000).

In general the multiple logistic regression models can be expressed in the following equation:

$$p_i' = \log_e(p_i/1-p_i) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_k X_k \quad \ldots\ldots\ldots\ldots \quad \textbf{(5.1)}$$

β_0 is the constant, $\beta_1, \beta_2, \ldots, \beta_k$ are the logistic regression coefficients and $X_1, X_2, \ldots, X_k$ *are* k explanatory variables.

The concept of logistic regression is different to the multiple regression models. Let Y_i denote the dependent variable for the 'ith' observation where Y_i = **1** if the 'ith' individual is success (satisfied), and Y_i = **0** if the 'ith' individual is failure (not satisfied). Suppose that for each of the individuals' **k** explanatory variables X_{i1}, X_{i2}, ..., X_{ik} are measured. These variables can be either qualitative or quantitative. In this model, the dependence of the probability of success on explanatory variables is assumed to be:

$$P(Y_i = 1) = p_i = 1 / [1 + \exp\{-(\beta_0 + \beta_1 X_{i1} + \beta_2 X_{i2} + \ldots + \beta_k X_{ik})\}] \quad (5.2)$$
$$= [1 + \exp\{-(\beta_0 + \beta_1 X_{i1} + \beta_2 X_{i2} + \ldots + \beta_k X_{ik})\}]^{-1}$$
$$\text{Thus} \quad p_i = [1 + \exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1}$$

Similarly the probability of failure is assumed to be

$$P(Y_i = 0) = (1 - p_i) = 1 - [1 + \exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1}$$
$$= [\exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]\ [1 + \exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1} \quad (5.3)$$

and

$$P(Y_i = 1) / P(Y_i = 0) = (pi / 1\text{-}pi)$$
$$= [1 + \exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1} / [\exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]\ [1 + \exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1} \quad (5.4)$$

$$\text{Thus } (pi / 1\text{-}pi) = [\exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1} \quad (5.5)$$

One can easily recognize that, regardless of the regression coefficients or the magnitude of the *X* values, this model will always produce predicted values (predicted Y*'s*) in the range of 0 to 1.

The name *logit* stems from the fact that one can easily linearise this model via the *logit* transformation. Suppose one can think of the binary dependent variable *Y* in terms of an underlying continuous probability p_i, ranging from 0 to 1. Then his probability p_i can transform as:

$$p_i' = log_e \{p_i / (1- p_i)\} \qquad (5.6)$$

This transformation is referred to as the *logit* transformation. Note that p_i' can theoretically assume any value between minus infinity and plus infinity. Since the logit transform solves the issue of the 0 or 1 boundaries for the original dependent variable (probability), one could use those (logit transformed) values in an ordinary linear regression equation. In fact, if someone performs the logit transform on both sides of the logistic regression equation stated earlier, they could obtain the standard linear regression model:

$$p_i' = log_e \{p_i / (1-p_i)\} \qquad (5.7)$$

where $\{p_i / (1-p_i)\}$ is defined as the odds of success and the errors are assumed to follow a binomial distribution. Here, instead of assuming that the relationship between p and $X's$ are linear, the model assumes that the relationship between $log_e\{p_i/(1-p_i)\}$ and $X's$ are linear.

Thus the convenient form of logistic regression model is

$$p_i' = log_e(p_i/1-p_i) = log_e\ [\exp\{-(\,_{j=0}\Sigma^k \beta_j X_{ij})\}]^{-1}$$
$$p_i' = log_e(p_i/1-p_i) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_k X_k \quad \ldots\ldots\ldots\ldots\ldots\ldots \quad (5.8)$$

where $X_{i0} = 1$ and p_i is the probability of 'success' for 'ith' respondents β_0 is the constant, $\beta_1, \beta_2, \ldots, \beta_k$ are the logistic regression co-efficients and $X_1, X_2, \ldots, X_k$ *are* k explanatory variables.

The maximum likelihood estimates of the parameters (βj) can be tested for statistical significance by test statistic $\beta j/S_{\beta j}$ -which follows χ^2 (chi-square) distribution with 1 degree of freedom. This permits one to test whether the estimated coefficients are significantly different from zero. The overall model adequacy can also be tested by the model χ^2 test and examination of the log-likelihood ratio (Hosmer & Lemoshow 2000).

The effects of each explanatory variable on dependent variable expressed by both the logistic regression co-efficient and odds ratios for each of the variable category were calculated from logistic regression co-efficient relative to the reference category. The odds ratios of less than 1.00 imply a lower likelihood whereas those greater than 1.00 indicate a higher likelihood. The logistic regression coefficients and odds ratios (OR), adjusted for the effects of other variables, with their 95%

confidence intervals (95% CI), are shown to express the likelihood of 'Satisfaction on Islamic banking services' for each explanatory variable.

To determine the factors which are associated with 'Satisfaction on Islamic banking services' (dependent variable), a forward stepwise multiple logistic regression model was employed which include all the variables used in bivariate analysis. The variables that are specified on forward stepwise technique are tested for entry into the model one by one, based on the significance level of the score statistic. At first, the most significant variable is entered into the model. After each entry, variables that are already in the model are tested for possible removal, based on the significance of the conditional statistic, the Wald statistic, or the likelihood-ratio criterion. The insignificant variable with the largest probability greater than the specified value is removed ($p>0.05$), and the model is re-estimated. Variables in the model are then evaluated again for removal. When no more variables satisfy the removal criterion, covariates that are not in the model are evaluated for entry. Model building stops when no more variables meet entry or removal criteria or when the current model is the same as a previous model. The results from final step are presented in the Table BD6.

It is to be noted that in the forward stepwise logistic regression model, the results showed the contribution for each of the significant factor, adjusting for all significant variables included in the model. The dependent and explanatory variables in the multivariate logistic regression analyses were coded in Table 8.1.

As of the 'Equation 5.1' discussed above for this study the equation for multiple logistic regression analysis will be as follows:

$$p_i' = \textbf{Probability } (X_{13}) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} \qquad (5.9)$$

5.7 Conclusion

The Islamic economic paradigm is well defined in the *Quran* and *Sunnah*, therefore the hypothesis development and evaluation of this thesis as carried out in light of the rationale of Islamic *Shariah* and its teaching. This chapter discussed in detail the justification of the methodology and site selection within the context of Islamic banking and finance. It discussed the questionnaire survey justification, questionnaire development along with the site selection appropriate to this research. It also explained the methodologies used for data collection and the statistical analysis to explore the association of socio-demographic characteristics and the satisfaction of Islamic banking services as well as highlighted the Islamic economic paradigm and how it differs from secularist paradigm. The methodologies used in this research are most appropriate for the study of Islamic economic behaviour which has its roots in the *Quran* and *Sunnah*, and customer satisfaction thus derives from the satisfaction of compliances to the core requirements of the religion of Islam.

Chapter 6

Bangladesh case study and survey results

6.1 Introduction

The research methodologies explained in the previous chapter involved case studies and survey data and this chapter contains case studies of three Islamic banks in Bangladesh. There are previous studies in Islamic banking which also selected Bangladesh as a site and one of the three banks selected by myself was studied by other researchers. This study, however, is different from the previous studies as it included the examination of Islamic banking sources for funds and their application in the light of Islamic *Shariah* law. It also undertook an investigation of their conformity to Islamic *Shariah* law and interviewed *Shariah* board members to obtain a greater in-depth understanding of the core component of *Shariah* governance. These case studies were derived from a series of interviews with the Bangladesh Central Bank and an analysis of the Survey results of regulators, *shariah* board and Islamic banks. These case study findings and survey results were analysed to investigate the differences between theoretical models and practical application.

6.2 Background- Bangladesh case study

In 1947 when Pakistan gained independence from British rules, it was created as an Islamic country. However in 1971, Bangladesh (previously known as 'East Pakistan), gained independence from Pakistan but was not created as a political

Islamic country. Bangladesh has the third largest Muslim population in the World. It has a population of 160 Million with 90% of the population Muslim. Despite its history, Bangladesh is a relatively progressive Islamic country and its government functions in a relatively secular regime. However, religion plays a very important part in everyday activities. Bangladeshi people have a reputation of being very pious and a desire of wanting to live their lives according to Islam. Politics and religions are kept separate, and though there are political parties based on religion they are marginal in Bangladeshi politics. Despite its roots of being a part of a politically separated Islamic country the legal and penal system remained western based.

Bangladesh was created at a time when the debate of Islamic banking and finance was gathering momentum. It was created within first paradigm of Islamic banking when several Islamic banks started their operations in Egypt and Malaysia. The Islamic Development bank and some other major Islamic banks were created soon after. However, there were no Islamic banks in Bangladesh until the early eighties.

There were two organisations which actively sought the establishment of Islamic banks in Bangladesh. These are called "Islamic Economic Research Bureau" and "Bangladesh Islamic Bankers Association". These two professional bodies sought an active role in seeking international investments for the establishment Islamic banks in Bangladesh and raising awareness amongst the country's local bankers by establishing training and workshops. The dedication and support from the political establishments created an enabling atmosphere for the creation of first Islamic bank in Bangladesh in 1983 called "Islami Bank Bangladesh Limited", a joint venture efforts of several Islamic banks from the Arab World, private sector and the government (Sarker 2002).

Islamic banks have existed in Bangladesh for over three decades. They are now a dominant player in Bangladesh's banking sector. Some prominent major Islamic banks are currently the most successful commercial banks of the country. There are currently six Islamic banks in Bangladesh, and some have presence in all corners of the country. There were 327 branches of Islamic banks all over Bangladesh out of which Islami Bank Bangladesh Limited has 176 branches. The conventional banks (local and foreign) had 21 branches which have "windows" for offering Islamic banking services. This activity makes Bangladesh as a perfect base for a case study and survey.

Bangladesh has a dual banking system, both conventional and Islamic. There are 48 banks in total within the country, out of which six are known as Islamic. This is approximately 12.5% in terms of the number of banks that exclude the Islamic banking windows of conventional local and foreign banks. According to the reports of Bangladesh Bank (June 2007) the deposits to the Islamic banking sector stood at Taka 286.5 Billion (£2.2 Billion) which at the time equated to 14.3% of the country's total banking system. More recently the investment of the Islamic banking sector stood at Taka 265.4 Billion (£2.4 Billion) which accounted to 17.2% of the total banking system (Financial Express, Dhaka, May 24 2008).

There exists an enabling environment for the creation and the developments of Islamic banks in Bangladesh. The government have subscribed to 5% share capital to the first Islamic bank (Islami Bank Bangladesh Limited) and have preferential provisions to encourage developments. As per Bangladesh Bank (The central bank), the Islamic banks are only required to maintain Statutory Liquidity Requirements (SLR) of 10%, whereas in comparison the conventional banks had to keep nearly 20%. This system has enabled Islamic banks in Bangladesh to hold more liquid fund for investments. The other and most significant relaxation in the banking system within Bangladesh was to allow the country's Islamic banks to set up their own mark-up rates and profit sharing ratios independently, considering their own position and the prevailing economic situation. This has helped them to develop Islamic banking in *Shariah* based PLS modes. The government has also brought amendments to the Banking Companies Act 1991 (Act No 14 of 1991) by incorporating the Islamic banking provision. The Bangladesh Bank did not set up a department in their Head office to specifically to monitor Islamic banks. The supervision and monitoring is conducted as per general guidelines of the conventional banks and the banking sector as a whole. Islamic banks are entrusted to implement Islamic baking according to the guidelines of the respective banks *Shariah* board. Therefore, the supervision and compliances to *Shariah* aspects of the banking remain outside the scope of central banking supervisory authorities. While this has aided the development of Islamic bank at a very rapid speed, the need of customers of the Islamic baking system has not been sufficiently addressed by the regulators. Even though actions such as the implementing of various Acts and provisions have occurred, to the general public it appears that Islamic banks in Bangladesh are a regulated sector that complies with Islamic *Shariah.* The promoters that are entrusted to monitor compliances cannot give confidence to users of Islamic banks.

6.3 Case study- the interview with the central bank (The Bangladesh Bank)

As a part of my case study I met with an executive of The Bangladesh Bank, to enable me to gain an insight into the regulation and monitoring of the Islamic banking sector in Bangladesh. Being of Bangladeshi origin and through my current pursuit of a research degree from an U.K. based university, assisted me to arrange this appointment through The Bangladesh Bank's Personnel Department. I was granted an appointment with a Senior Executive (Assistant Director) who was responsible for the Islamic banking sector during which I was cordially received. The interview undertaken was very frank in manner and it appeared that the officer felt comfortable to talk with me and honestly express his own concerns.

During my first meeting, the Executive of the Central Bank did not wish to answer my prepared questions during my scheduled interview and requested that I leave the questions with him so that he would be able to answer them and give a more full and considered response. In view of his reluctance to answer any specific question on my initial visit, a further appointment was set for the following day and I left him with a set of prepared questionnaires designed for the Bank's Regulators. These are intended to enquire into four main areas of concerns.

These are:

1. If there is any special regulation for Islamic banks.
2. If they are involved in interest based conventional money market activities.
3. Issues relating to Islamic banks corporate and *Shariah* governances.

4. Issues relating to *Shariah* board's authentication of Islamic banking services.

During my initial interview I was informed that Executives of the Central Bank Monitoring Department worked closely with the *Shariah* Board Secretariat of the Islamic Bank and that these executives try to check *Shariah* compliances. In case the Executives of the Central Bank Monitoring Department have a query on any issue relating to Islamic *Shariah*, they take up the matter with the *Shariah* Secretariat of the bank. The Bangladesh Bank has developed its own *Shariah* check list which it tries to follow when visiting the country's Islamic banks. I could not obtain any such documentation i.e. the fore mentioned checklist as I was told that the guideline was in the process of printing. However, I was informed by The Bangladesh Bank that the list was fully explanatory and that any staff of the bank irrespective of their experiences or insight to this sector, would be easily able to apply and use the checklist.

It transpired through my research that there is an ongoing process to have a central *Shariah* board for the Islamic banks of Bangladesh. This was created in 2001 and was recorded as having fifteen members by the end of 2006. Each Islamic banks in Bangladesh, as well as conventional banks with Islamic "windows", are members of this central *Shariah* board. This board is a self regulatory organisation which exists outside the central bank. The committee of its board is not yet fully operational and hence not effective as yet. According to the model, each bank would be a member of such a *Shariah* board; however the membership of the board is not designed to be staffed as it is by the Islamic scholars at this stage. I was informed that the purpose of such a *Shariah* board is initially to exchange views and build understanding of the sector with a view to build future capacity to implement necessary guidelines.

There is also in existence in Bangladesh an "Islamic Banks Consultative Forum" formed in 1995 to facilitate the effective interaction of all Islamic banks. This forum worked for the enactment of the Islamic Banking Act and is also working with the aim to create a central *Shariah* board and to create an Islamic money market. The forum had ten members by the end of 2006, of which six were Islamic Banks and four were from Conventional banks with Islamic "windows".

I learnt through my conducted interviews with executives that to facilitate liquidity to the Islamic banking sector, The Bangladesh Bank has developed Islamic Bonds on *Mudarabah* basis. This fund circulates among Bangladesh bank and Islamic banks on *Mudarabah* principle as an internal money market where excess liquidity or a liquidity shortfall can be managed by the Islamic Bond. The term *Mudarabah* means silent partnership, where the recipient of the fund manages the business and resulting profit is distributed at an agreed rate. During one of my interviews I questioned the Executive of the bank on how they ensure that the employed fund would generate profit and that the fund was applied in generating *Halal* income. The interviewee's response in this respect was not very convincing, reporting that at this stage it is an agreed principle between the central bank and Islamic banks, that the Islamic banks would generate *Halal* income. I further questioned the bank executive about the situation when the central bank absorbs excess liquidity from the Islamic banks by selling the *Mudarabah* Bond, how the central bank would ensure that they employ these fund in an Islamic manner to ensure that they earn *Halal* profit as well.

His response to this question was that the excess liquidity which the central banks absorb is re- employed to the deficit sector of other Islamic banks and thus the bank ensures that the fund is employed in Islamic manner. Banks employ these funds to conventional banks' "Islamic windows" as well, and thus conventional banks are also a part of this Islamic money market.

I asked the interviewee how he would ensure that the conventional banks do not employ the funds into other sectors as well. In response he informed me that the central bank ensured that there are adequate firewalls and safeguards to prevent the funds from becoming co mingled with conventional fund. According to him the conventional banks "Islamic Windows" are not allowed to take the fund out from the Islamic sector to conventional sector. However, he further informed me that there is no restriction for the flow of funds from conventional to the Islamic sector but once the fund is in the Islamic sector it cannot be re invested in the conventional sector or be taken away from the Islamic sector. He assured me that the Bangladesh bank ensures that there are adequate checks and firewall and these principles are adhered to.

Therefore, the system described above through interviews, has revealed the creation of an Islamic money market to provide liquidity to other Islamic banks and to the conventional banks with "Islamic windows". All onward movements are vaguely termed on Islamic principles.

I asked him how the share of the profit in the *Muarabah* partnership is determined. He replied that the prevailing rate is similar or close to the interbank lending rate but instead of loans or interest the bank uses profit and *Mudarabah* terms to comply with Islamic principles. He further informed that to comply with Islamic principles the whole return is not fixed at the outset. It is a two tier flexible rate determined by the Islamic bank's profitability. In the mechanism described it seems that Islamic banks declare their profit twice, interim provisional profit and final profit once the financial report is published. The provisional profit and final profit combines together to equate to the actual profit. The Islamic banks then apply weightage to different types of fund and profit is then distributed accordingly. Therefore, short term fund would have a lower weightage to match the lower interest rate for short term money.

He could not show me any documentation or agreement between the banks drawn on *Mudarabah* principles. His reply to this query was that currently no such documentation had been developed; therefore, the circulation of fund was currently simply a notional *Mudarabah.* This simply implies that instead of interest on loan it is profit of *Muradrabah* and the funds circulate on good faith. This fact highlights that the full implementation of Islamic finance in Bangladesh remains far from reality.

On the question of supervision and regulation of the Islamic bank, he informed me that there are favourable terms for the Islamic banks. They are required to maintain a Statutory Liquidity Reserve of 10% out of which 5% is in cash form and another 5% can be financed by Treasury Bills (Islamic Bond). The requirement for conventional banks is 18%, which has been reduced from 20%.

The interviewee was satisfied that the Islamic banking sector was doing enough to ensure that it operated a Islamic *Shariah* based banking system. I questioned him further to ask his views on how banks ensure that in reality what they practice is true Islamic banking. His response to this question was that they rely on the responses of the *Shariah* Secretariat and in the case in which they find any irregularities or they have a query, they take up these matters with the *Shariah* Secretariat. He reported that he felt that the *Shariah* Board is a very powerful arm of the Islamic banks in Bangladesh. For example all employees need to ensure they take clearance from *Shariah* Secretariat otherwise, they do not get a promotion. This ensures that the staff are motivated to avoid *Shariah* violation.

Executives do not have direct contact with the members of *Shariah* board. They deal with the Secretariat of the *Shariah* board, a department of the bank responsible to seek *Shariah* board guidance or raise them on an informal basis or if the matter need a debate it is raised in the periodical meetings of the full *Shariah* board members.

I asked him, if he was aware of any Islamic banks in Bangladesh who do not observe Islamic *Shariah* principles strictly. He replied that there was a bank in Bangladesh whose customers had twice suffered for the dishonestly of the senior executives. They have misappropriated the depositors' fund, and as a consequence the Bangladesh bank had to take over the operations of the bank and impose limits on withdrawal. They were hopeful of selling off the bank as a "going concern" to a foreign bank and optimistic that the banks customer would not lose out as a result. He sighted that the vibrant financial sector in Bangladesh is very lucrative for foreign investors to enter into a ready market. The financial institution in question had a declared profit of Taka1600 Million (£9.6Million) in the previous financial year.

I asked him if he was aware of any other banks having a liquidity problem. His response was that another Islamic bank had had a liquidity problem which The Bangladesh Bank has since resolved without the matter becoming public knowledge.

He said that Islamic banks encourage the Bangladesh Bank to be proactive in *Shariah* supervision and that he felt that there is a genuine partnership in this sector for mutual co operation in facilitating the unofficial Islamic inter-bank money market on *Mudarabah* principles.

According to him the Bangladesh Bank is actively working on guidelines for Islamic Banks and that this material is awaiting publication and distribution. The Bangladesh Bank is also a member of Islamic Financial Services Board (IFSB) Malaysia, which issues guidelines for Corporate governance to all its member countries.

This executive's responses to the Questionnaires are included with the other responses in the main table below. However, it is significant to note that he is aware of Islamic banks paying and receiving interest from money market operations.

The summary of the interview is that the central bank and the Islamic banks are co-operating in developing Islamic *Shariah* guidelines. Currently there is no existence of a proper infrastructure for fully complied Islamic *Shariah* banking. All existing efforts appear notional at this stage, where all the participants are willing to call the transactions to base on Islamic principles and share out profits instead of interest. There is no evidence of the interbank transactions linking to any trade or commerce, therefore, the element of "Buy" or "Sale" is missing from these transactions. Therefore, these are money to money transactions without any reference to an underlying venture or asset.

