# Preface

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**Biographical notes:** Yasushi Suzuki is a Professor at the Graduate School of Management, Ritsumeikan Asia Pacific University, Japan. His primary research interest focuses on the institutional political economy of financial development, on which he has published numerous articles in several peer-reviewed international journals. He has written couple of books on finance and banking as well as contributed several chapters in edited books. Besides teaching at the graduate school, he also supervises thesis for PhD students.

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The global financial crisis triggered by the US subprime mortgage crisis has shivered the core principles of free-wheeling capitalism. This unprecedented worldwide financial meltdown not only brought the supremacy of traditional interest-based banking system into question but also led to doubt as to whether conventional banking practice works as an influencing factor for financial mess. While the unending and counterfactual debates on the issue have been rising, scholars are increasingly tending to assess if the profit and loss sharing based Islamic banking can be a sustainable competitor, if not a direct alternative. This assumption has been further heightened by increased popularity of Islamic banking in the recent times, not only in the Arab or Islamic countries, but also in non-Muslim countries. The introduction of Islamic banking principles by various Western bankers has shown positive results that indicate that Islamic banking systems can work effectively in both developed and developing economies, regardless of religious boundary. Responding to this increased demand for Islamic financial services

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and products, the number of Islamic banks has been increasing rapidly throughout the world. Moreover, in some countries, conventional banks are also offering the same or almost similar services to the customers through either opening a new branch tagged after 'Islamic banking branch' or opening a new window named 'Islamic banking window'. The reason for increased demand is that conventional banks find it profitable to deal with Islamic investment funds, such as asset-leasing funds and share-dealing funds. At the same time, some conventional banks are trying to improve the management of these funds so as to compete with the Islamic banks.

Despite this overwhelming success of Islamic banks worldwide, these sorts of financial institutions are not beyond criticism. Some criticisms are baseless, so to say. But there are other concerns to which scholars focusing on Islamic finance in general and banking in particular should pay careful attention for the greater interest of the system as a whole. Most concerns stem from various aspects of Islamic finance which include but are not limited to:

- The extent of *Shari'ah* compliance of Islamic financial products,
- Lack of diversity and variability among and between them,
- Shortage of and inadequate mechanisms for trading Islamic derivative products,
- Weak and improper implication of corporate governance in Islamic financial institutions,
- Excessive concentration on a particular type of product (for instance, the so-called *Murabaha* syndrome in which institutions concentrate on conservative credit portfolio on asset-backed transactions at mark-up pricing),
- Risk-taking behaviour and risk mitigating techniques are not at their best.

This special issue, therefore, is an attempt to bring some critical issues to the forefront of academic discussion dedicated to Islamic banking and finance. We believe that this small effort will at least contribute towards enhancing our basic understanding about issues pertaining to Islamic banking for future policy-making purposes.

The basic principle of Islamic finance that differentiates it from the traditional mode of fixed-income based banking practice is the prohibition of *riba* and *gharar* (uncertainty). Primary confusion centres on whether it is '*riba*' or 'usury' that Islam prohibits. *Riba* in simple terms can be translated in English as 'interest' or 'excess of capital', whereas the literal meaning of 'usury' in general parlance is 'lending money at unfairly high rate of interest'. What does Islam prohibit, *riba* or usury? Despite disagreement, scholars of Islamic finance have been able to convincingly argue citing various *Qur'anic* verses and analysing the Prophet's *Sunn'ah* that it is not only unnecessary but also illogical to differentiate between these terms as long as Islamic *Shari'ah* is concerned.

This confusion can be attributed to our limited understanding of Islamic principles. Thus, eliminating any disagreement requires first, to broaden our understanding of Islamic principles applied to finance and banking. Doing this would help Islamic financial institutions extend their product variety. Some areas of Islamic finance, including *Shari'ah*-based bonds, Islamic venture capital and derivative markets, are hardly penetrated. Of course, some countries, particularly Malaysia and Turkey, are offering some of these products but at a very limited scale. It is expected that product

diversity of Islamic financial institutions will not only deepen the respective financial root to stability but also make the system a popular one irrespective of religion, country, race, etc.

The first paper of this special issue takes this matter into account. It attempts to highlight the importance of financial derivative and the mechanisms required to package it in commensuration with Islamic *Shari'ah*. In the traditional sense, a financial derivative is a sort of fictitious asset. It is derived from another real or intangible underlying asset on which the price of derivative contracts depends. In derivatives trading, taking or making delivery of an underlying asset is not warranted. This, in turn, leads contracting parties' risk exposure far greater than they can absorb in true sense. The paper thus reviews the existing financial derivative products, including forward, futures, options, and swaps, as well as problems embedded in them. Moreover, the authors attempt to figure out a *Shari'ah* version of these products shedding analytical light on different aspects of *Quar'an* and *Sunn'ah*. Derivatives are mostly traded for speculative purpose. In Islam, speculation is not permitted and the aim of prohibiting *gharar* associated with speculation is considered the wisdom for minimising potential periodic financial disaster, sometimes leading to financial crisis.

