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THE ISSUES AND CHALLENGES OF SHARIAH HARMONIZATION OF THE CROSS BORDER TRANSACTIOINS: CONCEPTUAL REVIEW OF ISLAMIC BANKING INDUSTRIES

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ABSTRACT

The paper aims to identify major's regulatory challenges are facing in maintaining proper harmonization of Shariah rulings of Islamic Bank across the world in the cross-border activities. The study found that the Islamic banking is confronting challenges to make appropriate rules and regulations for making the common standardized mode of finance to cope up with present market demand for their customer with conventional counterpart base on the Islamic sharia principles. Particularly, in the arena of competing in the global markets and establish unique regulatory institutions for proper harmonization of Shariah rulings of Islamic Banks over the cosmos in the cross-border actions. The study recommends that policymakers are to pay attention to solve the above regulatory issues to face the existing challenges for the smooth financial operation in the future.

Keywords: Harmonization, Islamic Banking, Regulations, Cross Border Activities.

JEL Classification Codes: G21, G24, L26, P51.

INTRODUCTION

The principles of Islamic finance have been practiced in the Muslim world and recently many non-Muslim countries adopted these principles, techniques, and instruments. Islamic finance refers to financial activities that are guided by the teachings of the Shari'ah (Islamic law), which strictly prohibits the payment and receipt of interest (Smolo & Habibovi, 2010). Due to the rapid expansion and growth of Islamic banking have attracted the attention of conventional commercial banks. Many more conventional banks are offering to provide Islamic banking products to their Muslim customers within the national and international perspective. Some banks have opened the Islamic banking window for providing banking services (Hassan & Dicle, 2005). At present, the harmonization of Shariah Rulings for Islamic banking and finance are important issues in the world banking system. Islamic banking is gaining popularity with the competition of conventional banking in the world. Even it covers the demand of Islamic modes of financing from the cross-countries customers, Islamic Banks are offering the cross-border opportunity of transaction in the global market (Brown & Skully, 2007). The necessity of harmonization of Shariah Rulings for all Islamic banking and finance over the world have risen due to different period of establishment of Islamic banking in the Islamic countries, various school of law and specific cultural background and different school of Shariah thoughts over the Muslim countries (Jalil & Muda, 2007; Karasik, Wehrey, & Strom, 2006; Ab Rahman, Alias, & Omar, 2012; Naghipour, Rasht, & Pourmohammad, 2012). One of the most serious challenges is facing by Islamic banking for standardized the unique mode of finance because i.e. lack of proper harmonization of Shariah Rulings within the same jurisdictions and among various regions. In the absence of harmonization of Shariah Rulings, it is creating confusion in the minds of the public about Islamic banking (Kermeli, 2000; Khan, 2007; Khan, 2010). Because of the main regulatory council of the Islamic banking is the Shariah board who control the whole banking system based on Islamic sharia and each bank have a separate sharia council to examines and evaluates each new product but there is mere coordinating with other banks within the boundary or cross-boundary (Amuda, 2010; Ansari, 1994; Bianchi, 2006; Choudhury & Ahmad, 2004). Even each board addressed a different particular school of thought (Iqbal, 2007). There is a diversity of opinion as to whether particular practices or products are Shariah-compliant. This means that some products and services may be approved as being Shariah-compliant by some Shariah scholars but not by others. On a global level, the approval of Islamic firms' products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators (Ainley, Mashayekhi, Hicks, Rahman, & Ravalia, 2007). In the competitive conventional market in the cross border arena, to expand the Islamic Banking services within the satisfaction customer, it is a regulatory challenge for Islamic Banking activities to solve this issues integrated and unique sharia decision can minimize time, effort, and confusion for innovation a new product (Abdul Hamid, 2008; Akhtar, 2007; Ariss & Sarieddine, 2007). In such situations, Islamic scholars agreed to develop common Shariah standards organizations as like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Furthermore, for example, the IFSB has recently called for a dialogue within the industry to adapt current insurance regulations to meet the specifics of Islamic finance. Greater standardization could reduce the potential for Shariah 'arbitrage' as well as making it easier for bankers and investors to understand the market (Ainley et al., 2007). However, continuous dialogue and consultation between International Accounting Standards Board (IASB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is needed to harmonize and minimize the difference between two frameworks.