The Bangladesh Bank helps Islamic banks in mobilising fund and acknowledges their contribution in the economy. They consider them at par with any other successful conventional commercial bank.

However, from the sudden collapse of an Islamic bank where the promoters misappropriated large sums of money and fled the country, it is evident that it is easy for the Islamic banks to take advantage from their faith based customers who bring fund, believing that the bank operates according to Islamic *Shariah* and that the Bangladesh Bank is monitoring the Islamic banks activities. This enables the bankers to manipulate their books without raising suspicion. A prominent Islamic Bank had suffered the same consequences twice during last 25 years, where the Bangladesh bank had to come to its rescue and the organisation was restructured, resold and remarketed in another name.

The above analysis from the interview is in line with literature reviews which have drawn similar examples in the eighties where most of the Islamic banks faced liquidity crises mainly from misappropriation of fund and manipulation of books and accounts. Regulators have not been able to address these concerns as yet because of absence a fully functional compulsory Islamic Banking regulation under the umbrella of any international body to monitor its oversight.

6.4 Survey results from the questionnaires sent to the Regulators

I have sent a total of 19 Questionnaires to the central banks in the region where Islamic banks are widely practiced, out of which I have received five samples returned. This is a very small sample as it is very difficult to get responses from Regulatory Authorities. The five responses came from important regions to give a good indication about Regulatory atmosphere. In a similar study by IOSCO (2004) they only had 3 responses from the central banks which shows the reluctance of the central bankers to responses even to the regulatory Authorities. The Islamic Development Bank also undertook a similar study and they had 12 Responses form various central banks (Chapra & Ahmed 2002)

The Summary (Appendix-F) of the returned questionnaires indicates that the Islamic banks are regulated almost as par to a conventional bank. They are required to follow International Accounting Standard (ISA) and none of them are required to follow AAIFO Standards. It is also evident that no special department are as yet dedicated to monitor or regulate the Islamic banking sector.

As per liquidity, there is evidence that the Islamic banks get short term funding from the money market the same way as a conventional bank on interest basis. This is quite significant as the Islamic banks should not get involved in any transaction involving interest. The authorities consider that the Islamic banks risk management is the same as conventional banks and enjoys good risk management track records. The regulators require that the bank have their own *Shariah* Supervisory boar. They however, would favour of a *Shariah* Supervisory Board at regulatory level, as in their opinion Islamic banks do not follow Islamic *Shariah* very strongly. This view was communicated by all respondents.

The above finding highlights the concerns about the corporate governance of Islamic banks. It raises the issue of transparency and compliances to *Shariah*. Customers are not aware that Islamic Banks are in fact running a conventional style banking system and are in essence rent seeking from their religious beliefs.

6.5 Case study- bank -A

6.5.1 Background of bank -A

Bank (A) is the most successful bank in Bangladesh, established in 1983 as a joint venture with sponsors from prominent Arab banking Institutions. It is also the first Islamic bank in South East Asia. Bank (A) has some 176 branches all over the country and has over £25mil (Tk3456Mil) paid up Capital and £980Mil (Tk132419Mil) in Deposits. The bank has twenty one thousand Shareholders with average share holdings of £1200 (Annual Financial reports 2007). The bank also has 3.6 Million depositors with average deposits of £270 pounds (from interview Data).

Bank A has a wide range of social and welfare organisations run through the Bank Foundation which includes a hospital, medical college, mobile eye camp as well as schools and colleges. The bank also has a scholarship programme for all level of education. Bank A is socially very proactive in order to present itself as a socially responsive organisation whose sole agenda is not simply dealing with financial matters. The social welfare organisations that Bank A runs help the bank to attract more customers who value their ethical and social activities.

6.5.2 Case study

My contact at Bangladesh Bank was kind enough to introduce me to a number of Islamic banks in Bangladesh. Due to this introduction I was quickly and cordially received by the Islamic banks with which I made contact. However, as a formality, I was asked to make an application to see the Executive Vice President (Finance) and to interview the *Shariah* board secretariat and its Members. The application was granted for the above meetings.

When arriving for my interview I was impressed by the apparent atmosphere of the bank which appeared very receptive with an Islamic environment. By the main hall on the ground floor level, there are a number of Islamic art pieces and verses from Quran displayed from wall to wall and even on the ceilings. There are two mosques facilities at the bank, one at the Ground floor and one at Upper floor by the *Shariah* Secretariat Offices. It is compulsory for all the staff to attend prayers in rotation and the *Jammat* (group prayers) are held several times. Staffs are also well trained to exchange Islamic greetings. In my opinion a visit to bank (A) would be a fulfilling experience for any Muslims as the organization appears to be a symbol of Islam and a fully pledged Islamic Organisation. During my initial conversation with the official of Human Resource Department personnel, I asked him if the bank have any non Muslim employees. In response he informed me there are no non Muslim employees. He said that when they advertise the vacancy in the local press, the job is open for all but in reality no non Muslim applies, as they probably do not fit with the characteristics of an Islamic banking environment.

Upon visiting bank A's Head Office in Dhaka, I met with the banks Executive Vice President of Finance. This appointment was organized through the banks Human Resources Department. On arrival at the bank I was greeted more cordially and was given permission to interview the *Shariah* Council of the bank.

The purpose of my interview was mainly to obtain information about:

1. The types of banking facilities it offers to customers.
2. The way they re- invest the customers fund with a view to earn *Halal* profit.
3. How they ensure *Shariah* compliances
4. How Corporate and *Shariah* governances interact.

During my interview I enquired about the types of Bank accounts and services that the bank offered. I was directed to see their published materials which contained many details. I then asked him if there were any specific Contract Forms, relating to various types of bank accounts. I was informed that the bank does not as yet have any specific contract forms to specify terms and conditions and obligations of each parties to the contract. Currently, they only operate within the common understanding of Islamic principles without any specific contract.

According to the leaflets handed in to me, the bank operates the following Accounts under *Shariah* Principles:

1. *Al Wadeeah* Current Account (Trustee type Account).
2. *Mudaraba Hajjj* savings Account (1 to 25 Years) (Silent Partnership with a view to accumulate fund for *Hajj*).
3. *Mudaraba Waqf* Cash Deposit.
4. *Mudaraba* Special savings Account (pension) (5 years to 10 years).
5. *Muadara Muhor* Savings Account.
6. *Mudaraba* Savings Bond (5 Years and 8 Years).
7. *Mudaraba* Monthly profit Deposit Scheme (3 Yeas and 5 years).
8. *Mudaraba* Term deposits (3 months, 6 months, 12 months, 24 months and 36 Months.
9. *Mudaraba* Savings deposit.
10. *Mudaraba* Special Notice deposit.
11. *Mudaraba* Foreign Currency Deposit.

The above can be classified into two broad types of Deposits:

Al- Wadiah (Trustee type).

Mudarabah (Investment Manager).

It is clear that the bank operates all types of Current, Savings and Terms Deposit on *Mudarabah* principles. *Mudarabah* is a silent partnership where the bank is a *Mudarib* i.e. Managers of the fund and providers of the fund gets profit at an agreed rate. According to Islamic *Mudaraba* priciples, the *Mudarib* does not suffer any losses, and all losses are for the providers of the fund. It became clear from the interview that in reality in an Islamic Banking system, in the event of the bank receiving the fund, the bank will take losses and the provider of the fund always gets profit. In the situation when the customer is *Mudarib*, whilst the customer should not suffer losses, the bank can make the customer take all losses. So in reality whilst '*Mudarabah* ' is a term that banks have borrowed from Arabic/Islamic books, they are in reality running a conventional type banking with the same outcomes as that of a conventional bank. Therefore the terms and Islamic names are notional only.

During my interview I enquired if the customers of the bank and the bank itself sign separate contracts and also whether there were any specimen contract available which I would be able to see or collect. The Executive Vice President informed me that there is as yet no such contract forms developed. Though the bank is working on principles of *Shariah* it is evident that the principles were not developed into any contract forms. I was provided with English literature describing in theory how these principles are supposed to work, however, there was no evidence of construction of *Shariah* based contracts within the bank.

The Treasury Management of the bank is fully active in the money market for shortage and excess fund management. They maintain deposits with other Islamic banks and the Bangladesh Central Bank (Bangladesh Bank) on Islamic principles. It is assumed that these Islamic banks will further generate their income from Islamic *Shariah* based activities, and as such in return would be considered as *Shariah* based income. As for The Bangladesh Bank, it operates Islamic Bond which the banks buy on short term maturity. Whilst all these activities are based on the principles of Islamic *Shariah*, there is no onward proof that anything else within these establishments is done Islamically.

The interviewee explained to me that the principles operate as follows:

Bank A will approach Bank B or vice versa with their requirements e.g. to say that they need £1Mil on *Murabah* Basis. The money will be exchanged on *Murabah* basis. The predetermined profit will also be exchanged which is the underlying cost of the money that will be determined based on the money market rate. There is no evidence that these fund are actually further channelled under Islamic contract, apart from the common promise by the banks to apply the fund under the Islamic principles of *Murabah* contract.

The *Murabah* is simply a mark-up contract against which both parties agree to pay at a future date a sum determined in advance. This is normally linked to a *bay' bi thaman ajil* (credit sale). From the interview it was clear that no such link is maintained in these interbank dealings, other than the common perception of an Islamic *Murabah* principle being applied. This is money for a money transaction at a predetermined mark-up. Therefore, the profit is simply translated as *Murabah* mark-up money.

When the banks accept funds from the depositors, these are accepted in a segregated manner, which gives customers full comfort that these funds are invested likewise. However all funds are co-mingled and invested at the discretion of the bank and profit is distributed on weightage basis, rather then on the actual or potential earnings from the segregated sector. From this practice it is clear that the losing sector is effectively being compensated by the other profitable sectors. The literature review has indicated that this is common practice with the Islamic banks that they ignore customers' wishes and work towards achieving an outcome similar to conventional banks. I intended to take this matter with the *Shariah* board to have their views if this violates of Islamic *Shariah* law.

The distributions of the profit to the various accounts are allocated on predetermined weightage basis. Investment of a three year fixed deposit is given as Weight-1 any higher or shorter period will have higher and lower weightage. Funds always attract profit at the prevailing money market rate and would never be subject to negative adjustments. It is assumed that all parties are earning profits irrespective and distribute profit. This system thus creates an artificial Islamic banking environment with outcomes equivalent to that of a conventional banking system. Terms are changed to present the products with Islamic clothes without any change of the structure or the operations of the bank.

The onward investments of the bank is mostly finances for stock in trade on the basis of back to back buy and sell and there are no further Islamic contracts to back up. The banks have not developed a contract structure by which it is linked to any real commodity other then to say that they agree to finance on a *Murabaha* basis with predetermined profit. Banks pay the suppliers direct as per order of their customers and the customers simultaneously agrees to a mark up payment to the bank at a future date. Bank does not sign any purchase contracts from the suppliers of the goods to be able to sell them onwards even for a back to back contract which is a precondition for any commercial transaction, Islamic or conventional. The bank does not assume ownership of the goods for any period of time. The way it operates at this stage is similar to a conventional bank issuing pay orders from the bank in the name of the suppliers. A credit line is established for the customers on a *Murabah* basis. It seems that all transactions are considered on an Islamic basis only and everyone agrees to call the products and actions by Islamic names.

This system of *Murabah* mark-up finances do not conform to an Islamic- mark- up *Murabah* contract on which the initial Islamic banking concepts were developed. The literature review indicates that Islamic mark up *Murabah* contracts are un-Islamic as the banks operate on back to back contracts without assuming liabilities for any period of time. (Usmani 1998) To conform to Islamic Law the bank must purchase the goods and assume ownership. The practices of Bank "A" is to attribute all their risks to buyer of the goods without even entering into any back-to-back contracts and the banks do not comply to the much criticised and disputed minimum requirement of Islamic commercial contract. Therefore, it seems that these practices are not in conformity or on the principles of Islamic *Shariah*.

This is very significant as this is the main source of revenue for the Islamic banks where over 90% of their operations are on *Murabah* finance. The investors to the Islamic banks rely on the fact that the banks earn *Halal* profits and they obtain a share of those *Halal* profits. The customers, are not aware of the way that banks are conducting their operations and the bank's *Shariah* committee is also silent on these non-compliances. Therefore, this system of banking would damage the long term prospects of Islamic banking in Bangladesh.

According to my interviewee the *Shariah* board of the bank is very active and monitors *Shariah* compliances. It is not clear what *Shariah* compliances they monitor. However this activity gives the image of a strict *Shariah* compliance regime within the bank on which customers can take satisfaction. I was informed that the promotions of managers are vetted by the *Shariah* board and they operate an interim audit to check the *Shariah* compliances by the senior executives.

Any dispute between the bank and the customers is settled on the basis of local laws and there is no provision of *Shariah* law in Bangladesh. This is an area of great concern for the customers and critics that in the event of a dispute with the Islamic bank the Islamic *Shariah* contract is nowhere to be seen. They defend their action that they must follow the law of the country as such they cannot consider any *Shariah* law in the event of dispute. This gives the bankers cover to acquire an outcome equivalent to conventional banking nullifying the effect *Shariah* banking principles.

This is not a good practice for the long term development of Islamic banking. The willing parties of a transaction can make provision to be bound by *Shariah* law and local law cannot be an obstacle in such contract construction.

I have taken up the above issues with the *Shariah* committee and they have also reconfirmed the modus operandi as above described. They did not develop any Islamic financial contracts as yet and all movement of the fund is on the basis of Islamic *Shariah* principles, as understood and agreed by the parties. Once again, this lacks the bare minimum compliances one should expect from an Islamic financial institution. This therefore, raises the question of corporate and *Shariah* governance and transparency. Currently the atmosphere and the environments are very impressive and Islamic. One is lead to believe that their financial activities are also Islamic but in fact the interview reveals that they do not even try to comply with the bare minimum requirements of Islamic *Shariah* law.

I proposed to the bank that as the banks accept the funds segregated, they should be able to keep them segregated. From the above list they have some eleven sources of receipt of the funds and it should not be difficult to have the funds and investments segregated and income distributed from the actual investment for the specific fund. This would be a fair allocation and would remove the possibility of the deficit sector being financed by the profitable sector. If this is what they do, then there is no difference with conventional banking that pools all their assets and revenues together and distributes them on market rate irrespective of profitability. The interviewee replied that practically it is not possible to keep the funds segregated or the income segregated as such all funds and income are pulled together and distributed on a weightage basis.

I then raised the issue of security and if the customers are required to give security. The interviewee notified me that the bank must take security from the borrowers.

The interviewee informed me that it is allowed in Islam to take security. In the event of customers unable to pay, the bank will not get involved whether the party was making profit or loss the security will be relied upon. This is also an area of criticism for the Islamic bank that when they invest the money onwards on the *mudarabah*, they are silent partners and the *Mudarib* (the investment manager) should suffer no losses and should be immune from the security. The interviewee reported that the bank takes security for all class of customers which enables them to obtain outcomes similar to conventional banking. This violates Islamic *Shariah* law where all losses are attributed to the customers.

I have taken up this issue and the above issues with the *Shariah* Secretariat whom I met with separately by appointment. The *Shariah* Secretariat cordially accepted me and expressed their pleasure for the issues and concerns I am addressing in this research. They further informed me that they had many other research students from all over the world but so far no one had addressed the core Islamic *Shariah* issues which I have been raising with them. They wanted to know about my own educational background, as in their opinion, unless I am an insider with *Shariah* education and banking knowledge it is not possible to know the root problem of Islamic banking. Once I assured them about my own Islamic educational background and personal experiences with Islamic banking they appeared very comfortable to talk to me and assist me in any way possible.

I raised the issues of banks taking securities from the customers. They informed that in Islam the bank is allowed to take security. They admit that for *Mudarabah* contracts banks should not rely on the security but they said in practice, if no security is taken, everyone will show losses and it will be very difficult for the bank to monitor the business. They must assume that all the banks are making profit. They also reported that no one should count for losses when the business is a 'going concern'. According to them the loss comes only if the business is closed down. However, they felt that this will give rise to moral hazard if customers are told that in certain circumstances banks are allowed to share losses. For this reason in all cases security is taken from the customer. This shows lack of transparency on the part of the bank.

It is therefore clear that Islamic banks have not been able or willing to be bound by the principles of Islamic *Shariah* law. They reconfirmed the findings obtained from the bank interview and restated that due to the large volume of transactions, fund segregation is not possible. Everything is co-mingled and the revenue is pooled together except from the revenue from the service sector which is not allocated to the investment income. However, they admit that even the service sector income should be in the pool of distributable profit as the bank builds its capacity to serve with the strength of depositors' fund.

They further informed that they are unhappy with the Malaysian practice of Islamic banking and especially *Sukuk* trading which they consider debt trading, strictly prohibited in Islam. They were also very critical on the Islamic products developed on the basis of *Hila* which mean "Ruse", a legal stratagem to circumvent various provisions El- Gamal 2005 xvi). They are in favour of developing products on contract base system and continuously working towards better understanding and developing products to comply to *Shariah*. They emphasised the greater role they are taking by their foundation for social development which benefits the society as a whole. From my discussions with the local community it appears that they enjoy a good reputation and have good image mainly due to the above facts.

6.6 Case study- Bank -B

6.6.1 Background of Bank -B

I have selected Bank B for my second case study. This is the only bank in Bangladesh incorporated from the outset as a full Islamic bank without any external funding and because it is the third largest Islamic bank in Bangladesh and rising very rapidly. This bank also enjoys a reputation for being a good *Shariah* compliance bank. It was established in 1995 and now has 46 branches all over Bangladesh. It has a paid up capital of just over £6 Million Pounds (£6.32Mil) and the number of shareholders are nearly four and half thousand with an average holding of Approximately £1400. Bank B was established as an Islamic bank from the outset. It has a deposit of £124 Million and the customer numbers are unknown (not disclosed). It is the only Islamic bank with all local sponsors therefore, they are not influenced by outside factors.

The atmosphere of the bank is receptive, very cordial and very Islamic in manner. It assures the customer to be a superior type of bank with Islamic *Shariah* in their heart and mind. Therefore, the customers may feel that they cannot or do not need to raise any questions.

6.6.2 Case study

The appointment was organised by the same contact of The Bangladesh Bank who is responsible to monitor Islamic banks and as such I was very cordially received. The bank also agreed to meet me on a short notice. I was met by the Senior Vice President and Head of the Treasury Management. They discussed very frankly and raised the issues which sometimes conflicts with their own conscious. One of the officer said that he was very enthusiastic to join the Islamic bank and was happy to bring into the bank the entire fund he and the family saved over the years. His was conscious he would not allow his parents, who are very religious, to bring their deposits to the bank. I found this discussion at the heart of my research and concern. The customers of Islamic bank now believe that the banks are Islamic in name and in nature and all of their activities are *Shariah* compliant. If at any stage these practices come to the open, there would be massive withdrawals from the Islamic banks. In his words, in reality there are hardly any difference between conventional banks and Islamic banks. Having worked in the conventional banks he says that the Islamic banks are openly dealing with interest when re-investing the fund and bidding the fund with higher returns if someone has large deposits.

Their practices of distribution of profit or return to the account holders are similar to Bank A. This bank also allocates the profit on weightage basis to the various types of deposits and it distributes on an average 70% of its income to the depositors in the form of profit.

He informed that the bank must always offer higher return than other banks to attract deposits. There is a vicious circles as other banks in turn bid these customers fund by offering higher return which causes sudden withdrawal causing a mismatch to its investments.

Bank B deposits 10% of its funds with The Bangladesh Bank and he said that their bank enjoys good standing with them which even allows them to hold a lower SLR. I could not check with The Bangladesh Bank if they have differential policies or they try not to implement the rules strictly or applied the rules arbitrarily. If this differential system prevails then it will not be good for long term sustainability of the Islamic financial sector as such differential practices may exist elsewhere.

He frankly admitted that there are inter-bank transactions with other Islamic banks; these are simply money to money contracts. He even did not specify that these had any Islamic names simply termed as loans and investments. He is aware that this probably would not comply to *Shariah* law but seems to acknowledge that this is what is happening in reality.

In his admission the central *Shariah* board of the bank is not very effective. The chairman of the bank is also on their *Shariah* board , therefore, the *Shariah* board is in his control as well. They are in the process of a *Shariah* manual being drawn out. This implies that the *Shariah* board is only kept for rubber stamping the wishes of the management. This is a concern among the Islamic religious circles and among the critics that the Islamic bank maintains a *Shariah* board only to comply with the rules. It uses its influence in obtaining their approval for any products and services they offer.

They informed me that the main investment instrument of the bank is a *Murabaha*, stock finance. Banks pay for the stock in trade on behalf of the customers and hold the stock at the banks customers' warehouse at customers' risk. Customers withdraw the goods against promise to pay the mark up price. The bank never assumes any risk or responsibilities. The bank pays for the goods by debiting the Customer's Account.

They both informed me that the Profit and Loss Sharing system may not work in reality as the customers always want positive return. He further informed me that they declare the profit twice to comply with Islamic banking principles of not offering fixed and pre determined rate. The provisional rate is always intentionally kept lower than the final profit. They fear that if in the final distribution customers do not get some extra over and above provisional declaration, they would move their fund to other Islamic banks who would offer more. There will be non confidence to the bank causing sudden withdrawal. They cannot foresee what would happen if they have to claw back from the provisionally declared profit. He had very harsh words to say during the interview, for example, that he thinks that be the bank will possibly be harshly treated by the depositors.