According to some economists and financial analysts, the US subprime mortgage crisis which triggered the worldwide financial meltdown was mostly due to reckless trading of financial derivatives. It has been shown in several studies that the notional principle of derivative trading at the outset of the financial mess was many times higher than the world's gross domestic product. At the same time, it has been reported that financial institutions engaged in derivative trading used to assume more risk than they could absorb. This resulted in the collapse of large financial institutions (Lehman Brothers, for example), the bailout of banks and insurance companies (the case of AIG) by national governments, and downturns in stock markets around the world. In the paper titled 'Islamic banks and conventional banks within the recent global financial crisis: empirical evidence from the GCC region', the authors attempt to assess how financial crisis affects Islamic financial institutions, dividing their analysis into pre- and post-crisis periods. They find that Islamic banks were not only more profitable than their conventional counterparts but the former were also less risky. They attribute the relative stability of Islamic banks during 2007–2008 to the requirements of the *Shari'ah* principles. Prohibition of Islamic banks from engaging in risky or uncertain (speculative) ventures occurs at the cost of efficiency. Confirming this hypothesis, the paper further shows that Islamic banks are less efficient than conventional banks.

This issue has been tackled in another paper, which examines if the Indian single banking system is more efficient than the dual banking system in Pakistan. Applying both parametric and non-parametric tests, the authors confirm the finding of the previous article showing that the Indian banking sector has been relatively more efficient than the Pakistan banking sector. This finding is in conformity with the literature providing evidence from international and regional data that Islamic banks are less efficient than their conventional counterparts. Though it seems to appear a paradox that an inefficient Islamic bank is less susceptible to crisis, the anomaly has been explained convincingly by a number of studies. Efficiency estimation mostly applies parametric and non-parametric tests, which require some assumptions concerning the status quo, especially in regard to determining the input that a bank uses to produce the output. This sort of measure has been reported in the literature as favouring larger banks. Needless to say, the history of most Islamic banks is comparatively short and, therefore, they haven't been able to

capitalise on economies of scale in producing higher level of output (investments) competing in a market with well-established conventional banks. Even in the GCC countries, which are considered to be a sanctuary for Islamic banking, Hakim and Chkir show that conventional banking industry is more concentrated than the Islamic banking, leading to a bigger size of the former than the latter. Therefore, it is not unusual for Islamic banks to work a little farther from the efficient frontier. However, it is found that most Islamic banks are well capitalised, which has made them less risky though less efficient than conventional banks.

Efficiency is an issue that most Islamic banks should consider seriously. Increasing efficiency is indeed, a challenge for Islamic financial institutions particularity for banks. One way of getting out of this trap is to increase a bank's intermediation level. This requires, of course, arranging diversified Islamic financial products. The urge is due to the fact that Islamic banks so far are not so successful in offering state-of-the-art financial products to customers, and some of their typical products are not business friendly. Or, in other words, the nature of some financial products is such that they create liquidity problem for Islamic banks. Commodity *Murabaha* is a case in point. This problem is discussed by Gundogdu and Dogan, who offer a two-step *Murabaha* as an alternative to commodity *Murabaha*. Besides repackaging existing financial products, banks have to aspire for new avenues of opportunities. Many analysts are of the opinion that venture capital is going to be the rising star of Islamic finance because it is a *Shari'ah*-based instrument and, though risky, embodies huge profit potential. Islamic financial institutions, therefore, should attempt to finance feasible venture capital. However, Shaikh in this special issue, sorts out an extended list of opportunities that Islamic banks might find profitable to explore in the future. The author further views that financing infrastructure and development projects might be lucrative ventures to be sought after. Furthermore, renewable energy is a buzzword in the academic and finance world, which recently has created a bankable opportunity in the form of carbon-finance for Islamic banks.

Of course, the above-mentioned topics are the issues to be put forward for further discussion and analysis. This is indeed, the aim of this special issue. Instead of aspiring to provide any ready-to-use solution, it aims to stimulate discussion and debate on emerging issues pertaining to Islamic banking. We hope that readers will judge this special issue from this perspective. If so, they would find these papers interesting and contributing to the existing literature.