This highlights the atmosphere in which Islamic banks now survive in Bangladesh. Sometimes these Islamic banks even attract money by paying over 20% profits against central bank's base lending rate of about 12%. This shows the expectation of the depositors and if these vicious cycles prevails that institution will become vulnerable and would struggle to pay such a high return. The same has happened to the above mentioned Islamic bank where the promoters had fled the country with depositors' money.

This prove that the Islamic banks distribute a very high rate of profit irrespective of their earnings and always attracts fund by higher bidding. This concern was also highlighted from the literature review and this remains a cause for concern for long term sustainability.

The bank was frank in their discussions and the senior management had doubts about actual compliances of Islamic *Shariah*. It is all notional and even they ignore these notional terms as well when under pressure to attract fund or to re-invest if the opportunity arises.

All fund are accepted in different Islamic names and then co-mingled and incomes are co- mingled and distributed in weightage basis.

The onward investments of the banks are mostly on *Murabaha* basis (mark up transactions) financing the stock in trade. They also allocate almost 10% of their investments to the industrial sector, mainly the garment industry who need funds for various commodities procurements. They also have investments in the large industrial sector. The bank B also confirmed that there have never been any negative adjustments to the depositors' fund.

I also met the *Shariah* secretariat of the bank twice. During my first meeting I found out that the *Shariah* Secretariat have only one personnel, a religious scholar who is trying his best to draw *Shariah* Manuals for the bank. He has shown me various publications by the banks and the *Shariah* Manual manuscript which is in the process of being printed. He could not provide any cross evidences except to say that they are at a very early stage of developing a fully functional *Shariah* Board. According to him the Chairman of the bank being on the *Shariah* Board is a handicap for its development. He is sole authority in every respect.

He has filled in previously left questionnaires as he had to consult the other *Shariah* Board Members for some answers. These are included in the analyses of the returned questionnaires of *Shariah* Board Members.

6.7 Case study bank-C

6.7.1 Background bank- C

This is the second largest Islamic bank in Bangladesh with nearly £13 Mil paid up Capital and deposits of £260 Mil Pounds. It has 35 branches in the main town centres. It was established in 1999 and was started as a conventional bank which then converted into a full Islamic Bank from 1st July 2004

6.7.2. Case study

My meeting was organised by a local contact who is a majority share holder of this bank. He telephoned the managing Director of the bank who despite his busy schedule allowed me to meet him very quickly. After meeting me for a short period he called the Senior Executive of the bank and organised a meeting with him for the following day to conduct an interview. This senior executive holds a Diploma in Banking from the London Based Institute of Islamic Banking and Insurance. He also informed me that he himself is following a part time PhD course from a local university. He showed me various excerpts of his writings in the local papers which are aimed to bolster the image of the Islamic bank for which he works. He was trying to be very helpful in answering my questions and also called the Member of the *Shariah* board to be present at the same meeting.

Bank C has a fully integrated *Shariah* Council which works within the bank premises. The bank accepts fund similar to the other Islamic banks as *Al Wadiah* (Trustee type) and *Mudaraba* (Investment Manager)

This bank seems to display a good working atmosphere and good discipline and efficiency in all respect. This is probably because of their roots from a conventional banking atmosphere. I felt that they were not very frank when responding to my questions. The officer was under lot of strain to close large investment deals as big parties were waiting to meet him. However, he was very kind to allow me the conduct an interviews in his spare moments. He was very anxious to assist me in my research and has therefore allowed me to conduct the interview in a mixed atmosphere

According to him to comply with Islamic *Shariah* the bank does not Guarantee the return of fund to the depositors except *Al wadiah.* They also do not guarantee return on investment. He informed me that the return or profit distribution is at the discretion of the management. However, it is common knowledge that these terms are notional written or unwritten to comply to *Shariah* Principles and in reality all fund is guaranteed under normal banking terms. However, they distribute 65% of their Investment income to various Accountholders on the basis of allocated weight. The bank has a self financing Deposit protection fund which they can access in case of shortfall. He informed me that the funds are not segregated and all income is co mingled. He also confirmed that the conventional Auditors do not require *Shariah* Audit. The *Shariah* Board operates internal Audit to all branches.

Their main mode of Investment is *Murabaha* on cost plus basis and the bank does not hold stock in trade. All goods are paid for on behalf of the customers and on customers' risk.

The *Shariah* Secretariat of the bank similar to bank B is managed one personnel only who has Islamic knowledge. This is a fully integrated office whose main job is to liaise with The *Shariah* Board Members to seek their guidance on any issue.

I was informed that maintain interbank deposits with other Islamic Banks on *Mudarabah* principles. It seems that they have developed various mechanisms even to allow overdraft into the Current Account. The bank calls that this is a dynamic purchase account with fluctuating requirements within an agreed limit. They do not accept any restricted deposits where the investor wishes to dictate the sector for further investments by the bank. The interviewee reported there are practical problems in accepting restricted fund. Similar to the Bank A and Bank B they collect the fund in various segregated modes and then these are co-mingled and re invested at their discretion.

For some reason they also suggest that they hold only 1% with Bangladesh bank. When I queried this discrepancy with the regulation, he informed me that the central bank also take account of their standing.

They are a very progressive bank and soon intended to use an Islamic Credit Card. The interviewee communicated that he felt that there are shortage of experts who understand Islamic *Shariah* as well as banking and computer programming. All these three areas of knowledge are required for developing a credit card to operate. They also believe that they are major investors in the market with nearly Taka40000 Million (£300Mil) investments in the market.

I also tried to take a separate interview with the Member of *Shariah* secretariat. He was not very helpful and was hesitant and seems to lack knowledge or did not wanted to be very helpful. He may have other fear of losing the job if shows very co-operative. and helpful. However, he did say that when banks tell the *Shariah* Board their requirements they then develop products complying with *Shariah*. Both of them cooperated in filling questionnaires relating to Islamic banks and for the *Shariah* secretariat. The *Shariah* Secretariat of the bank is an integral part of the bank and work closely with the Management. I saw a separate desk for the *Shariah* Secretariat. I did not see an impressive detached department for the *Shariah* secretariat as was in the bank A & B.

From the above three case studies it is revealed that it is common practice with all Islamic banks to display high *Shariah* atmosphere and environment so that they can build customers confidence to be a *Shariah* compliance bank. They offer banking accounts and facilities using Islamic and Arabic names and these are notional terms only with very minimal *Shariah* compliances. The study also revealed the complex mechanism they adapt to obtain the outcome similar to conventional banks. The survey results also makes clear that the banks are not transparent about the *Shariah* compliances and they rely on their image and environment for the faithful to come to them with their fund. These findings are in line with literature review discussed in the previous chapters.

6.8 Survey results of the *shariah* board of Islamic financial institutions

I sent out 76 Questionnaires to various banks and had only 10 replies . These samples represent the region I have investigated in this research. From this poor response it can be understood that the *Shariah* Board of the Islamic Financial Institutions are not proactive and do not engage with their customers or with the outside world. Accordingly the above sample though very insignificant in number is a highly significant response. Three samples were collected by hand in Bangladesh for which it took nearly three weeks of constant phone calls as the *Shariah* Board members who required the banks permission to respond. However, these results provide a very important insight into these financial institutions.

The *Shariah* Board as it seems are a detached arm of the Islamic Financial Institution. They are nowhere to be found. It seems that they liaise with a *Shariah* Secretariat of the bank which is a de facto *Shariah* Board. It oversees the day to day *Shariah* issues which are headed by an Islamic Scholar who has good command of English and has working knowledge of the bank. Any issues which need the approval of the *Shariah* Board can be referred to them as an ongoing basis who gets direction verbally or seldom in writing. This will then be raised in the final meeting where all *Shariah* Board Members are present who debates the issues again and confirms their position.

It is therefore apparent, that the *Shariah* Board Members do not face the customers. They only face the board in an elegant setting several times in a year. The *Shariah* Board Members are the most important members of the bank whom the management keeps in good book and are heavily remunerated for their approval of the banks activities and for not causing big upset in banks operations. Out of 10 samples three were from the *Shariah* Secretariat who filled them on behalf of *Shariah* Board and seven from *Shariah* Board members.

The analyses of the table (Appendix-G) show that some 40% of the members are also on the Board of other Islamic financial Institutions which suggest that some banks are trying to integrate both corporate and *Shariah* governance. It also can indicate as was the case of bank B in Bangladesh that the Chairman of the bank is also a Member of the *Shariah* Board to influence the *Shariah* committee decision. The corporate governance of the bank is the dominant executive arm. Their participation in the *Shariah* board can be seen to influence the board to get their authentication to bank's wishes. They should encourage the *Shariah* board members participation to the executive board so that the *Shariah* board can influence the executive board to be pro active in complying the *Shariah*.

The survey results revealed that Islamic *Shariah* knowledge at degree level is the requirement of most of the banks however 90% holds post graduation degree with 40% PhD's .

It was revealed from the analyses of *Shariah* Board returned Questionnaires that the main role of the *Shariah* Board are:

(Multiple response)

-Is to advise all aspects of *Shariah* Law 70%

-Advising in formulating products 40%

-Issuing *Shariah* Certificates 30%

From the above it is clear that the majority involvement of the *Shariah* Board is in advising all aspects of *Shariah* law. They also work in developing products and in some cases their involvement is simply issuing certificates.

Most of the banks work on a majority decision of 80% and only 20% work on unanimous decision. On critical points dealing with core *Shariah* questions the responses differ quite considerably from the Financial institution Regulators and

Shariah Board. They seem to contradict each other which raise the question of transparency. It seems no one is willing to give true facts when faced with critical questions. The *Shariah* Board members are not aware that the Islamic financial institutions involves in paying and receiving interest. This shows that their knowledge of bank operations are very limited as all the banks are in some way involved in receiving and paying the interest.

The *Shariah* Board is also unaware of how the bank is keeping the fund. The 40% thought that the banks kept the fund segregated with 10% not known. This can be interpreted as 40% segregated and 60% not segregated.

On the profit distribution they thought that 80% believed that it is based on actual profit and 20% says on notional profit. This contradicts with bank survey findings. There are discrepancies in the distribution of losses. 50% says it is based on actual loss and 50% not applicable or not known. It means that 50% thought that the bank do not share out losses.

Therefore the bank only distributes profit irrespective of their making profit can only be termed as interest. The *Shariah* board is ignorant of these facts or did not wish to own up the facts. This raises the question of transparency and corporate governance is not open with the *Shariah* Board and not sharing or exchanging the facts.

6.9 The survey results of the Islamic financial institutions

Seventy six questionnaires were sent and only thirteen responses were received. This is a very poor response and this again proves the reluctance of the Islamic Financial Institutions to display transparency and to be pro active. The analysis shows (Appendix-H) that Islamic banks in many regions are offering a wide range of services including trading, insurance, real estate and off-shore banking. They also offer a wide range of savings and investment accounts to their customers however, they do not widely offer the equity participation types of accounts even though they are renowned for promoting equity based banking. This analysis also shows that the bank distributes profit irrespective of their earnings and it does not ask the depositors to share any losses, even though they had suffered losses which could be attributed to the depositors according Islamic *Shariah* law. The banks take personal guarantees from borrowers (85%) and rely on these guarantees in the event that customers are unable to meet their obligation. The analysis also shows that in most cases, the conventional audit did not require the bank to provide them with a *Shariah* audit. The responses also reveal (23%) that the banks had litigation with customers on *Shariah* issues.

6.10 Conclusion

This chapter explained the importance of Bangladesh for Islamic banking research through undertaking a study of three different Islamic banks to find out if practices were significantly different between the different organisations. It also investigated the Islamic banking regulations adopted by banks in Bangladesh and in particular their efforts to ensure that the banks comply to Islamic *Shariah* law. These guidelines were re-examined from the three Islamic banks who took part in this research. The case study highlighted how the practices differ from their theoretical foundation and the core objectives of the Islamic banks. The data obtained from the returned survey of regulators, Islamic banking institutions and the *Shariah* board of Islamic Banks was analysed in this chapter. This analysis was compared and contrasted with the case studies findings forming the basis of analysis of Islamic banking customers' satisfaction. The case studies indicate that the *Shariah* compliances are very minimal and notional, and the customers' faith on the bank drives their success.

Chapter 7

Survey results: descriptive analysis

7.1 Introduction

The previous chapter specifically dealt with examining the regulatory atmosphere and the practices of Islamic banks in Bangladesh. This chapter analyses the returned samples of Islamic banking customers from the four regions; Bangladesh, Malaysia, Dubai and the U.K. A total of 551 returned questionnaires were analysed to determine the association to Islamic banking customers' satisfaction. This data was analysed as separate case studies, and further analysis was conducted in the form of one linked study as described in the methodology section. Previous study in this area also adopted the same technique of descriptive analysis. In addition to previous studies, this study attempted to analyse satisfaction in relation to *Shariah* and transparency issues which no other study has previously undertook. The questionnaires were designed to investigate customer satisfaction and compliances to Islamic *Shariah* and the customers' faith in relation to the services they obtain from the Islamic banks. The cross tabular analysis have provided indications of how they differ across regions, status of the customers and their age and occupation.

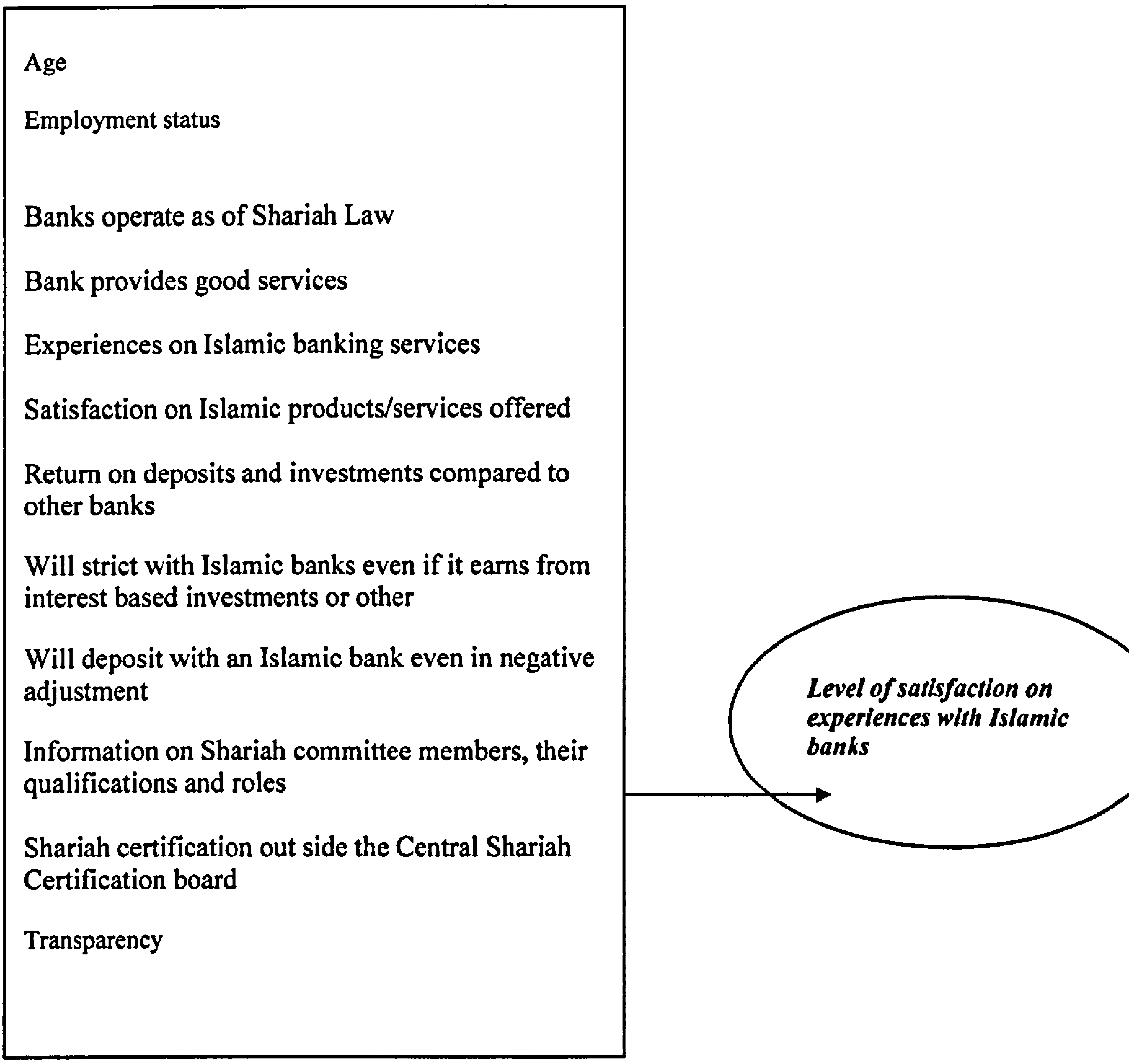
7.2 Analytical framework

The review of literature shows that customer's socio-demographic, religious affiliation and experiences on Islamic bank related services might have association with customer's satisfaction on Islamic banks. This study assumes that socio-demographic and banking services related factors may influence on output related factors. The analytical framework presented in Figure 7.1 shows a hypothetical model for the interaction of customer and banking related services. The following hypothesis (association) of this hypothetical model are tested in this chapter:

Level of satisfaction on Islamic banking experience may have association with customer's age, employment status, services provided by Islamic bank, customers experiences on Islamic banking services, satisfaction on Islamic bank related products, return on deposits and investments compared to other banks, 'information on *Shariah* committee members, their qualifications and roles', '*Shariah* certification out side the Central *Shariah* Certification board' and 'Transparency of Islamic bank' and 'Types of account' might have associated with 'operates as of *Shariah* Law', 'faith on Islamic banks' and 'satisfaction on Islamic banks'.

To test the above hypotheses, bivariate (cross-tabular) and multivariate analyses (e.g. multiple logistic regression and ordinal multiple logistic regression techniques) were performed. In bivariate analyses, all available variables were tabulated by the outcome variable. Results of bivariate analyses were expressed as percentages and Chi-square tests were used to examine the association or group differences ($p<0.05$). The multivariate analysis gives an additional perspective on this issue by highlighting the independent effect of each of the explanatory variable on dependent variables adjusting for other variables.

Figure 7.1: Hypothetical framework (analytical) for factors associated with satisfaction on Islamic banking related services



7.3 Results from Bangladesh survey

This section begins with the description of socio-demographic characteristics of the respondents. The second section presents the results of bivariate analyses that examine the association of Islamic bank related services with socio-demographic and behavioural characteristics of the customers. Through multivariate analyses the next section assesses the major predictors of Islamic bank related services in Bangladesh. The final section discusses the findings and makes recommendations for possible measures to improve the Islamic banking system as compared conventional banks.

7.3.1 General characteristics of the study (surveyed) population

A total of 401 customers from various Islamic banks in Bangladesh were interviewed. The socio-demographic and satisfaction of Islamic bank related information are presented in BDTable-1 to BD Table- 4. Nearly two thirds of the customers were under the age of 51 years, only 3.2% (n=13) were female and 22.9% were full time employed (Table BD1).

Table BD1: General Characteristics of the Islamic Bank Account Holders (n=401)

	Islamic Bank Account Holders (n=401)	
	Number	Col %
Respondents' age category (in years)		
18 - 30 Years	107	26.7
31 - 40 Years	154	38.4
41 - 50 Years	84	20.9
51+ Years	56	14.0
Gender		
Male	388	96.8
Female	13	3.2
Employment status		
Full-time Employed	92	22.9
Part-time Employed	7	1.7
Student	20	5.0
Unemployed	2	0.5
Retired	35	8.7
Others	245	61.1
Name of Islamic Bank		
Exim Bank Limited	50	12.5
Islamic Bank Bangladesh Limited	250	62.3
Shahjalal Islami Bank Limited	51	12.7
Al-Arafa Islamic Bank Limited	50	12.5

The majority of the customers/respondents were from Islamic Bank Bangladesh Limited (62.3%), followed by Shahjalal Islamic Bank Limited (12.7%) holding Savings Accounts (57.1%) and Current Accounts (41.9%). More than 80% of the respondents are holding accounts with Islamic Banks because of good services, 40% of the respondents believed that Islamic Banks are operating as per *Shariah* law (Table BD2).

Table BD2: General Characteristics of the Islamic Bank Account Holders (n=401)

	Islamic Bank Account Holders (n=401)	
	Number	Col %
Types of Account the respondents hold (Multiple choice)		
Current	168	41.9
Savings	229	57.1
Investment	6	1.5
Term Deposit	8	2.0
Others	8	2.0
D.P.S	10	2.5
Reasons for taking services from an Islamic financial institution		
Believe that they operate according to Islamic Shariah	163	40.6
Good Services	326	81.3
Good investment return	1	0.2
Very Bad	12	3.0
Near from his shop/Business place	16	4.0
Experiences about an Islamic financial institutions services		
In line with conventional banks	33	8.2
Better than conventional banks	306	76.3
Poorer than conventional banks	17	4.2
Worse than conventional banks	2	0.5
Neither better nor worse than conventional banks/Unsure	43	10.7
Level of satisfaction about Islamic products and services are structured and offered		
Very Satisfied	40	10.0
Satisfied	282	70.3
Neither satisfied or unsatisfied/Unsure	56	14.0
Unsatisfied	21	5.2
Very unsatisfied	2	0.5

Table BD3: General Characteristics of the Islamic Bank Account Holders (n=401)

	Islamic Bank Account Holders (n=401)	
	Number	Col %
Return on deposits and investments compared to other banks		
Similar with a conventional banks	60	15.0
Better than a conventional banks	218	54.4
Poorer than conventional banks	45	11.2
Neither better nor worse than conventional banks/Unsure	78	19.5
Holding account with another Islamic bank		
Yes	55	13.7
No	346	86.3
Shared loses as portion their account when bank suffer loses		
Yes	186	46.4
No	215	53.6
If the fund is subject to negative adjustment, would you still deposit with an Islamic bank		
Yes	231	57.6
No	170	42.4
Do you consider Islamic bank		
More Risky than conventional bank	1	0.2
Similar to conventional bank	61	15.2
Less risky than conventional bank	105	26.2
No risk at all	176	43.9
Not Known	58	14.5
If you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would you still		
Consider banking with them	70	17.5
Move to another Islamic bank	122	30.4
Move to a conventional bank	206	51.4
Other	3	0.7

Table BD4: General Characteristics of the Islamic Bank Account Holders (n=401)

	Islamic Bank Account Holders (n=401)	
	Number	Col %
Bank should give you full information on Shariah committee members, their qualifications and their roles		
Strongly Agree	30	7.5
Agree	213	53.1
Neither agree nor disagree	130	32.4
Disagree	24	6.0
Strongly disagree	4	1.0
When borrowing from Islamic bank do you have to give them additional guarantees/securities?		
Yes	382	95.5
No	18	4.5
Do you have borrowings from an Islamic bank		
Yes	69	17.2
No	332	82.8
When borrowing from an Islamic bank, do you feel that their repayments work out?		
Similar with conventional banks	57	14.3
Higher than conventional banks	9	2.3
Lower than conventional banks	88	22.0
Not Known/Unsure	246	61.5
In the event of your inability to fulfil your obligations do you expect Islamic bank to be lenient compared to conventional bank		
Lenient compared to conventional banks	112	27.9
Same as conventional banks	27	6.7
More harsh than conventional banks	11	2.7
Unsure	251	62.6
Would you be willing to see Shariah certification to be done by out side Central Shariah Certification board?		
Strongly agree	92	22.9
Agree	132	32.9
Neither agree nor disagree	67	16.7
Disagree	93	23.2
Strongly disagree	17	4.2
Which of the following closely match about your opinion on the transparency of your bank very transparent		
Very transparent	46	11.5
Fairly Transparent	273	68.1
Not transparent	24	6.0
Not Known	58	14.5
How would you rate your experience and rate of satisfaction with your Islamic bank		
Excellent	83	20.7
Very good/ Good	266	66.3
Neither good nor poor	23	5.7
Poor	25	6.2
Very poor	4	1.0

7.3.2 Satisfaction on Islamic banking: results from bivariate (cross-tabular) analysis

The results presented in Table BD5 showed that 87% of the respondents are satisfied on Islamic banking services (table BD5). The- results presented in table BD5 also revealed that level of satisfaction on Islamic banking services significantly differ by various services provided by Islamic banks.

Table BD5: Satisfaction on Islamic banking by socio-demographic and banking service related factors

	X13 Q23 Level of satisfaction				Total Number	Value of Chi-Square statistic and p values
	Not satisfied		Satisfied			
	Number	%	Number	%		
All respondents	**52**	**13.0**	**349**	**87.0**	**401**	
X1 Q1 Age groups						Chi-Square=2.58, p=0.108
Up to 40 years	39	14.9	222	85.1	261	
Over 40 years	13	9.3	127	90.7	140	
X2 Q3 Employment status						Chi-Square=1.03, p=0.309
Unemployed/Student/Retired	5	8.8	52	91.2	57	
Employed/Others (self employed)	47	13.7	297	86.3	344	
X3 Q5a Following Shariah						Chi-Square=1.56, p=0.211
No	35	14.7	203	85.3	238	
Yes	17	10.4	146	89.6	163	
X4 Q5b Good Services						Chi-Square=3.80, p=0.051
No	15	19.7	61	80.3	76	
Yes	37	11.4	288	88.6	325	
X5 Q6 Service better than Conventional banks						Chi-Square=48.62, p<0.001
No	25	40.3	37	59.7	62	
Yes	27	8.0	312	92.0	339	
X6 Q7 Satisfied with Islamic products						Chi-Square=60.17, p<0.001
No	31	39.2	48	60.8	79	
Yes	21	6.5	301	93.5	322	
X7 Q8 Return on investments						Chi-Square=17.69, p<0.001
No	29	23.6	94	76.4	123	
Yes	23	8.3	255	91.7	278	
X8 Q12 Question of faith						Chi-Square=12.93, p<0.001
No	34	20.0	136	80.0	170	
Yes	18	7.8	213	92.2	231	
X9 Q14 Question of faith will strict with Islamic Banks						Chi-Square=3.08, p=0.079
Will not stay	33	15.8	176	84.2	209	
Stay with Islamic bank	19	9.9	173	90.1	192	
X10 Q15 Information on Committee						Chi-Square=3.92, p=0.048
No	27	17.1	131	82.9	158	
Yes	25	10.3	218	89.7	243	
X11 Q21 Trust to Shariah Certification						Chi-Square=0.832, p=0.362
No	26	14.7	151	85.3	177	
Yes	26	11.6	198	88.4	224	
X12 Q22 Transparency						Chi-Square=40.96, p<0.001
No	28	34.1	54	65.9	82	
Yes	24	7.5	295	92.5	319	

7.4 Results from Malaysian Survey

This section begins with the description of socio-demographic characteristics of the respondents. The second section presents the results of bivariate analyses that examine the association of Islamic bank related services with socio-demographic and behavioural characteristics of the customers in Malaysia. The final section discusses the findings and makes recommendations for possible measures to improve the Islamic banking system as compared conventional banks.

7.4.1 General characteristics of the Malaysian surveyed population

A total of 93 customers from various Islamic banks in Malaysia were interviewed. The socio-demographic and satisfaction of Islamic bank related information are presented in Table MA1 to Table MA3. Of the respondents, 79.6% were under the age of 51 years, only 2.2% (n=2) were female and 12.9% were full time employed (Table MA1).

Table MA1: General Characteristics of the Islamic Bank Account Holders (n=93)

	Islamic Bank Account Holders (n=93)	
	Number	Col %
Q1. Respondents' age category (in years)		
18 - 30 Years	26	28.0
31 - 40 Years	48	51.6
41 - 50 Years	16	17.2
51+ Years	3	3.2
Q2 Gender		
Male	91	97.8
Female	2	2.2
Q3. Employment status		
Full-time Employed	12	12.9
Part-time Employed	34	36.6
Student	21	22.6
Unemployed	20	21.5
Retired	1	1.1
Others	5	5.4
Q4 Types of Account the respondents hold (Multiple choice)		
Current	6	6.4
Savings	90	96.8
Q5 Reasons for taking services from an Islamic financial institution		
Believe that they operate according to Islamic Shariah	37	39.8
Good Services	52	55.9
Good investment return	3	3.2
Very Bad	1	1.1
Near from his shop/Business place	-	-
Q6. In your experiences, do you find an Islamic financial institutions services are		
In line with conventional banks	56	60.2
Better than conventional banks	30	32.3
Poorer than conventional banks	4	4.3
Neither better nor worse than conventional banks/Unsure	3	3.2
Q7. Are your satisfied with the way Islamic products and services are structured and offered		
Ery Satisfied	6	6.5
Satisfied	76	81.7
Neither satisfied or unsatisfied/Unsure	11	11.8
Q8. Do you find that the return on deposits and investments are		
Similar with a conventional banks	49	52.7
Better than a conventional banks	35	37.6
Poorer than conventional banks	2	2.2
Worse than conventional banks	1	1.1
Neither better nor worse than conventional banks/Unsure	6	6.5

Table MA2: General Characteristics of the Islamic Bank Account Holders (n=93)

	Islamic Bank Account Holders (n=93)	
	Number	Col %
Q9. Do you have account with another Islamic bank		
Yes	33	35.5
No	60	64.5
Q11. When depositing with an Islamic bank, do you expect if bank suffer loses the bank may apportion their loses to your account		
Yes	33	35.5
No	60	64.5
Q12. If your fund is subject to negative adjustment, would you still deposit with an Islamic bank		
Yes	27	90.0
No	3	10.0
Q12. If your fund is subject to negative adjustment, would you still deposit with an Islamic bank		
Yes	33	35.5
No	60	64.5
Q13. Do you consider Islamic bank		
More Risky than conventional bank	7	7.5
Similar to conventional bank	42	45.2
Less risky than conventional bank	7	7.5
No risk at all	32	34.4
Not Known	5	5.4
Q14. If you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would you still		
Consider banking with them	68	73.1
Move to another Islamic bank	24	25.8
Other	1	1.1
Q15. Do you believe that the bank should give you full information on Shariah committee members, their qualifications and their roles		
Strongly Agree	4	4.3
Agree	70	75.3
Neither agree nor disagree	19	20.4
Q16. Do you have borrowings from an Islamic bank		
Yes	21	22.6
No	72	77.4
Q17. When borrowing from Islamic bank do you have to give them additional guarantees/securities?		
Yes	85	91.4
No	8	8.6

Table MA3: General Characteristics of the Islamic Bank Account Holders (n=93)

	Islamic Bank Account Holders (n=93)	
	Number	Col %
Q18. When borrowing from an Islamic bank, do you feel that their repayments work out?		
Similar with conventional banks	51	54.8
Higher than conventional banks	23	24.7
Lower than conventional banks	3	3.2
Not Known/Unsure	16	17.2
Q19. What is your main reason of borrowing from Islamic bank?		
Not dealing with Riba and operates under Islamic Shariah law	36	38.7
Better Rate	42	45.2
More accommodating compared to conventional bank	6	6.5
Convenience	3	3.2
Other	5	5.4
Unsure	1	1.1
Q20. In the event of your inability to fulfil your obligations do you expect Islamic bank to be lenient compared to conventional bank		
Lenient compared to conventional banks	31	33.3
Same as conventional banks	44	47.3
More harsh than conventional banks	2	2.2
Unsure	16	17.2
Q21. Would you be willing to see Shariah certification to be done by out side Central Shariah Certification board?		
Strongly agree	2	2.2
Agree	72	77.4
Neither agree nor disagree	18	19.4
Strongly disagree	1	1.1
Q22. Which of the following closely match about your opinion on the transparency of your bank very transparent		
Very transparent	3	3.2
Fairly Transparent	56	60.2
Not transparent	5	5.4
Not Known	29	31.2
Q23. How would you rate your experience and rate of satisfaction with your Islamic bank		
Excellent	1	1.1
Very good/ Good	75	80.6
Neither good nor poor	16	17.2
Poor	1	1.1

7.4.2 Satisfaction on Islamic banking: results from bivariate (cross-tabular) analysis

The results presented in Table MA4 showed that 81.7% of the respondents are satisfied on Islamic banking services (table MA4). The results presented in table MA4 also revealed that level of satisfaction on Islamic banking services significantly differ by various services provided by Islamic banks.

Table MA4: Satisfaction on Islamic banking by socio-demographic and banking service related factors

	X13 Q23 Level of satisfaction				Total Number	Value of Chi-Square statistic and p values
	Not satisfied		Satisfied			
	Number	%	Number	%		
All respondents	**17**	**18.3**	**76**	**81.7**	**93**	
X1 Q1 Age groups						Chi-Square=0.099, p=0.753
Up to 40 years	14	18.9	60	81.1	74	
Over 40 years	3	15.8	16	84.2	19	
X2 Q3 Employment status						Chi-Square=0.133, p=0.715
Unemployed/Student/Retired	7	16.7	35	83.3	42	
Employed/Others (self employed)	10	19.6	41	80.4	51	
X3 Q5a Following Sharia						Chi-Square=0.17, p=0.897
No	10	17.9	46	82.1	56	
Yes	7	18.9	30	81.1	37	
X4 Q5b Good Services						Chi-Square=0.075, p=0.785
No	8	19.5	33	80.5	41	
Yes	9	17.3	43	82.7	52	
X5 Q6 Service better than Conventional banks						Chi-Square=7.65, p=0.006
No	4	57.1	3	42.9	7	
Yes	13	15.1	73	84.9	86	
X6 Q7 Satisfied with Islamic products						Chi-Square=17.18, p<0.001
No	7	63.6	4	36.4	11	
Yes	10	12.2	72	87.8	82	
X7 Q8 Return on investments						Chi-Square=15.61, p<0.001
No	6	66.7	3	33.3	9	
Yes	11	13.1	73	86.9	84	
X8 Q12 Question of faith						Chi-Square=0.335, p=0.563
No	12	20.0	48	80.0	60	
Yes	5	15.2	28	84.8	33	
X9 Q14 Question of faith will strict with Islamic Banks						Not applicable (only one cases in no category)
Will not stay			1	100.0	1	
Stay with Islamic bank	17	18.5	75	81.5	92	
X10 Q15 Information on Committee						Chi-Square=2.82, p=0.093
No	6	31.6	13	68.4	19	
Yes	11	14.9	63	85.1	74	
X11 Q21 Trust to Sharia Certification						Chi-Square=9.07, p=0.003
No	8	42.1	11	57.9	19	
Yes	9	12.2	65	87.8	74	
X12 Q22 Transparency						Chi-Square=16.80, p<0.001
No	14	41.2	20	58.8	34	
Yes	3	5.1	56	94.9	59	

7.5 Results from Dubai survey

This section begins with the description of socio-demographic characteristics of the respondents. The second section presents the results of bivariate analyses that examines the association of Islamic bank related services with socio-demographic and behavioural characteristics of the customers in Dubai. The final section discusses the findings and makes recommendations for possible measures to improve the Islamic banking system as compared conventional banks.

7.5.1 General characteristics of the surveyed population from Dubai

A total of 30 customers from various Islamic banks in Dubai were interviewed. The socio-demographic and satisfaction of Islamic bank related information are presented in Table DUB1 to Table DUB3. Of the respondents, 79.3% were under the age of 51 years, only 13.0% (n=3) were female and all of them were full time employed (Table DUB1).

Table DUB1: General Characteristics of the Islamic Bank Account Holders (n=30)

	Islamic Bank Account Holders (n=30)	
	Number	Col %
Q1. Respondents' age category (in years)		
18 - 30 Years	9	31.0
31 - 40 Years	14	48.3
41 - 50 Years	5	17.2
51+ Years	1	3.4
Q2. Gender		
Male	20	87.0
Female	3	13.0
Q3. Employment status		
Full-time Employed	30	100.0
Q4 Types of Account the respondents hold (Multiple choice)		
Current	30	100.0
Savings	17	56.7
Investment	12	40.0
Others	6	20.0
Q5 Reasons for taking services from an Islamic financial institution (Multiple choice)		
Believe that they operate according to Islamic Shariah	20	66.7
Good Services	11	36.7
Good investment return	6	20.0
Very Bad	3	10.0
Near from his shop/Business place	-	-
Q6. In your experiences, do you find an Islamic financial institutions services are		
In line with conventional banks	10	33.3
Better than conventional banks	15	50.0
Poorer than conventional banks	4	13.3
Neither better nor worse than conventional banks/Unsure	1	3.3
Q7. Are your satisfied with the way Islamic products and services are structured and offered		
Very Satisfied	4	13.3
Satisfied	22	73.3
Neither satisfied or unsatisfied/Unsure	2	6.7
Unsatisfied	2	6.7
Q8. Do you find that the return on deposits and investments are		
Similar with a conventional banks	15	55.6
Better than a conventional banks	6	22.2
Poorer than conventional banks	1	3.7
Neither better nor worse than conventional banks/Unsure	5	18.5

Table DUB2: General Characteristics of the Islamic Bank Account Holders (n=30)

	Islamic Bank Account Holders (n=30)	
	Number	Col %
Q9. Do you have account with another Islamic bank		
Yes	14	46.7
No	16	53.3
Q11. When depositing with an Islamic bank, do you expect if bank suffer loses the bank may apportion their loses to your account		
Yes	24	85.7
No	4	14.3
Q12. If your fund is subject to negative adjustment, would you still deposit with an Islamic bank		
Yes	27	90.0
No	3	10.0
Q13. Do you consider Islamic bank		
More Risky than conventional bank	18	60.0
Similar to conventional bank	3	10.0
Less risky than conventional bank	8	26.7
No risk at all	1	3.3
Q14. If you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would you still		
Consider banking with them	4	13.3
Move to another Islamic bank	24	80.0
Other	2	6.7
Q15. Do you believe that the bank should give you full information on Shariah committee members, their qualifications and their roles		
Strongly Agree	20	66.7
Agree	8	26.7
Neither agree nor disagree	1	3.3
Disagree	1	3.3
Q17. When borrowing from Islamic bank do you have to give them additional guarantees/securities?		
Yes	14	58.3
No	10	41.7
Q18. When borrowing from an Islamic bank, do you feel that their repayments work out?		
Similar with conventional banks	11	45.8
Higher than conventional banks	6	25.0
Lower than conventional banks	3	12.5
Not Known/Unsure	4	16.7
Q19. What is your main reason of borrowing from Islamic bank? (multiple)		
Not dealing with Riba and operates under Islamic Shariah law	29	96.7
Better Rate	8	26.7
More accommodating compared to conventional bank	9	30.0
Convenience	14	46.7
Other	1	3.3

Table DUB3: General Characteristics of the Islamic Bank Account Holders (n=30)

	Islamic Bank Account Holders (n=30)	
	Number	Col %
Q20. In the event of your inability to fulfill your obligations do you expect Islamic bank to be lenient compared to conventional bank		
Lenient compared to conventional banks	19	63.3
Same as conventional banks	8	26.7
More harsh than conventional banks	1	3.3
Unsure	2	6.7
Q21. Would you be willing to see Sariah certification to be done by out side Central Sariah Certification board?		
Strongly agree	11	36.7
Agree	7	23.3
Neither agree nor disagree	6	20.0
Disagree	4	13.3
Strongly disagree	2	6.7
Q22. Which of the following closely match about your opinion on the transparency of your bank very transparent		
Very transparent	8	26.7
Fairly Transparent	18	60.0
Not transparent	2	6.7
Not Known	2	6.7
Q23. How would you rate your experience and rate of satisfaction with your Islamic bank		
Excellent	9	30.0
Very good/ Good	17	56.7
Neither good nor poor	4	13.3

7.6 Results from UK survey

This section begins with the description of socio-demographic characteristics of the respondents. The second section presents the results of bivariate analyses that examine the association of Islamic bank related services with socio-demographic and behavioural characteristics of the customers in UK. The final section discusses the findings and makes recommendations for possible measures to improve the Islamic banking system as compared conventional banks.

7.6.1 General characteristics of the surveyed population from U.K.

A total of 27 customers from various parts in the U.K. have responded to the Questionnaires sent. The socio-demographic and satisfaction of Islamic bank related information are presented in Table UK1 to Table UK3. Of the respondents, 63% were under the age of 51 years, only 7.7% (n=2) were female and 37% were full/part-time employed (Table UK1).

Table UK1: General Characteristics of the Islamic Bank Account Holders (n=27)

	Islamic Bank Account Holders (n=27)	
	Number	Col %
Q1. Respondents' age category (in years)		
31 - 40 Years	5	18.5
41 - 50 Years	12	44.5
51+ Years	10	37.0
Q2. Gender		
Male	24	92.3
Female	2	7.7
Q3. Employment status		
Full-time Employed	3	11.1
Part-time Employed	7	25.9
Unemployed	13	48.1
Others	4	14.8
Q4 Types of Account the respondents hold (Multiple choice)		
Current	5	20.0
Savings	21	84.0
Investment	4	18.2
Q5 Reasons for taking services from an Islamic financial institution		
Believe that they operate according to Islamic Shariah	25	92.6
Good Services	4	14.8
Good investment return	2	7.4
Q6. In your experiences, do you find an Islamic financial institutions services are		
In line with conventional banks	2	7.4
Better than conventional banks	21	77.8
Poorer than conventional banks	3	11.1
Neither better nor worse than conventional banks/Unsure	1	3.7
Q7. Are your satisfied with the way Islamic products and services are structured and offered		
Very Satisfied	7	25.9
Satisfied	18	66.7
Neither satisfied or unsatisfied/Unsure	1	3.7
Unsatisfied	1	3.7
Q8. Do you find that the return on deposits and investments are		
Similar with a conventional banks	4	15.4
Better than a conventional banks	19	73.1
Poorer than conventional banks	3	11.5

Table UK2: General Characteristics of the Islamic Bank Account Holders (n=27)

	Islamic Bank Account Holders (n=27)	
	Number	Col %
Q9. Do you have account with another Islamic bank		
Yes	6	22.2
No	21	77.8
Q11. When depositing with an Islamic bank, do you expect if bank suffer loses the bank may apportion their loses to your account		
Yes	26	96.3
No	1	3.7
Q12. If your fund is subject to negative adjustment, would you still deposit with an Islamic bank		
Yes	22	81.5
No	5	18.5
Q13. Do you consider Islamic bank		
More Risky than conventional bank	14	51.9
Similar to conventional bank	6	22.2
Less risky than conventional bank	5	18.5
Not Known	2	7.4
Q14. If you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would you still		
Consider banking with them	2	7.4
Move to another Islamic bank	25	92.6
Move to a conventional bank	-	-
Other	-	-
Q15. Do you believe that the bank should give you full information on Shariah committee members, their qualifications and their roles		
Strongly Agree	6	22.2
Agree	15	55.6
Neither agree nor disagree	6	22.2
Q16. Do you have borrowings from an Islamic bank		
Yes	13	48.1
No	14	51.9
Q17. When borrowing from Islamic bank do you have to give them additional guarantees/securities?		
Yes	18	72.0
No	7	28.0
Q18. When borrowing from an Islamic bank, do you feel that their repayments work out?		
Similar with conventional banks	5	19.2
Higher than conventional banks	19	73.1
Lower than conventional banks	1	3.8
Not Known/Unsure	1	3.8

Table UK3: General Characteristics of the Islamic Bank Account Holders (n=27)

	Islamic Bank Account Holders (n=27)	
	Numbe r	Col %
Q19. What is your main reason of borrowing from Islamic bank?		
Not dealing with Riba and operates under Islamic Shariah law	26	96.3
Better Rate	0	0
More accommodating compared to conventional ank	2	7.4
Convenience	1	3.7
Other	1	3.7
Q20. In the event of your inability to fulfil your obligations do you expect Islamic bank to be lenient compared to conventional bank		
Lenient compared to conventional banks	16	59.3
Same as conventional banks	8	29.6
More harsh than conventional banks	2	7.4
Unsure	1	3.7
Q21. Would you be willing to see Shariah certification To be done by out side Central Shariah Certification board?		
Strongly agree	5	18.5
Agree	12	44.4
Neither agree nor disagree	8	29.6
Disagree	2	7.4
Q22. Which of the following closely match about your opinion on the transparency of your bank very transparent		
Very transparent	5	18.5
Fairly Transparent	10	37.0
Not Known	12	44.4
Q23. How would you rate your experience and rate of satisfaction with your Islamic bank		
Excellent	8	30.8
Very good/ Good	15	57.7
Neither good nor poor	2	7.7
Poor	1	3.8

7.7 Conclusion

The findings showed how Islamic banking practices differ from region to region and also how the sensitivities of the customers differ across the regions. These findings are consistent with existing literature reviews which indicate that Malaysian practices differ considerably from other regions as their practices are very close to a conventional banking system as shown from the customers' response in this region. On the crucial questions relating to *Shariah* non compliance by the Islamic banks, the attitude of Malaysian banking customers are moderate. Responses also highlighted the attitude of customers in the U.K., which showed high sensitivity to non compliances by the Islamic banks. This is because customers in the western countries would go to an Islamic bank through choice and would, therefore, demand high compliance. The analysis shows that sensitivity differs across the region which is in line with other findings. This chapter identified the variables which have a strong association to the satisfaction of Islamic banking customers.

Chapter 8

Satisfaction on Islamic banking services: results from logistic regression analysis

8.1 Introduction

The previous chapter described the socio-demographic characteristics of the respondents and examined the association of these factors with regards to 'satisfaction on Islamic Banking Services'. This section also further examines the hypothesis of socio-demographic characteristics and satisfaction of banking services through Multiple Logistic Regression analysis adjusting for all other factors. This research is unique to this analysis, as no previous studies have analysed Islamic banking customers' satisfaction using Multiple Logistic Regression methods. This analysis identifies that customers' satisfaction has high correlation to Islamic *Shariah* variables.

8.2 Model specification and variables selection

One of the primary objectives of this study was to estimate a comprehensive model for the probability of satisfaction on Islamic bank related service. Following the analytical framework discussed earlier in the literature and methodology section, this section examined the association of socio-demographic characteristics and satisfaction of banking services. The dependent/outcome variable used in this study was 'Satisfaction on Islamic banking services' which is a dichotomous variable (takes two values e.g. 1 for 'satisfied' and 0 'not satisfied'), in this situation multiple logistic regression analysis has been commonly used to explore the independent contribution of each potential explanatory variable on dependent variable adjusting for other variables (Hosmer & Lemoshow 2000).

As of methodology section "Equation 5.8" above the convenient form of logistic regression model is :

$$p_i' = \log_e(p_i/1 - p_i) = \log_e\ [\exp\{-(\textstyle\sum_{j=0}^{k}\beta_j X_{ij})\}]^{-1}$$

$$p_i' = \log_e(p_i/1 - p_i) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \ldots + \beta_k X_k \quad \ldots\ldots\ldots\ldots \quad (8.1)$$

where $X_{i0} = 1$ and p_i is the probability of 'success' for 'ith' respondents β_0 is the constant, $\beta_1, \beta_2, \ldots, \beta_k$ are the logistic regression co-efficients and $X_1, X_2, \ldots, X_k$ *are* k explanatory variables.

To determine the factors which are associated with 'Satisfaction on Islamic banking services' (dependent variable), a forward stepwise multiple logistic regression model was employed which include all the variables used in bivariate analysis. The variables that are specified on forward stepwise technique are tested for entry into the model one by one, based on the significance level of the score statistic. At first, the most significant variable is entered into the model. After each entry, variables that are already in the model are tested for possible removal, based on the significance of the conditional statistic, the Wald statistic, or the likelihood-ratio criterion. The insignificant variable with the largest probability greater than the specified value is removed (p>0.05), and the model is re-estimated. Variables in the model are then evaluated again for removal. When no more variables satisfy the removal criterion, covariates that are not in the model are evaluated for entry. Model building stops when no more variables meet entry or removal criteria or when the current model is the same as a previous model. The results from final step are presented in the Table BD6.

It is to be noted that in the forward stepwise logistic regression model, the results showed the contribution for each of the significant factor, adjusting for all significant variables included in the model. The dependent and explanatory variables in the multivariate logistic regression analyses were coded in Table 8.1.

As of the 'Equation 8.1' discussed above for this study the equation for multiple logistic regression analysis will be as follows:

$$p_i' = \textbf{Probability } (X_{13}) = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \beta_8 X_8 + \beta_9 X_9 + \beta_{10} X_{10} + \beta_{11} X_{11} + \beta_{12} X_{12} \qquad \textbf{(8.2)}$$

Where X13= Level of Satisfaction on Islamic banking services, X1 =Age groups, X2 =Employment status, X3 =Following *Shariah*, X4= Good Services, X5= Service better than Conventional banks, X6 =Satisfied with Islamic products, X7= Return on investments, X8= Question of faith, X9 =Question of faith will strict with Islamic Banks, X10= Information on Committee, X11= Trust to *Shari'ah* Certification and X12 =Transparency.

Table 8.2.1: Definitions of variables for Logistic Regression Analysis

Name of Variables	Description of Variables
Dependent Variable	
X13 Q23 Level of satisfaction on Islamic banking services	0= No, 1 =Satisfied
Explanatory Variables	
X1 Q1 Age groups	0 =Under 40 years, 1=Over 40 years.
X2 Q3 Employment status	0=Unemployed/Student/Retired, 1=Employed/Others (self employed)
X3 Q5a Following Sharia	0= No, 1 =Yes
X4 Q5b Good Services	0= No good services, 1 =Yes good services
X5 Q6 Service better than Conventional banks	0= No, 1 =Yes
X6 Q7 Satisfied with Islamic products	0= No, 1 =Yes
X7 Q8 Return on investments	0= No, 1 =Yes
X8 Q12 Question of faith	0= No, 1 =Yes
X9 Q14 Question of faith will strict with Islamic Banks	0= No, 1 =Yes
X10 Q15 Information on Committee	0= No, 1 =Yes
X11 Q21 Trust to Sharia Certification	0= No, 1 =Yes
X12 Q22 Transparency	0= No, 1 =Yes

8.3 Satisfaction on Islamic banking services: results from logistic regression analysis- Bangladesh

The results from logistic regression analysis showed that X5 (Q6 service better than Conventional banks), X6 (Q7 Satisfied with Islamic products), X8 (Q12 Question of faith) and X12 (Q22 Transparency) had relatively strong significant ($p<0.05$) associations with the 'satisfaction of Islamic banking services' (Table BD6). The logistic regression coefficients indicate that customers satisfied on 'Islamic products and services' were about six times more likely to have overall satisfaction on Islamic banking system (OR=6.06, 95% CI: 2.97-12.36), and those who have faith (X8) were about four times as likely to have satisfaction on Islamic banking services as compared to others (OR=3.85, 95% CI: 1.85-8.01).

The customers over the age of 40 (Table BD5) and the customers who are un employed have shown more satisfaction over other groups to Islamic banking services. This is because older people are more religious minded and desire to conduct their financial activities according to Islamic *Shariah.* The unemployed group is also more religiously minded and have strong association with mosques, therefore, is more willing to believe that the Islamic banking services are better than conventional banks. Therefore they are more satisfied with Islamic banking services.

As expected those who believe that Islamic banks provides better services than conventional banks are more satisfied (92%) , satisfied with Islamic products (93.5%) wishes to continue banking with Islamic banks (90.1%) and have shown overall satisfaction with investment returns, transparency and *Shariah* certification.

However when asked "if you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would they consider banking with Islamic banks or move?" (Table BD3), only 17.5% showed that they will be willing to stay with Islamic banks and over 50% will move to conventional banks and about 30% customers will move to other Islamic banks. Therefore, religious minded customers are showing greater satisfaction because they believe that Islamic banks are conducting their affairs according to Islamic *Shariah* and thus resultant income received from Islamic banks are considered *halal* by this group.

The value of model chi-square and -2log likelihood statistic suggested that the fitted model was highly significant i.e. the overall fit of the logistic regression model was good and the model correctly classified about 90% of all cases.

Table BD6: Factors associated with satisfaction on Islamic banking services: results from multiple logistic regression analyses

Explanatory variables	Logistic Regression coefficients (β)	Adjusted Odds Ratio (95% CI)	Significant level
X5 Q6 service better than Conventional banks			
No	-	1.00	
Yes	1.30	3.67 (1.67-8.08)	0.001
X6 Q7 Satisfied with Islamic products			
No	-	1.00	
Yes	1.80	6.06 (2.97-12.36)	0.001
X8 Q12 Question of faith			
No	-	1.00	
Yes	1.34	3.85 (1.85-8.01)	0.001
X12 Q22 Transparency			
No	-	1.00	
Yes	1.38	3.96 (1.86-8.46)	0.001
Constant	**-1.84**		**0.001**
Model Summary			
Total number of cases	401 (100% included in the analysis)		
Model Chi-square	168.77, df=4		0.001
-2 Log likelihood	216.58		0.001
Cox & Snell R square		0.207	
Nagelkerke R square		0.384	
% Correctly classified		89.8	

8.4 Satisfaction on Islamic banking services: results from logistic regression analysis- Malaysia

The results from logistic regression analysis showed that X6 (Q7 Satisfied with Islamic products) and X12 (Q22 Transparency) had relatively strong significant ($p<0.05$) associations with the 'satisfaction of Islamic banking services' (Table MA5). The logistic regression coefficients indicate that customers satisfied on 'Islamic products and services' were about 11.7 times more likely to have overall satisfaction with the Islamic banking system (OR=11.70, 95% CI: 2.21-61.77) and those have believe in banks are transparent (X12) were about twelve and half times as likely to have satisfaction on Islamic banking services as compared to others (OR=12.47, 95% CI: 2.89-53.70).

In line with Bangladesh survey results the Malaysian results also showed that the customers over the age of 40 (Table MA4) and the customers who are un employed have shown more satisfaction over other groups to Islamic banking services. This is because older people are more religious minded and desires to conduct their financial activities according to Islamic *Shariah.* The unemployed group is also more religious minded and have strong association with mosques, therefore, is more willing to believe that the Islamic banking services are better than conventional banks. Therefore they are more satisfied with Islamic banking services.

As expected those who believe that Islamic banks provides better services than conventional banks are more satisfied (82.7%) , satisfied with Islamic products (87.8%) wishes to continue banking with Islamic banks (81.5%) and have shown overall satisfaction with investment returns, transparency and *Shariah* certification. However when asked "if you are to discover that Islamic banks are earning from interest based investments or other prohibited activities would they consider banking with Islamic banks or move?" (Table MA2), the results are significantly different from those of Bangladesh. Mostly 73.1% showed that they will be willing to stay with Islamic banks and only 25.8% will move to other Islamic banks.

This is in line with Literature review that the Malaysian Islamic banking services have converged more freely with conventional banks and the differences between Islamic banking and conventional banking are blurred. In Malaysia they show leniency in the interpretation of religious terms and their practices differ from those of Bangladesh and Middle East.

Therefore, religious minded customers are showing greater satisfaction because they believe that Islamic banks are conducting their affairs according to Islamic *Shariah* and thus resultant income received from Islamic banks are considered *halal* by this group.

The value of model chi-square and -2log likelihood statistic suggested that the fitted model was highly significant i.e. the overall fit of the logistic regression model was good and the model correctly classified about 87% of all cases. It is to be noted that the because small sample size in Malaysian the survey (n=93), the ultimate results from multiple logistic regression analysis may not be generalisable.

Table MA5: Factors associated with satisfaction on Islamic banking services: results from multiple logistic regression analyses -Malaysia

Explanatory variables	Logistic Regression coefficients (β)	Adjusted Odds Ratio (95% CI)	Significant level
X6 Q7 Satisfied with Islamic products			
No	-	1.00	
Yes	2.46	11.70 (2.21-61.77)	0.001
X12 Q22 Transparency			
No	-	1.00	
Yes	2.52	42.47 (2.89-53.70)	0.001
Constant	**-1.62**		**0.001**
Model Summary			
Total number of cases	93 (100% included in the analysis)		
Model Chi-square	28.15, df=2		0.001
-2 Log likelihood	60.13		0.001
Cox & Snell R square		0.261	
Nagelkerke R square		0.426	
% Correctly classified		87.1	

8.5 Satisfaction on Islamic banking services: results from logistic regression analysis based on combined data from Bangladesh and Malaysia

The results from logistic regression analysis on combined sample showed that X5 (Q6 service better than Conventional banks), X6 (Q7 Satisfied with Islamic products), X8 (Q12 Question of faith) and X12 (Q22 Transparency) had relatively strong significant ($p<0.05$) associations with the 'satisfaction of Islamic banking services' (Table BD_MA7). These findings are consistent with the results found in Bangladesh and Malaysian sample respectively (Table B6 and MA5).

These results indicate that the religious minded older generation believe that Islamic banks services are better than conventional banks and they believe that their products and services are s*hariah* compliant. They also believe that banks are transparent and more *Shariah* compliances would results in higher satisfaction. Customers are very sensitive on these issues and believes that the Islamic banks are complying with Islamic s*hariah* law and running their affairs accordingly.

Table BD-MA7: Factors associated with satisfaction on Islamic banking services: results from multiple logistic regression analyses (combined Bangladesh and Malaysian data)

Explanatory variables	Logistic Regression coefficients (β)	Adjusted Odds Ratio (95% CI)	Significant level
X5 Q6 service better than Conventional banks			
No	-	1.00	
Yes	1.04	2.73 (1.33-5.59)	0.001
X6 Q7 Satisfied with Islamic products			
No	-	1.00	
Yes	1.769	5.86 (3.07-11.16)	0.001
X8 Q12 Question of faith			
No	-	1.00	
Yes	1.08	2.96 (1.57-5.55)	0.001
X12 Q22 Transparency			
No	-	1.00	
Yes	1.60	4.99 (2.68-9.27)	0.001
Constant	**-1.69**		**0.001**
Model Summary			
Total number of cases	494 (100% included in the analysis)		
Model Chi-square	116.39, df=4		0.001
-2 Log likelihood	286.13		0.001
Cox & Snell R square		0.205	
Nagelkerke R square		0.370	
% Correctly classified		86.0	

8.6 Conclusion

The results from the logistic regression analysis showed that satisfied with Islamic products and transparency had relatively strong significant ($p<0.05$) associations with the 'satisfaction of Islamic banking services'. The logistic regression coefficients indicate that customers satisfied on 'Islamic products and services' were about 11.7 times more likely to have an overall satisfaction with the Islamic banking system (OR=11.70, 95% CI: 2.21-61.77) and those that hold a belief that these banks are transparent (X12) were about twelve-and-a- half times as likely to be satisfied with Islamic banking services as compared to others (OR=12.47, 95% CI: 2.89-53.70).The results show that the risk of non compliance to *Shariah* is very high and that customers are very sensitive to this issue. The results also prove that the customers attach high value to compliance with *Shariah,* to the extent that they are willing to take negative returns.

Chapter 9

Satisfaction on Islamic banking services: results from ordinal logistic regression analysis

9.1 Introduction

This section also examines the association of socio-demographic characteristics and satisfaction of banking services through Ordinal Logistic Regression model. In addition to cross-tabular (bivariate) and multiple logistic regression techniques which presented in previous chapters (chapters seven and eight), this chapter further examine same hypotheses through Ordinal Logistic Regression model. The analysis showed strong correlation to variables identified from the previous analysis. All analysis showed that compliances to *Shariah* is central for the Islamic banking customers and non compliances has serious implication for the Islamic banking sector. This research is unique that no previous study has analysed Islamic banking customers' satisfaction using Ordinal Logistic Regression methods. This analysis identified that customers satisfaction had high correlation to Islamic *Shariah* variables

9.2 Model specification and variables selection

One of the primary objectives of this study was to estimate a comprehensive model for the probability of satisfaction of Islamic bank related services. Following the analytical framework and literature discussed earlier in the methodology section, by using the Ordinal Logistic Regression model, this section examined the association of socio-demographic characteristics and the satisfaction of banking services. The dependent variable 'Satisfaction on Islamic banking services' was a 5-point Likert scale question and was used to assess one's experience and level of satisfaction with the Islamic bank e.g. 1) Excellent; 2). Very good/Good; 3) Neither good nor poor; 4) Poor; and 5) Very poor.

In the previous section (Chapter 8) to determine the factors which are associated with 'Satisfaction on Islamic banking services' were treated as dichotomous dependent variable e.g. takes two values '1' for 'Satisfied' and '0' for 'Not satisfied'.

In this section 'Satisfaction on Islamic banking services' was considered as an 'ordered dependent variable' and for interpretation purposes the this question has been recorded as follows: 1= 'Poor/Very poor'; 2='Neither poor nor good'; 3='Very good/good' 4='Excellent'. Since the recoded 'Satisfaction on Islamic banking services' is an ordered dependent variable in this situation Ordinal Logistic Regression has been commonly used (Hosmer & Lemeshow 2000).

The basic idea underlying the proportional odds model is re-expressing the categorical variable in terms of a number of binary variables based on internal cut-points in the ordinal scale. For example, if Y is an ordered response variable on K-point scale for N participants then we can write a general ordered regression model as:

$$\mathbf{g\,[Yij] = x\beta_j} \qquad \textbf{(9.1)}$$

Where, for j = 1, 2, ..., (K-1) thresholds (for K-point of response), and i = 1, 2, ..., N participants

g [•] is a link function. Setting g [•] to log [Pr(Y>$\mathbf{Y_j}$)/Pr(Y =$\mathbf{Y_j}$)], (9.2)
log [Pr(Y > $\mathbf{Y_j}$) / Pr(Y≤ $\mathbf{Y_j}$)],

or log [Pr(Y = $\mathbf{Y_{j+1}}$)/Pr(Y = $\mathbf{Y_j}$)] (9.3)

results in the continuation-ratio, proportional-odds or adjacent category models, respectively.

The dependent and explanatory variables in the multivariate ordinal logistic regression analyses were coded in Table 9.1. The association of each explanatory variable with dependent variable were expressed by the ordinal logistic regression co-efficient. Because of the sufficient sample size for Bangladesh (n=401), one ordinal logistic regression model was used for Bangladesh data. As the sample size for Malaysia (n=93) was small, to get better estimates a separate ordinal logistic regression model was used on combined data from Bangladesh and Malaysia. The ordinal logistic regression coefficients were adjusted for the effects of other variables, the regression co-efficients are shown to express the association of 'Satisfaction on Islamic banking services' for each of the explanatory variable.

Table 9.1: Definitions of variables for ordinal logistic regression analysis

Name of Variables	**Description of Variables**
Dependent Variables	
X13 Q23 Level of satisfaction on Islamic banking services	1= 'Poor/Very poor'; 2='Neither poor nor good'; 3='Very good/good' 4='Excellent'
Explanatory Variables	
X1 Q1 Age groups	0 =Under 40 years, 1=Over 40 years.
Q3 X2 Employment status	0=Unemployed/Student/Retired, 1=Employed/Others (self employed)
Q5a X3 Following Shariah	0= No, 1 =Yes
Q5b X4 Good Services	0= No good services, 1 =Yes good services
Q6 X5 Service better than Conventional banks	0= No, 1 =Yes
Q7 X6 Satisfied with Islamic products	0= No, 1 =Yes
Q8 X7 Return on investments	0= No, 1 =Yes
Q12 X8 Question of faith	0= No, 1 =Yes
Q14 X9 Question of faith will strict with Islamic Banks	0= No, 1 =Yes
Q15 X10 Information on Committee	0= No, 1 =Yes
Q21 X11 Trust to Shariah Certification	0= No, 1 =Yes
Q22 X12 Transparency	0= No, 1 =Yes

Table 9.2 : Factors associated with satisfaction on Islamic banking services: results from multiple ordered (Ordinal) logistic regression analyses

	Bangladesh (n=401)		Bangladesh + Malaysia (n=494)	
variables	Ordinal Logistic Regression coefficients	Significant level	Ordinal Logistic Regression coefficients	Significant level
Dependent Variables with Threshold				
[X_13 = 1.00]	0.65	0.2747	0.64	0.2040
[X_13 = 2.00]	1.54	0.0104	1.86	0.0003
[X_13 = 3.00]	6.14	0.0000	6.57	0.0000
Explanatory variables				
X1 Age groups (0=Under 4o years; 1=Over 40 years)	**0.65**	**0.0086**	**0.63**	**0.0054**
X2 Employment status (0=Unemployed; 1=Employed)	**-0.65**	**0.0505**	-0.23	0.3898
X3 Following Shariah (No=0, Yes=1)	**0.74**	**0.0155**	**0.98**	**0.0005**
X4 Good Services (No=0, Yes=1)	-0.01	0.9698	0.36	0.1915
X5 Service better than Conventional banks (No=0, Yes=1)	**0.86**	**0.0157**	**0.67**	**0.0478**
X6 Satisfied with Islamic products (No=0, Yes=1)	**1.59**	**0.0001**	**1.55**	**0.0001**
X7 Return on investments (No=0, Yes=1)	0.17	0.5293	0.15	0.5587
X8 Question of faith (No=0, Yes=1)	**1.13**	**0.0001**	**1.06**	**0.0001**
X9 Question of faith will strict with Islamic Banks (No=0, Yes=1)	0.21	0.4567	0.03	0.9119
X10 Information on Committee (No=0, Yes=1)	-0.08	0.7642	-0.17	0.4813
X11 Trust to Shariah Certification (No=0, Yes=1)	0.38	0.1363	0.14	0.5423
X12 Transparency (No=0, Yes=1)	**1.51**	**0.0001**	**1.55**	**0.0001**
Model Summary				
-2 Log likelihood	479.242	0.001	582.895	0.001
Model Chi square	167.371		184.429	
Cox & Snell R square	0.341		0.312	
Nagelkerke R square	0.401		0.369	

9.3 Results from ordinal logistic regression analysis

The results from ordinal logistic regression analysis for Bangladesh data showed that X1 (age), X2 (employment status), X5 (Q6 Service better than Conventional banks), X6 (Q7 Satisfied with Islamic products), X8 (Q12 Question of faith) and X12 (Q22 Transparency) had relatively strong significant ($p<0.05$) associations with the 'satisfaction of Islamic banking services' (Table XX). Older, unemployed and religious minded clients were more likely to be satisfied on Islamic Banking services as compared to others (young and employed). A similar association was also observed for total data (Bangladesh + Malaysia). The value of model chi-square and -2log likelihood statistic suggested that the fitted model was highly significant i.e. the overall fit of the logistic regression model was good.

Considering the dependent variable 'Satisfaction on Islamic banking services' as ordered response variable the results found in this chapter (based on ordinal logistic regression model) is consistent with the results found in previous chapter (chapter 8), where 'Satisfaction on Islamic banking services' was treated as dichotomous variable (based on multiple logistic regression model).

9.4 Conclusion

The above analysis showed strong a correlation to the variables identified in the previous analysis. All analysis showed that compliances to *Shariah* is central for the Islamic banking customers and non-compliance has serious implications for the Islamic banking sector. The results found through Ordered Multiple Logistic regression are consistent with those from the Multiple Logistic Regression, discussed in the previous chapter.

Chapter 10

Conclusions

10.1 Summary of Contributions and Findings

The main objective of this study was to investigate the extent to which Islamic banks corporate and *Shariah* governances ensure *Shariah* compliances and to explore customers' satisfaction of Islamic banking services. The hypotheses which have been examined in this thesis were namely:

Hypothesis 1 - Current Islamic banking practices are superficial, driven by market forces and not by religious convictions.

Hypothesis 2 - Existing environments is an obstacle for the Islamic banking to offer standardised products in a transparent way.

Hypothesis 3 - Regulatory shortcomings makes Islamic banking prone to systematic risks.

Hypothesis 4 - Practices of Islamic banking differ from their theoretical foundation and core objectives

Hypothesis 5 - Level of customers satisfaction of Islamic banking have association with clients socio-demographic characteristics and services provided by the bank.

In addition to above hypotheses, this thesis also explored the *Shariah* practices in different countries in relation to Islamic banking. This chapter summarises the conclusions of this study and its contribution to existing research based on literature reviews and survey analysis. This chapter also suggests some policy measures for the improvement of Islamic banking. Finally the chapter also highlights the strength and weakness of this study and outlines recommendations for further research.

The extensive literature review which has been presented in this thesis highlighted that that:

- Current Islamic banking practices are superficial, driven by market forces and not by religious convictions.
- Existing environments is an obstacle for the Islamic banking to offer standardised products in a transparent way.
- Regulatory shortcomings makes Islamic banking prone to systematic risks.
- Practices of Islamic banking differ from their theoretical foundation and core objectives.

Another key finding of this study was drawn from the logistic regression analysis of the Bangladesh survey and the combined survey of Bangladesh and Malaysia. This indicated that customers satisfied with 'Islamic products and services' were about six times more likely to have an overall satisfaction of the Islamic banking system. Customers who believe that banks are operating according to Islamic *Shariah* law and are transparent are approximately four times more likely to be satisfied with Islamic banking services. The findings of this thesis indicated that customers also believe that Islamic bank's services are better than conventional banks and are about four times more likely to have overall satisfaction from their services.

From the above analysis this thesis has found that customers' satisfaction will reduce significantly if Islamic banks are not transparent and do not follow Islamic *Shariah* law in their product development, not keeping their customers' faith in mind with regard to their operations. If Islamic banks are to improve services further by complying with Islamic *Shariah* law customers' satisfaction would greatly increase. The above factors showed strong significant ($p<0.05$) associations with the 'Satisfaction of Islamic banking services'. These associations found in this thesis are added to existing research which highlights the significance of *Shariah* compliance to customers of Islamic bank.

This study has also investigated the view points of a diverse range of customers of Islamic banks, showing differences in satisfaction using an ordinal multiple logistic regression analysis on both Bangladesh and Malaysian data. This analysis reconfirmed that 'Age', 'Employment status', 'Services better than Conventional banks', 'Satisfied with Islamic products', 'Question of faith' and 'Transparency' had relatively strong significant ($p<0.05$) associations with the 'Satisfaction of Islamic banking services'. Older, unemployed and religious minded clients were more likely to be satisfied with Islamic banking services as compared to others (young and employed). A similar association was also observed from the total data (Bangladesh plus Malaysia). The use of the ordinal multiple logistic regression model to explore the Islamic banking customers' satisfaction is a unique contribution in this type of research.

Another important contribution of this thesis is that, based on the case study and literature review, this thesis examined the supply and demand side of Islamic banking system, taking into account the views of different stakeholder groups. This study has examined the banking practices from both *Shariah* compliances perspectives and regulatory oversight. By taking into account these different perspectives it has drawn out an overall picture of the regulatory and *Shariah* shortcomings and moral hazards described in Chapter 4.

This thesis has identified the value to which customers attach to the Islamic banking system and their expectations of *Shariah* compliances and good services. This establishes the utility functions of the Islamic banks customers. The multiple logistic regression model has indentified that the 'Satisfaction on Islamic products' and 'Transparency', as the most sensitive factors and established a function of utility which can be a guide for the innovation, practices and the regulation of Islamic banking for sustained development. The use of the multiple logistic regression and ordinal multiple logistic regression model to identify the important factors and their association/correlation to customers' satisfaction is a unique contribution in the analysis of Islamic banks customers' utility functions.

This thesis has also identified and examined the conflicting nature of the banks role where depending on the type of investment they act as agents, trustees or partners, and these roles are swapped with customers depending on the nature of transactions. It also examined the loop hole in the regulation that despite giving licences to Islamic banks regulators do not require the banks to follow or adhere to Islamic *Shariah* law. This is a theoretical contribution of this thesis to the understanding of the Islamic banking environment from both *Shariah* law and regulatory perspectives.

This study has collected survey data from nearly 600 respondents from four important regions as well as conducted interviews with *Shariah* board members, banks, customers and the regulatory authorities to draw an overall picture of Islamic banking industry. This thesis has therefore made this practical contribution in Islamic banking research.

This research has shown that Islamic banks are to function in a way that all stakeholders working as partners and sharing the benefits and risks without charging interest and abide by Islamic *Shariah* law. This research collates the roots of Islamic finance and all *Shariah* issues (Chapter 2) to demonstrate its importance in honest accounting and reporting for the Islamic banking sector. This is another practical contribution of this thesis in understanding the issues and concerns from the Islamic jurisprudence point of view which no other study has previously undertook in this way.

This research has identified the importance of *Zakat* (chapter 2) and showed the benefits Islamic banks can derive by management of *Zakat* funds, thus providing greater interaction between the customers and the banks. This research has identified that through the management of *Zakat* fund the Islamic bank can increase its image of a socially responsive bank and can thus reach out to the grass root Muslims. This research has therefore, made this practical contribution in the development of Islamic banking sector.

By examining existing literature, this study also highlighted the growth of Islamic banks in relation to the demand of Islamic banking services with the rapid growth of Muslim population all over the world. The information on demand of Islamic banking services indicate that in future the Islamic banking services will need adequate supply of funds and increase the number of Islamic banking financial institutions to meet the customers demand all over the world.

This is a comprehensive study of all the elements of regulatory, corporate and *Shariah* governances of the Islamic financial industry to derive customers utility functions and customers satisfaction.

10.2 Policy Implications

Based on the literature review and survey results, the following policy implication arises out of this research:

The first policy implication arising from this research is that current regulatory efforts need to be harmonised and that regulatory agencies must create an enabling atmosphere for Islamic banks. Regulatory agencies should also have enforcement powers. In the absence of such efforts, the banks would try to benefit from regulatory and *Shariah* arbitrage opportunities. Where such arbitrage opportunities prevail, banks would not be inclined for full transparency, which will therefore be an obstacle for good corporate and *Shariah* governance.

The second policy implication arising from the literature review is that Islamic banks should be allowed to issue financial statements and reporting as per AAOFI standards. ISA standards are not consistent with Islamic principles; this causes the bank to record their transactions which contravenes Islamic *Shariah* law. The functions of conventional accounting and Islamic accounting differ quite considerably due to the fact that the conventional accounting model was developed on Anglo-American accounting practices which dealt with the identifying, recording, classifying and interpreting economic data to permit users to make informed decisions. Islamic banks' transactions have elements of trusts, agency and partnership. Therefore, the recognition criteria in an Islamic regime are quite different.

The third policy implication of this thesis is that regulators must ensure that *Shariah* certification is done by a central *Shariah* certification agency. Islamic banks around the world should follow the guideline of this agency on any *Shariah* issues and all products and services must be authenticated by this agency. This will bring standardisation and will enhance customer trust that will enable the sector to prosper.

The fourth policy implication of this research is that central banks in each jurisdiction must develop an Islamic money market where an Islamic bank can manage excess liquidity and a liquidity shortfall. The central banks must also build a special reserve fund to help this sector with any liquidity crisis. The central bank must also develop an Islamic bond on Islamic principles which can also be used for liquidity management of Islamic banks.

This research identified that Islamic banking is not as yet popular at grass root level. The banks must display full transparency, product information and engage with customers to explain fully the modus operandi so that customers can build confidence to *Shariah* compliances.

This research indentified that those controversial products such as options and derivatives whose *Shariah* compliances are highly questionable. Islamic banks are said to mimic conventional banks in almost all areas of financial products, which raises doubt of *Shariah* compliances by Islamic banks. They must stick to core banking products on PLS modes, engage to develop products, finance businesses and generate income from productive activities rather than speculative transactions. Islamic banks can work towards this goal.

Islamic banks can take comfort that this study shows that the customers are satisfied with services and returns provided; that these returned are earned in a *Halal* way. Islamic banks must take this point seriously; that non compliances to *Shariah* related issues would make the banks vulnerable. Banks must work towards building customers' confidence by increasing the compliances to *Shariah*. The *Shariah* board can engage with customers, and banks must be proactive to display that the board is working independently and are not influenced by the management.

This study will also help regulators to understand the critical area of Islamic finance and the concerns surrounding the Islamic banking market. This will thus enable regulators to address the special risks the Islamic banking industry faces and to develop the appropriate regulation for a sound and sustainable Islamic financial market. Regulators can also ensure that proper regulatory oversight is in place to increase confidence and transparency for all.

The regulators and practitioners can gain insight from this research and can cater for products and services, taking into account the factors most valued by the customers.

Finally this research demonstrates that products and services to comply with *Shariah*, together with a better *Halal* return, full transparency and accountability, is the key for sustained growth of Islamic banking. All the players engaged in Islamic banking sector can work towards fulfilling these goals.

The reform suggested by this research specifically in the area of transparency and standardisation can be implemented at the regulatory level by Islamic Financial Services Board (IFSB). Currently they are issuing non-binding Shariah guidelines; therefore, they have already the expertise in hand. They can set up a Central Shariah Supervision Board and make it mandatory for Islamic banks to have their products and services vetted by this board. This can be implemented through the central banks that can monitor those compliances. The above process would reduce the role of in-house Shariah supervision board of an Islamic bank from certification to an advisory role. The world Bank research on Shariah Governance also called for centralised Shariah Supervisory Board (Grais and Pellegrini 2006). If this can be ensured then products and services across the region will be standardised. The Shariah board would then be incorporated within the corporate governance to ensure the compliances of IFSB, verifying transactions to comply with centralised

Fatwas, advising management of *zakat* fund and advising on cleansing of non-*Shariah* compliance earnings. Currently non Islamic countries do not consider that Shariah matters are their purview(Grais & Pellegrini 2006), therefore, initiative through IFSB would require Islamic and non- Islamic countries cater for effective *Shariah* Governance (Chapra and Habib 2002). These compliances requirements can also be incorporated within the Basel Accord on banking. The above would add to the creditability of Islamic banks and would gradually remove the moral and Shariah hazards from this segment. Transparency would lead to standardisation if the organisations offering Islamic Financial services can be brought together under one regulatory regime with respect to *Shariah* governance.

10.3 Limitations

Although the main aims and objectives set out in chapter one has been addressed by this research, there are still areas of limitations which need further examination.
The main aim of this research was to examine corporate and *Shariah* governance with the view to establish the extent of compliances to *Shariah* and the regulatory oversight. It therefore selected to examine Islamic banks and their customers. This study sought to establish the compliances of *Shariah* Law by Islamic banks only, and not to look towards major conventional banks with an Islamic banking window. The clients of conventional banks are from different religious background and might not process the knowledge of Islamic banking related services. Because of clients' privacy, banks are not permitted to provide outsiders with their customers contact detail. Due to this reason it is very difficult to select a representative group of clients from conventional banks using a proper sampling technique. This is one of the many

reasons that this study selected customers from Islamic banks only. Some customers also use both Islamic and conventional banking services. Due to this dual atmosphere it would have been difficult to identify customers of conventional banks who go to conventional banks for Islamic banking within one study. This study uses a sole examination of Islamic banks to address a cluster of banks and customers whose sole base is *Shariah* compliance Islamic banking. It would have been difficult to bring two regimes into one study. It has not been possible to interview Islamic banks personally in Malaysia due to limited time and resources. However, the customers' survey from Malaysia, Bangladesh, Dubai and the banks returned samples from various regions, providing sufficient indication to draw an insight of Islamic banking practices from both the supply and demand side. Due to the Data Protection Act this research could not send questionnaires directly to the customers by post as such it adopted interviews outside banks and mosques and relied on personal interviews in obtaining data. It assumed that the respondents giving views on both conventional and Islamic banking questionnaires had the experiences from both the sectors.

Another important limitation of this study was that this only highlighted the growth of Islamic banking in relation to the demand of Islamic banking services. The way Muslim population is growing all over the world there will be substantial demand of Islamic banking services. Because of time line of this thesis and collection of such robust and huge information on sources of future Islamic banking funds/assets in various regions of the world, it was not possible to explore whether the Islamic banks in future can meet the customers demand by supplying adequate funds through increasing number of financial institutes complying with future global political situation.

10.4 Future research

Islam is the second largest religion in the world with over one billion followers in both Muslim and non-Muslim countries. Muslims value their faith and its guidance, which provides a growing need for fully compliance *Shariah* banking and the development of products to comply with *Shariah.* Future research can be examined to cater for such products and develop products moving away from notional compliances to real compliance.

A comprehensive research of the supply side of Islamic banking can be undertaken to examine its contribution in the overall economic development in the Islamic countries and the role they can comply in performing their to the greater Muslim *Umma* (community).

In order to make Islamic banks more transparent a large scale future research is also needed to examine the barriers that are facing by Islamic banks to comply with a conflicting nature of prudential, accounting and banking regulations with Islamic *Shariah* law with the view to draw specific regulation and enabling atmosphere for the Islamic banking sector.

A further research is also required to address the conflicting nature of Shariah Certification currently developed on piecemeal basis by various banks to bring them under one regulatory umbrella like IFSB which can be made mandatory for all Islamic banks to follow.

Further study needed to explore the supply side of Islamic banking and finance especially, the way Muslim population is growing all over the world, and the demand of Islamic banking will increase as well. It is important to explore whether the Islamic financial institutes will be capable to meet the growing customer demands by supplying adequate funds to customer in a *Shariah* compliant mode.

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APPENDICES

APPENDIX A: Covering Letter

Date

To

Dear Sir or Madam,

I am a PhD student at London Metropolitan University, London Metropolitan Business School, Finance & Financial Services Group. I am conducting research on Islamic Banking: issues of transparency and standardization.

There are several indications in the literature that the Islamic banking sector is growing very fast and is attractive to both Muslim and non- Muslims customers because of its religious and ethical Investments. However, the sector lacks transparency and standardization which is essential for long term sustainability. I am therefore undertaking research in this field.

I would very much like your co-operation in conducting this research and would kindly request you if you would respond to the attached questionnaires. I can assure you that these questionnaires are solely for the purpose of my PhD research thesis and your responses will be treated with the strictest confidence. Your responses will be used for statistical analyses only and no one will be identified in any report.

Could you please fill out the questionnaire as soon as possible and return it to me in the reply paid envelop. You may also respond by fax or by email.

If you would like to receive a copy of the summary of the findings, please provide your contact details in the attached questionnaire.

If you have any queries you may contact my supervisor:
Professor Nicholas Sarantis, email: n.sarantis@londonmet.co.uk

Thank you very much for your participation in this research.

Yours sincerely
Mohammed Faizullah
Finance & Financial Services Group
Email: m.faizullah@londonmet.ac.uk
Direct Fax: +

APPENDIX –B: Questionnaires for the Depositors and Borrowers of Islamic Financial Institution

Please tick as appropriate

1. Respondents Age Category (in years)
   18 – 30 1☐ 31 – 40 2☐
   41 – 50 3☐ 51+ 4☐
2. Sex: Male 1☐ / Female 2☐

3. Employment status:
   1. Full-time Employed 1☐ 2. Part-time Employed 2☐ 3. Student 3☐
   4. Unemployed 4☐ 5. Retired 5☐ 6. Others 6☐

4. Type of Account you hold (Please tick)?
   1. Current Yes 1☐ No 2☐ 2. Savings Yes 1☐ No 2☐
   3. Investment Yes 1☐ No 2☐ 4. Term Deposit Yes 1☐ No 2☐
   5. Others Yes 1☐ No 2☐ Please specify: ____________________

5. What are your reasons for taking services from an Islamic financial institution?
   You believe that they operate according to Islamic Shariah Law 1☐
   Good Services 2☐
   Good investment return 3☐
   Other reasons 4☐ (Please specify)____________________________________
6. In your experiences, do you find an Islamic Financial Institution services are (please tick)
   In line with conventional banks 1☐ Better than conventional banks 2☐
   Poorer than conventional banks 3☐ Worse than conventional banks 4☐
   Neither better nor worse than conventional banks/Unsure 5☐
7. Are you satisfied with the way Islamic products and services are structured and offered
   Very Satisfied 1☐ Satisfied2☐ Neither satisfied or unsatisfied/Unsure 3☐
   Unsatisfied 4☐ Very unsatisfied 5☐

8. Do you find that the return on your deposits and investments are;
   Similar with a conventional banks? 1☐ Better than a conventional banks? 2☐
   Poorer than conventional banks? 3☐ Worse than conventional banks? 4☐
   Neither better nor worse than conventional banks/Unsure? 5☐

9. Do you have account with another Islamic bank? Yes 1☐ No 2☐

10. If Yes, do the returns of both the bank have close resemblances? Yes 1☐ No 2☐

11. When depositing with an Islamic bank, do you expect that if bank suffers losses the bank may apportion their losses to your account? Yes 1☐ No 2☐

12. If your fund is subject to negative adjustment, would you still deposit with an Islamic bank? Yes 1☐ No 1☐

13. Do you consider Islamic Banks
More Risky than conventional bank 1☐ Similar to conventional bank 2☐
Less risky than conventional bank 3☐ No risk at all 4☐
Not Known 5☐

14. If you are to discover that Islamic banks are in fact earning from Interest based investments or other prohibited activities would you still
1. Consider banking with them? Yes 1☐ No 2☐
2. Move to another Islamic bank Yes 1☐ No 2☐
3. Move to a conventional bank Yes 1☐ No 2☐
4. Other Yes 1☐ No 2☐ (If Yes Please specify)
____

15. Do you believe that the bank should give you full information about Shariah committee members, their qualifications and their role
Strongly Agree 1☐ Agree 2☐ Neither agree nor disagree 3☐
Disagree 4☐ Strongly disagree 5☐

16. Do you have borrowings from an Islamic bank? Yes 1☐ No 2☐
If Yes: What type of Borrowings

1. Murabaha	Yes 1☐ No 2☐	2. Musharaka	Yes 1☐ No 2☐
3. Mudaraba	Yes 1☐ No 2☐	4. House Purchase	Yes 1☐ No 2☐
5. Car Purchase	Yes 1☐ No 2☐	6. Overdraft	Yes 1☐ No 2☐
7. Other	Yes 1☐ No 2☐	Please specify: ______________	

17. When borrowing from Islamic bank do you have to give them additional Guarantees / Securities? Yes 1☐ No 2☐

18. When borrowing from an Islamic Bank, do you feel that their repayments work out;
Similar with conventional banks 1☐ Higher than conventional banks 2☐
Lower than conventional banks 3☐ Not Known/Unsure 4☐

19. What is your main reason of borrowing from Islamic bank (please tick)
1. Not dealing with Riba and operates under Islamic Shariah law Yes 1☐ No 2☐
2. Better Rate Yes 1☐ No 2☐

3.More accommodating compared to conventional bank Yes 1☐ No 2☐
4. Convenience Yes 1☐ No 2☐
5. Other Yes 1☐ No 2☐ (If yes, please specify)______________________________

20. In the event of your inability to fulfil your obligations do you expect the Islamic bank to be
Lenient compared to conventional banks 1☐ Same as conventional banks 2☐
More harsh than conventional banks 3☐ Unsure 4☐
Other 5☐ Please specify ____________________________

21. Would you be willing to see Shariah Certification to be done by out side Central Shariah Board.
Strongly agree 1☐ Agree 2☐
Neither agree nor disagree 3☐ Disagree 4☐ Strongly disagree 5☐

22. Which of the following closely match about your opinion on the transparency of your bank
Very transparent 1☐ Fairly Transparent 2☐ Not transparent 3☐
Not Known 4☐

23. How would you rate your experience and level of satisfaction with your Islamic bank?
Excellent 1☐ Very good/ Good 2☐ Neither good nor poor 3☐
Poor 4☐ Very poor 5☐
Others 6☐ Please specify ____________________________

APPENDIX-C: Questionnaires for the Islamic Financial Institutions

1. Name of the Establishment (optional):
2. Address :

3. Name of the Respondents (Interviewees) position (optional):

Q1. Is your institution engaged in multiple activities (in addition to core banking activities)

1. Trading Yes 1☐ No 2☐ 2. Insurance Yes 1☐ No 2☐
3. Real Estate Yes 1☐ No 2☐ 4. Offshore banking Yes 1☐ No 2☐
5. Other Yes 1☐ No 2☐ (If yes, please specify

____

Q2. Does the Institution have a Shariah Board? Yes 1☐ No 2☐

Q7. If Yes: How many members are there in the Shariah Board?

Q8. Please state the mandatory minimum qualifications of the Shariah Board mem

Q9. Is the decision of the Shariah Board reached by

- Majority decision 1☐
- Unanimous decision 2☐
- Other 3☐ Please specify ______________

Q10. Do the Shariah Board operate an interim audit? Yes 1☐ No 2☐

Q11. Are the Shariah Board members involved in the management of the bank? Yes 1☐ No 2☐

Q12. Is your institution affiliated to any Islamic Banking Association? Yes 1☐ No 2☐ (If No in Q12, please go to Q14)

Q13. If Yes in Q12: Do they Provide any Guidelines for Corporate and Islamic Governance? Yes 1☐ No 2☐

Q14. Does your institution follow the Auditing and Accounting Organization for Islamic Financial Institutions (AAOIFI) Standards? Yes 1☐ No 2☐

Q15. Does your institution also follow the International Accounting Standards? Yes 1☐ No 2☐

Q16. Does your institution provide the following A/C, (Please tick)?

1. Current Yes 1☐ No 2☐ 2. Term Deposit Yes 1☐ No 2☐
3. Investment Yes 1☐ No 2☐ 4. Equity Partnership Yes 1☐ No 2☐
5. Other Type Yes 1☐ No 2☐ If yes, please specify ______________

Q17. what are the reasons for customers coming to Islamic Financial Institutions :
For Islamic Shariah Finance Yes 1☐ No 2☐ Not known 3☐
For higher return than conventional bank Yes 1☐ No 2☐ Not known 3☐
Favourable terms Yes 1☐ No 2☐ Not known 3☐
Convenience Yes 1☐ No 2☐ Not known 3☐
Other Yes 1☐ No 2☐ Please specify ______________________

Q18. Does your Islamic Financial Institution operate a Shariah approved deposit protection? Yes 1☐ No 2☐

Q19. Does your Islamic Financial Institution keep the depositors fund segregated?
Yes 1☐ No 2☐

Q20. Is the allocation of profit to the investors/depositors based on
Notional profit 1☐ Actual profit 2☐ Other 3☐ Please specify__________

Q21. Does your institution ask depositors to take a share in its losses?Yes 1☐ No 2☐

Q22. Does your institution keep earnings segregated?
Yes 1☐ No 2☐ Not known 3☐

Q23. Has there been any undertaking by your Islamic Financial Institution that has resulted in a loss? Yes 1☐ No 2☐ Not Known 3☐

Q24. Has there been any negative adjustments to the Depositors Fund?
Yes 1☐ No 2 ☐ Not Known 3☐

Q25. Are the allocations of losses to the investors/depositors based on
An estimate 1☐ Actual 2☐
Other 3☐ Please specify ______________________

Q26. Has there been any litigation between your bank and its customer on Islamic Shariah issues? Yes 1☐ No 2☐ Not Known 3☐

Q27. In the case of borrowers inability to fulfil its obligations which of the following law applies :-
1. Shariah law Yes 1☐ No 2☐ 2. Local Law Yes 1☐ No 2☐
3. Other Yes 1☐No 2☐ If yes, please specify

____

Q28. In the event of an undertaking providing negative return, will the customer be exposed to losing their own asset? Yes 1☐ No 2☐ Not known 3☐

Q29. Does your institution take Personal Guarantees or any other additional securities?
Yes 1☐ No 2☐

Q30. At your institution, is the return on Investments based on:
London Inter Bank Offer Rate (LIBOR) 1☐
Central Bank's Base Rate 2☐

Other standardised benchmark 3☐ Please specify________________________________

Q31. Do the Conventional auditors of your institution require you to provide them with an Islamic Shariah Audit certificate as a part of their audit process?

Yes 1☐ No 2☐

Q32. Does your institution levy "Zakat" out of the depositors funds?

Yes 1☐ No 2☐

Q33. If Yes: How would you rate customers reaction to levying Zakat

Very favourable 1☐ Moderate support 2☐ Unfavourable 3☐
Not known 4☐

Q34. Are the customers allowed to opt out from Zakat Levy?

Yes 1☐ No 2☐

If Yes: estimated opt out rate over 50% 1☐
Between 20% to 50% 2☐
Below 20%3☐
Not known 4☐

APPENDIX- D: Questionnaire for the Shariah Board of Islamic Financial Institutions

GENERAL (optional)

1. Respondent's Name:
   Position:

2. Name of the institution and address:

Questions relating to the Shariah and banking issues:- (Please tick the appropriate box)

Q1. Are you a member of the Shariah Board at the above Institution:
Yes 1☐ No 2☐

Q2. Are you also a Shariah Board Member at another Islamic Financial Institution:
Yes 1☐ No 2☐

Q3. What is the minimum qualification required for a member of a Shariah Board.______________________________

Q4. What is your Qualifications: ______________________________

Q5. Which of the following most closely describes the role of Shariah Board in the above Institution:
Advising the institutions with all aspects of Islamic Shariah Law 1☐
Advising the Institutions in formulating Islamic Shariah products and services 2☐
Issuing Shariah certificates in relation to their products and services.3☐
Other4☐ Please specify____________________

Q6. Is the decision of the Shariah Board taken by:
Majority decision 1☐ Unanimous decision 2☐
Other 3☐ Please specify: ____________________

Q7. Are you aware of any special provision for the regulation of Islamic Financial Institutions:
Yes 1☐ No 2☐ Not known 3☐

Q8. Are you also involved in the management of your financial institution
Yes 1☐ No 2☐

Q9. Are you aware of your institutions paying and receiving interest from the money market activities:
Regularly 1☐ Sometimes 2☐ Never 3☐
Not allowed 4☐ Not known 5☐

Q10. Are you aware of differences in practices by the different Islamic Financial Institutions:
Yes 1☐ No 2☐

Q11. Which of the following Accounting Standards does your institutions need to

follow:
Accounting and Auditing Organisation for Islamic Financial Institutions, Bahrain (AAOIFI) Standards 1☐
International Accounting Standards (IAS) 2☐
Other 3☐ Please specify: ______________________________

Q12. Does the bank operate a Shariah Approved Deposit Protection:
Yes 1☐ No 2☐ Not known 3☐

Q13. Does the bank keep the depositors fund segregated:
Yes 1☐ No 2☐ Not known 3☐

Q14. Is the allocation of profits to the investors/depositors are based on:
Notional profit 1☐ Actual profit 2☐ Not known 3☐

Q15. In your opinion is the allocation of losses of the investors/depositors based on:
Estimate 1☐ Actual 2☐ Not applicable 3☐ Not known 4☐

Q16. Does the bank keep earnings segregated:
Yes 1☐ No 2☐ Not known 3☐

Q17. Does the bank ask the depositors to take share in the losses:
Yes 1☐ No 2☐ Not known 3☐

Q18. Has there been any negative adjustments to Depositors Fund:
Yes 1☐ No 2☐ Not known 3☐

Q19. In the case of a customer not being able to fulfill it's obligate, which of the following would your institution apply:
Shariah Law 1☐ Local Law 2☐
Other 3☐ Please specify: ______________________

Q20. In the event of a losing venture is the borrower/equity partner exposed to losing their own asset: Yes 1☐ No 2☐ Not known 3☐

Q21. Do the bank take Personal Guarantees or any other additional securities:
Yes 1 ☐ No 2 ☐ Not known 3☐

Q22. Is the return on Investment based on
London Interbank Offer Rate (LIBOR) 1☐
Central Bank's Base Rate 2☐
Other standardised benchmark 3☐ Please Specify________________

Q23. If you were to discover that Islamic banks were in fact earning from Interest based investments or other prohibited activities, would you still consider to being on their Shariah Board: Yes 1☐ No 2☐

Q24. Would you be willing to see an external Central Shariah Board for issuing Shariah Certification:

Strongly agree	1☐	Agree	2☐
Neither agree nor disagree	3☐	Disagree	4☐
Strongly disagree	5☐		

APPENDIX- E: Questionnaire for the Regulatory Authorities (Regulators/Supervisors)

GENERAL (optional)

1. Name of the institution and address:

2. Respondent's:
Name:
Position:

I. Questions relating to the Banking Institutions:-
Please tick the appropriate box

Q1. In your jurisdiction are financial institutions allowed to engage in the following activities
(in addition to core banking activities)
1. Trading Yes 1☐ No 2☐ 2. Insurance Yes 1☐ No 2☐
3. Real Estate Yes 1☐ No 2☐ 4. Offshore banking Yes 1☐ No 2☐
5. Other Yes 1☐ No 2☐ If yes, please specify ____________________

Q2. Do the financial institutions strictly follow the Code of Corporate Governance imposed by regulators?
Strictly followed 1☐ Not very strictly followed 2☐
Not /or Never followed 3☐ Not known 4☐

Q3. In your opinion, does financial institutions provide very accurate data to the authorities
Very accurate 1☐ Modestly accurate 2☐ Neither3☐ Not known 4☐

Q4. Which of the following Accounting and Auditing Standards are Financial Institutions required to follow in their financial reporting.
International Accounting Standards 1☐
Home Country Accounting Standards 2☐
Neither 3☐
Not Known 4☐

II. Questions relating to the Islamic banking Institutions

Please tick the appropriate box

5. Do the authorities impose any special provision for the regulation of Islamic financial Institutions
Yes 1☐ No 2☐
If Yes, please specify

____

6. Which of the following Accounting and Auditing Standards are the financial

institutions required to follow in their financial reporting.

International Accounting Standards 1☐

Home Country Accounting Standards 2☐

Auditing and Accounting Organization for Islamic Financial Institutions, Bahrain (AAIFO) Standards 3☐

Other 4☐ Please specify________________________

Not known 5☐

7. Is the supervision of Islamic banking the responsibility of:

the same department as conventional bank 1☐

a separate department 2☐

Other 3☐ Please specify________________________

8. Do the authorities provide short term liquidity to Islamic financial institutions on :-

Special terms 1☐ Same terms as conventional bank 2☐

No provision to provide 3☐ Not Known 4☐

9. Do the financial institutions acquire short term funding from the money market?

Regularly 1☐ Sometimes 2☐

Never 3☐ Not allowed 4☐

Not known 5☐

10. Are the authorities aware of Islamic Financial Institutions paying and receiving interest from the money market activities? Yes 1☐ No 2☐ Not known 3☐

11. Do the authorities consider Islamic Financial Institutions to be:

More risky than conventional bank 1☐

Same as conventional bank 2☐

Less risky than conventional bank 3☐

Not known 4☐

12. What extent are the authorities satisfied with the Risk Management of the Islamic Financial Institutions? Excellent 1☐ Very good 2☐ Good 3☐ Poor 4☐

13. Do you consider that there should be a Shariah Supervisory Board at the regulatory level

Strongly agree 1☐
Agree 2☐
Neither agree nor disagree 3☐
Disagree 4☐
Strongly disagree 5☐
Not known 6☐

14. Do the Islamic Financial Institutions need to have their own Shariah Supervisory Board?

Yes 1☐ No 2☐ Not sure 3☐

15. Do the members of the Shariah Board need to have special qualifications?

Yes 1☐ No 2☐ Not known 3☐

16. Do the regulatory authorities monitor the qualifications of the members of the Shariah supervisory board?

Yes 1☐ No 2☐ Not known 3☐

17. Do authorities believe that the Islamic Financial Institutions are strictly following Islamic shariah rules in their overall conduct?

Strongly followed 1☐ Not very strongly followed 2☐ Not followed 3☐
Not Known 4☐

18. Do the authorities ensure that the Islamic Financial Institutions regularly conduct Shariah Audit?

Yes 1☐ No 2☐

19. How strongly would the authorities be willing to see an external Central Shariah Board for issuing Shariah Certification

Very willing 1☐ Willing 2☐ Not willing 3☐

20. Are Islamic financial products/instruments standardized in your jurisdiction?

Standardized above 50% 1☐ Standardized below 50% 2☐
Not standardized 3☐ Not known 4☐

21. In your opinion, which of the following represents the future direction of Islamic banks in 10 years time

Develop as a fully mature Islamic financial institutions 1☐
Develop as very close resemblance to conventional bank 2☐
Not know 3☐
Other 4☐ Please specify ______________________________

APPENDIX- F: Survey results from the questionnaires sent to the Regulators

Description of Question items	Number of respondents 5			
Unless Specified ,1. Yes. 2. No 3. Not Known	1	2	3	4
Q1. In Your jurisdiction are financial Institutions allowed to engage the following				
Q1.1 Trading	1	2		
Q1.2 Insurance	2	3		
Q1.3 Real Estate	1	4		
Q1.4 Off Shore banking	2	3		
Q2 Do the financial Institutions strictly follow Code of Corporate Governance	3	2		
Q3 Does they provide Accurate Data	4	1		
Q4 Which of the following Accounting and Auditing Standards Are they required to follow				
ISA	4			
Home Country	2			
Q5 Does the authorities impose any special provision to IFI	3	1		
Q6Which of the Following Islamic Financial Institutions need to follow				
ISA	2			
Home Country Standards	1			
AAIFO				
Q7 Is the Supervision of Islamic Banking responsibility of				
Same Department	2			
Separate Dept				
Other	2			
Q10 Does the Authorities provide short term liquidity to IFI				
Special terms	1			
Same as Conventional bank	1			
No provision to provide	2			
Q9 Do the Islamic Financial Institutions require Short term funding From the money market				
Regularly	0			
Sometimes	3			
Never	1			
Are the Authorities aware of Financial Institutions receiving and paying interest from the money market activities	3	1		

Q11 Do the authorities consider Islamic Financial Institutions be more risky Than conventional bank				
Same as conventional bank	4			
Q12 What extent are the authorities satisfied with Risk Management of IFI				
Excellent				
Very Good	2			
Good	2			
Q13 Do you consider that there should be Shariah Supervisory Board At Regulatory level				
Strongly Agre	1			
Agree	2			
Neither agree nor disagree	1			
Disagree	1			
Q14 Do the Financial Institutions need to have their own Shariah Supervisory Board	3	1		
Q15 Do the Member of the Shariah Board need to have special Qualifications	4			
Q16 Do the Regulatory authorities monitor qualifications	2	2		
Q17 Do the Financial Institutions believe that IFI strictly Follow Shariah				
Strongly Followed				
Not very strict	4			
Not followed				
Q18 Do the authorities ensure that Islamic Financial Insititutions regularly Conduct Shariah Audit	4			
Q19 How strongly would the authorities be willing to see external Shariah Certification				
Very Wiling	1			
Willing	1			
Not willing	2			
Q20 Are Financial products/instruments standardised				
Above 50%	2			

Below 50%	1			
Not Standardised	1			
Q21 In your opinion which of the following represent future directions of Islamic banks in 10 years				
Develop as a fully mature Financial Institution	1			
Develop as very close resemblance to conventional bank	2			
Not Known	1			

APPENDIX- G: Survey Results of the shariah board of Islamic financial institutions

Description of Question items	Number of respondents 10				
Unless Specified ,1. Yes. 2. No 3. Not Known	1	2	3	4	5
Q.1 Are you a member of the Shariah Board at the above Institution:	7	3			
Q.2Are you also a Shariah Board Member at another Islamic Financial Institution:	4	5			
Q.3What is the minimum qualification required 1. Shariah Knowledge 2.Degree	7	2			
Q.4What is your Qualifications: 1.PhD 2. Masters 3. Degree	4	5			
Q.5Which of the following most closely describes the role of Shariah Board 1.Advising the institutions with all aspects of Islamic Shariah Law 2.Advising the Institutions in formulating Islamic Shariah products and services 3. Issuing Shariah certificates in relation to their products and services. 4.Other Pleas specify (Multiple Response)	7	4	3		
Q6. Is the decision of the Shariah Board taken by: 1. 1.Majority decision 2. Unanimous 3. Other -Please specify:	8	2			
Q.7 Are you aware of any special provision for the regulation of Islamic Financial	6	3	1		
Q8. Are you also involved in the management of your financial institution	3	7			
9.Are you aware of your institutions paying and receiving interest from the money market activities: Regularly 1☐ Sometimes 2☐ Never 3☐ Not allowed 4☐ Not known 5☐			1	7	1
Q10. Are you aware of differences in practices by the different Islamic Financial Institutions:	8	1			
Q.11 Which of the following Accounting Standards does your institutions need to follow: 1.Accounting and Auditing Organisation for Islamic Financial Institutions, Bahrain (AAOIFI) Standards 2. International Accounting Standards (IAS) 3. Other (Multiple Response)	9	5	2		
Q.12 Does the bank operate a Shariah Approved	6	3	1		

Deposit Protection:					
Q13. Does the bank keep the depositors fund segregated:	4	5	1		
Q Q.14 Is the allocation of profits to the investors/depositors are based on: Notional profit 1☐ Actual profit 2☐ Not known 3☐	2	8			
Q15.In your opinion is the allocation of losses of the investors/depositors based on: 1.Estimate 2. Actual 3.Not applicable 4. Not known	5	3	1	1	
Q16. Does the bank keep earnings segregated:	3	5	2		
Q.17Does the bank ask the depositors to take share in the losses	7	1	1		
Q.18 Has there been any negative adjustments to Depositors Fund:		8	1		
Q19. In the case of a customer not being able to fulfill it's obligate, which of the following would your institution apply: 1.Shariah Law 2. Local Law 3. Other	4	5			
Q20. In the event of a losing venture is the borrower/equity partner exposed to losing their own asset:	5	1	2		
Q.21 Do the bank take Personal Guarantees or any other additional securities:	10				
Q.22 Is the return on Investment based on 1. London Interbank Offer Rate (LIBOR) 2. Central Bank's Base Rate 3. Other standardised benchmark	2	6	1		
Q.23 If you were to discover that Islamic banks were in fact earning from Interest based investments or other prohibited activities, would you still consider to being on their Shariah Board:		7			
Q.24 Would you be willing to see an external Central Shariah Board for issuing Shariah Certification: 1.Strongly agree 2.Agree 3.Neither agree nor disagree 4.Disagree 5.Strongly disagree	4	3	1	2	

APPENDIX-II: The survey results of the Islamic financial institutions

Description of Question items	Number of respondents 13				
Q1Is your Institution engaged in multiple activities	1	2	3	4	5
Q1.1Trading	8	2			
Q1.2Insurance	4	2			
Q1.3Real estate	8	1			
Q1.4Off shore banking	3	1			
Q2 Does Your Institution have Shariah Board	13				
Q7How many members are in the Shariah Board	3=1	5=4	4 = 4	6=2	
Q8Mandatory Min Qualification	PhD=2	MA=1	Sh.Degree=6		
Q9Is the Decision By					
Q9.1Majority	10				
Q9.2Unanimous	2				
Q10 Do the Shariah Board operate interim Audit	12	1			
Q11 Are the Shariah Board Members involved in the Management of the bank	2	11			
Q12 Is your institution affiliated to any Islamic banking Association	11	2			
Q13 Do they provide guideline	10				
Q14 Does your institution follow AAOIFI Standards	8	5			
Q14 Does your Institution also fllow ISA	13				
Q16 Does your Institution provide the following account					
Current	12	1			
Term Deposit	10	1			
Investment	12	0			
Equity Partnership	1	6			
Other Type					
Q17 what are the reasons for customers coming to Islamic Financial Institutions					
17.1 For Islamic Shariah Finance	13				
17.2 For higher return than conventional bank	3	2			
17.3 Favourable terms	4	2			
17.4 Convenience	9				
17.5 Other					
Q18 Does your Institution operate Shariah approved Deposit Protection	8	4			
Q19Does your Institution Keep the depositors fund segregated	6	7			

Q20 Is the allocation of profit based on	4	7	2		
Q21 Does your Institution ask depositors to take a share in its losses	9	4			
Q22 Does your institution keep the earnings segregated	8	3			
Q23 Has there been any undertaking resulted in a loss	6	6	1		
Q24 Has there been any negative adjustments to the Depositors fund		10	1		
Q25 Are the allocations of losses based on	1	10			
Q26 Has there been any litigation on Shariah issues	3	7	3		
Q27 In case of borrowers inability to fulfil its obligations which of the following law applies					
Shariah Law	7				
Local Law	8				
Q28 In the event of an undertaking providing negative return will the customers be exposed to losing their own asset	4	4	5		
Q29 Does your institution take personal guarantees or other securities	11	2			
Q30 Is the return based on	3	7			
Libor					
Central Bank Base Rate					
Q31 Do the conventional Auditors require Shariah Audit	6	7			
Q32 Does your Institution Levy Zakat	1	10			

Q33 How would you rate customers reaction					
Favourable					
Moderate					
Unfavourable					
Q34 Are customers allowed to opt out					
Opt out Rate Over 50%					

APPENDIX-I : SOURCES OF JURISPRUDENCE TEXTS FROM QURAN AND HADITH

TEXTS FROM *QURAN*:

On Riba (Interest):

Chapter 3:130 (translation from *Tafsir Ibn Kathir* Volume 2:266)

"O, you who believe! Do not consume Riba doubled and multiplied, but fear Allah that you may be successful"

Chapter 30:39 (translation from *Tafsir Ibn Kathir* Volume 7:550)

"And that which you give in Riba in order that it may increase from other people's property has no increase with Allah; but that which you give in Zakah seeking Allah's Face, then those they shall have manifold increase".

Chapter 2:275, 276 (*translation* from *Tafsir Ibn Kathir* Volume 2:69 &75)

"275. Those who eat Riba will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaytan leading him to insanity. That is because they say: "Trading is only like Riba," whereas Allah has permitted trading and forbidden Riba."

" 276. Allah will destroy Riba and will give increase for Sadaqat"

On property transactions and on honesty:

Chapter 2 :188 (translation from *Tafsir Ibn Kathir* Volume 1:522)

"And eat up not one another's property unjustly (in any illegal way, e.g., stealing, robbing, deceiving), nor give bribery to the rulers (judges before presenting and cases) that you may knowingly eat up a part of the property of others sinfully".

Chapter 4:29 (translation from *Tafsir Inb Kathir* Volume 4:430)

" O you believe! Eat not up your property among yourselves unjustly except it Be trade amongst you, by mutual consent".

On commitment and obligation:

Chapter 5:1 (translation from Tafsir Ibn Kathir Volume3 : 72)

"O you who believe! Fulfil your) Obligations".

Chapter 2:280 (translation from Tafsir Ibn Kathir Volume 2:78)

"And if the debtor is having a hard time, then grant him time till it is easy for him to repay; but it you remit it by way of charity, that is better for you if you

did but know."

Chapter 11:85 (translation from Tafsir ibn Kathir Volume 5:96)

"And O my people! Give full measure and weigh in justice and reduce not the thins that are due to the people, and do not commit mischief in the land, causing corruption".

Chapter 83:1,2,3,4,5&6 (translation from *Tafsir Ibn Kathir* Volume 10:397)

"1. Woe to Al- Mutaffin

2. Those who, when they have to receive by measure from men, demand full measure,

3. And when they have to give by measure or weight to men, give les than due,

4. Do they think that they will be resurrected.

5. On a Great Day?

6. The day when (all) mankind will stand before the Lord of all that exists?"

Chapter 2:282 (Translation from *Tafsir Ibn Kathir* Volume 2:84)

"O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you. Let not the scribe refuse to write, as Allah has taught him, so let him write. Let him (the debtor) who incurs the liability dictate, and he must have Taqwa of Allah, his Lord, and diminish not anything of what he owes. But if the debtor is of

poor understanding, or weak, or is unable to dictate for himself, then let his guardian dictate in justice and get two witnesses out of your men.......You should not become weary to write it (your contract), whether it be small or big, for its fixed term ,that is most just with Allah; more solid as evidence, and more convenient to prevent doubts among yourselves, save when it is a present trade which you carry out on the spot among yourselves, then there is no sin on you if you do not write it down. But take witnesses whenever you make a commercial contract."

On speculation and gambling:

Chapter 2:219 (translation from *Tafsir Ibn Kathir* Volume 1:604)

"They ask you (O Muhammad) concerning alcoholic drink and gambling. Say: "In them is a great sin, and (some) benefits for men, but the sin is greater Than"

On trade:

Quran (4:29) *"But let there be among you traffic and trade by mutual goodwill."*

TEXTS FROM *Hadiths*

on Riba:

> *"Allah has curses the one who accepts Riba (usury and interest), the giver of it, The two witnesses of it and the one who writes it" (Sahih Muslim: 955 Volume 2:p485).*

The *Sunan* compliers and *At-Tirmithi* graded it *Sahih*) (quoted from *Minhaj Al-Muslim* Volume 2: 215) (Omer & Haq 1996:19).

> *"one dirham of Riba that a man devours, while knowing it is Riba, is more severe (in crime) than thirty six acts of fornication (or adultery) ."*

(Ahmed with a *Sahih* chain of narration) (quoted from *Minhaj Al-Muslim* Volume 2: 215)

Hadith (last Sermon of the Prophet)

> *"Riba of the days of ignorance stand nullified. And the first riba I cancel is our own riba, the riba owed to Abbas bin Abdul Muttalib. It stand nullified, all of it."*

(Muslim Cited *Siddiqui* 2004, 38/39)

> *"All riba is annulled. But you will get back your principal amounts. Neither*

shall you wrong nor shall you be wronged against. Allah has decried that there shall be no riba. The riba of Abbas bin Abdul Mutaalib is cancelle , all of it".

(*Ibn Hisham* V2 P603 Cited *Siddqui* 2004:39)

"all the conditions agreed upon by the Muslims are upheld, except condition which allows what is prohibited or prohibits what is lawful"

(*Usmani* 2005:45).

Hadith -The Prophet observed

"Wealth rightly acquired is a good thing for the righteous man"

(*Al-Bukhari* 1349H pp45-46 cited *Siddiqui* 2004 P26) .

Hadith Reported by *Abu Sa'id al-Kurdi* the Prophet said

"Do not sell gold for gold except when it is like for like, and do not increase one over the other, do not sell silver for silver except when it is like for lik, , and do not increase one over the other, and do not sell what is away (from among these) for what is ready" (*Al Bukhari* cited Siddiqui 2004:48).

According another report the Prophet said:

"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt--- like for like equal for equal and hand to hand. If

commodities differ, then you may sell as you wish, provided the exchange is hand to hand" (*Shaih Muslim* cited *Siddiqui* 2004:48/49).

To prohibit Riba al_fadl the Prophet said – reported by Abu Sa'id al Khudri and Abu Hurairah: a man employed by the prophet, peace be upon him, in Khyber brought for him Janibs. The prophet asked: Are all dates from Khayber like this? The man replied, By God, no, O! Prophet We tak one Sa' of these for two, or two of these for three. The prophet, peace b upon him, said: Do not do that. Sell the Janib for dirhams then buy Janib with dirhams"

(*Al-Bukhari Siddiqui* 2004).

Is it *Riba* to take in country A and be paid in country B

"It is reported about Zainab, wife of Abdullah ibn Masud, that she said. The Prophet of Allah gave me fifty one wasaqs of Khayber dates and twenty wasaqs of barley. Then Asim bin 'Adi asked me, can I give you dates here and take your dates in Khayber? She said: Not till I enquire about it. She asked Umar who told her not to do that and said: What happens to liability (during the time period that elapses) between the two (taking possession in place A and delivering in place B).

Badawi 1964, p 211 quoting *Al-Mabsut by Sarakhsi* Vol 14) (*Siddiqui* 2004:53)

"The wife Prohet Aisha, reacted to a deal in which a lady purchased Something for six hundred dirhams paid in cash whereas she, the purchaser,

herself had sold it to be same person for eight hundred dirhams on credit, Aisha condemned the deal and said it involves riba"

(*l-andlusi* 1993, Vol 2, p349 cited *Siddiqui* 2004).

" *The well off person who delays the payment of his debt subjects himself to punishment and disgrace" The form of punishment must be at the discretion of the court payable to the state and not for the providers of fund*"

(*Usmani* 2005).

On Speculation:

"Sell not what is not with you"

"Jafar ibn abi wahsiyah reported from Yusuf ibn Mahak, from Hakim ibn Hizam who said " I asked the prophet: "O Messenger of God. A man comes to me and asks me to sell him what is not with me. I sell him (what he wants) and then buy he goods for him from the market(and deliver them)." The Prophet replied: "Sell not what is not with you"

(*Abu Daud & Tirmidhi* Cited – *Iqbal and Khan* 2005).

On *Gharar:*

Ahmad and Ibn Majah narrated on the authority of Abu-Said Al-Khudriy) The Prophet (pbuh) has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of charities prior to their receipt, and the purchase of the catch *of a diver".* *Hadith (El- Gamal* 2000 *)*

On trade:

Al-Suyuti mentioned in Al-Jami Al Saghir , Authority Rafi " The prophet (pbuh) was asked: " which are the best forms of income generation?" He (pbuh) replied: "A man's labour, and every legitimate sale"

On Islamic forward sale ***(salam and istisna):***

Hadith (El Gamal 2000) This *hadith* was narrated by all six major books of *Hadith* authority of *Ibn Abbas*

"The Messenger of Allah (pbuh) came to Madinah, and found its inhabitants entering salam contracts (with price paid in advance) in fruits for one, two and three years. He (pbuh) said: " whoever enters into a salam contract, let him specify a known volume or weight and known terms of deferment"

In Islamic *Shariah* the use of *Salam* (to avoid *Riba) was* allowed for agricultural products so that small farmers could grow their crop to feed the families with payment required to be made in full. Agricultural products must be able to express quality and quantity unambiguously, for example, precious stones would differ in value for same weight in different sizes and pieces.

Hadith

"whoever wishes to enter into a contract of salam, he must effect the salam according to the specified measure and specified weight and specified date of delivery"

(this *hadith* is authentic and reported in all six books of *Hadith Usmani* 2005:189)

On Sale of debt:

"Sale of Debt against a debt is strictly prohibited"

(*Hadith* cited Usmai 2005)

APPENDIX-J: COLLECTION *FATAWAS* RELEVANT FOR ISLAMIC BANKING

The *fatwa of Sheikh -al_Azhar Muhammad Sayyid Tantawi*, The Mufti of Egypt. Islamic research institute *fatawa* (December 2002).

The *Mufti* of Egypt *Syed Tantawi,* issued the famous *Fatawa* in 2002. In fact this fatwa was issued in 1989 and was published in one of his book's and did not receive much publicity. Later in 2002 it was published by the prestigious *Azhar* Islamic Research Institute (IRI). It has been re- issued by a member of IRI, who is also Chairman of the board of directors of a bank mostly copies from the above book. In this Fatwa it is viewed that the depositors of the bank should be viewed as a passive investors and the bank as their investment agent would reduce the bank interest from prohibited to permissible pre-specifying share of profit. He viewed that depositors are entitled to a percentage of actually realizable profit based on their capital input. This concept however violates Islamic silent partnership contract features (*Mudaraba)* where in it must be pre-specified the percentage of total profit rather than pre specified percentage of total capital. Dr. Tantawi argued in favour of a pre-determined percentage of Capital instead of pre-determined percentage of profit – pro rata to capital on the ground of moral hazard and dishonesty which may be manipulated against depositors.

The above *Fatawa* by such an authoritative Mufti was universally condemned and he was attacked by many for a lack of knowledge and pity. It was also viewed that he has issued this *Fatwa* at a time when the Egyptian Government was worried about savings Mobilization. The above *Fatawa* raised many eyebrows and had attracted many headlines such as *"A slap to the face of extremists and peddlers of religion: Finally, bank interest is permissible"* (Egyptian Magazine Rose *al_Yusuf* December 13, 2002) " Now shall we cancel Islamic Banking" (ibid).

On the face of total outrage an official rebuttal was issued in January 2003 by the council of the Islamic Jurisprudence Academy (IJA; *Majma' al- Fiqh al- Islami*) rejecting the Islamic legitimacy of all forms of bank interest.

Islamic *Fiqh* Academy *Fatawas*

On bonds:

Resolution No. (60/11/6) at 6th Session held on 14t/20th March 1990 at Jeddah

They studied the papers and recommendations of a seminar held in Morocco during October 1989 by IDB and IRTI. In their view that "the bond is a certificate by which issuer undertakes the liability of paying its face value to the bearer on its maturity along with an agreed interest relating to its value or to a predetermined profit, either in lump sum or as a discount or in the form of prizes to be distributed on the basis of ballot". They Resolved that

> *"The bond which represent an undertaking to pay its amount along with interest related to its face value or to a predetermined profit are prohibited in Shari'a. Their issuance, their purchase and their negotiation, are all prohibited*

because they are interest bearing loans, no matter whether their issuing authority belongs to the private sector or is a public entity related to the state. The change in the nomenclature, such as calling the bonds" certificate" or "investment securities" or "saving certificates" or calling the interest "profit" or "income" or "service Charge" or "commission" has no effect on the aforesaid ruling"

(Islamic *Fiqh* Academy Resolutions 1985-2000 IBD/IRTI2000).

On bank deposits:

Resolution No. 86/3/95 at 9th Session of Islamic *Fiqh* Academy April 1995 held in Abu Dhabi)

They have studied the research papers submitted to them on the subject of " Bank Deposits (Bank Accounts)" and they have listened to the debate around the subject. The resolved that:

"Call deposits (current accounts) whether at Islamic banks or interest based banks, are considered loans, from Shari'a perspective, since the bank taking delivery of these deposits is answerable for their safety and bound shari'a wise to returning them on call".

Some deposits are resolved as usurious and unacceptable and some investments deposits if maintained accordance to *Shariah* contract format for profit share on the basis of *Mudarabah,* subject to its applicable rules and if the *Mudarib* (the bank) do not guarantee capital of the depositor is considered permissible, provided that the bank is fully transparent and provide all the data and information for the sake of avoiding to deceive the parties concerned.

(Islamic *Fiqh* Academy Resolutions 1985-2000 IBD/IRTI2000)

APPENDIX-K: COLLECTION COURT CASES RELEVANT FOR ISLAMIC BANKING

1. Islamic Investment Company of the Gulf (Bahamas) Ltd. Vs Symphony Gems N.V & others

The above case was heard in the High Court in London relating to a *Murabaha* agreement. It was a case involving international trade finance whereby finance provided by the bank to facilitate the trade was converted in an Islamic mode of *Murabaha* finance. The bank purchaser ordered the bank to procure the goods and sell it to them immediately thereafter and the new agreed price to paid by instalments (maturity dates). The Buyer failed to pay any instalment and claimed that the goods never reached their destination; in other words the bank failed to deliver the goods. Under Islamic *Shariah* Law the bank must first own the goods before sale and banks normally covers this risk of non-delivery by express contract terms also applied here in *"that the buyer must pay notwithstanding any defect, deficiency or any loss or any other breach of any supply contract or any other matter whatsoever*". The contract was subject to English law to the extent it did not violate the mandatory provisions of Islamic *Shariah.*

The defendant argued that the contract had violated the Islamic *Murabaha* contract terms whereby obligation to pay dependant on claimant effecting of delivery. Secondly the defendant argued that the claimant violated the Islamic *Shariah* Law as such the contract is illegal and thirdly on *ultra vires* that the bank was conducting business outside the objectives of Islamic *Shariah.* The High Court rejected all the above defences and concluded that the defendant remain liable also in the event of a failure of delivery. The court did not allow any *Shariah* consideration as the case is about default in payment which the claimant is entitled to recover. This case highlighted two points: that irrespective of contract construct the conventional English court cannot give an Islamic *Shariah* judgement. The Bank is not bound to follow Islamic *Shariah* Law. The court views them as a financing agreements with abstract payment obligation (Balz 2004).

From the above ruling it can be said that Islamic banking terms are only nominal terms and not effective terms. These are the main arguments against Islamic banks that they practice conventional banking in Islamic names. They do not practice a truly Islamic banking under truly Islamic principles and never intended to be bound by them.

2. Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd.

and others [2004] EWCA Civ19

In this case the decision of Court of Appeal in an English court totally disregarded the Islamic *Shariah* Clauses. The above bank entered into two *Murabaha* facilities with the defendants. The agreement stated that *"subject to the principles of Glorious Shariah, this agreement shall be governed by and construed in accordance with the laws of England".* The fact of the case that the advances were required as working capital but the defendants have draw down the cash and no goods were purchased. The defendants then defaulted on payments.

The defendant argued that these transactions are not enforceable in English law in accordance with Islamic *Shariah* principles. They further argued that the bank knew that these were a loan on interest disguised as *Murabaha*; therefore, these agreements were invalid. There were two fundamental principles in this judgement, firstly under the Rome Convention only a choice of law between the laws of two different countries and not between the law of a country and a non national system of law such as *Shariah* law. Secondly, they decided that there could not be two governing laws in respect of the same agreement. Therefore the judgement came in favour of the bank (Beale 2004).

From this judgement it is clear that appropriate legal infrastructure must be developed to cater for Islamic *Shariah* modes of finance as intended between the parties. This would add to the transparency, accountability and good corporate governance. It can therefore be seen why Islamic banking as it stands today can at times be looked at suspiciously.

3. Bank Islam Malaysia V. Adnan b. Omar

(Kuala Lumpur High Court Suit No. S3-22-109-91)

In this case an Overdraft to buy a Land for RM125000 was structured as Credit sale for RM 583,000 repayable over 180 instalments where borrower/buyer defaulted . In this case the borrower sold a piece of Land to the bank for RM 125000 and immediately bought back basis credit repayment for RM583,000 and the bank had a legal Charge over the land. The Judge gave judgement favouring the bank, saying that it was not a credit sale rather a loan disguised as a sale where the borrower knew full well all terms and conditions. Therefore, the court had disregarded the buy and sell agreements. However on appeal the High court ordered the bank to allow rebate for the unexpired period (Rosly 2005).

4. Dato' Haji Mahmud Vs. Bank Islam Malaysia

In this case an overdraft was structured as a credit sale whereby the bank took charge on a piece of land as part of a buying contract for RM520,000 and immediately sold it on credit for RM629,200. After default the customer took action against the bank that the land should not be handed back to the bank as it was contrary to the Kelantan Malay Reservation Enactment. Upon investigation it was revealed that a transfer never took place. The ownership remained with the owner (here the Plaintiffs) and was charged to the bank. Therefore, the subject matter of the lawsuit was not valid. It was actually a collateralized loan given by the bank to plaintiffs as no actual transfer of ownership was evident in credit sale. The sum up concluded that the sales contracts were of no effect. Only the loan stood up (Rosly 2005).