In such circumstances, the harmonization of Shariah Rulings is an important issue to make enhance steps for Islamic banking in the global arena. The main aim of this paper is to identify majors challenges are facing due to the proper harmonization of Shariah rulings by Islamic Bank over the world in the cross-border activities.

HARMONIZATION OF SHARIAH RULINGS

The harmonization of Shariah rulings is essential to make the smooth operation of Islamic Banking activities in the cross border area but lack of proper standardization of common product for all school of thoughts; it has faced challenges with conventional banking (Abdul Hamid, 2008; Akhtar, 2007). Because the main regulatory council of Islamic banking is the Shariah board that controls the whole banking system based on Islamic sharia and each bank has a separate sharia council to examines and evaluates each new product but there is merely coordinating with other banks within the boundary or cross-boundary. Even each board addressed a different particular school of thought. (Iqbal, 2007). There is a diversity of opinion as to whether practices or products are Shariah-compliant. This means that some products and services may be approved as being Sharia-compliant by some Shariah scholars but not by others. On a global level, the approval of Islamic firm's products and services may also depend on the jurisdiction they are to be offered in. This can add another layer of complication for regulators (Ainley et al., 2007). In the competitive conventional market in the cross-border arena, to expand the Islamic Banking services within the satisfaction customer, it is a regulatory challenge for Islamic Banking activities to solve this issue integrated and unique sharia decision can minimize time, effort, and confusion for innovative new products. In such situations, Islamic scholars agreed to develop common Shariah standards organizations as like the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). Furthermore, for example, the IFSB has recently called for a dialogue within the industry to adapt current insurance regulations to meet the specifics of Islamic finance. Greater standardization could reduce the potential for Shariah 'arbitrage' as well as making it easier for bankers and investors to understand the market (Ainley et al., 2007).

There are several broads challenges are identified in the further harmonization and possibly standardization of Shariah i.e. (i) Competition in Global Markets, (ii) Unique Regulatory Institutions.

COMPETITION IN GLOBAL MARKETS

The competitions of Islamic and conventional banks are increasing day by day in the cross border transaction due to globalization (Brown & Skully, 2007). The world markets are rapidly converging into a single marketplace. The liberalization of foreign exchange markets has further reinforced this trend. Technological innovations are also playing an important part in financial integration and globalization (Amihud, Delong, & Saunders).The discovery of easy communication waves through electronic correspondence has reduced the cost of international communication. Customers in many countries can navigate on Internet banking, unit trusts, mutual funds, and even business firms (Ahmad, Khan, & Iqbal, 1998; Iqbal, 2007; Mamun, Hassan, & Isik, 2011).

Due to a lack of proper harmonization of Shariah rulings, financial innovations of the unique standardized mode of products' main challenges to cope up with the rising demand from the customers through the condition of sharing risk, lowering transaction costs, and reducing asymmetric information and agency costs (Iqbal, 2007). It is the process of making design, development, and implementation of innovative financial instruments and products as well as the formulation of creative solutions. Financial engineering may lead to a new consumer-type financial instrument or new security, or a new process or creative solution to corporate finance problems, such as the need to lower funding costs, manage risk better, or increase the return on investments (Ahmad et al., 1998, Iqbal, 2007). From the Islamic Banking perspectives, it is a prime challenge to introduce new Shariah-compatible products based on understanding the risk-return characteristics of each building block of the system and offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety (Hassan & Dicle, 2005, Iqbal, 2007, Tahir & Bakar, 2009).

In the cross-border context global transaction has been increased and as well as increased difficulties lack integrated capital market. The wide range of instruments with varying structures of maturity and opportunities for portfolio diversification and risk management can be a way of solution for a transparent integrated capital market in cross countries. In the same way, Islamic Banking has to focus on the development of products that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic (Iqbal, 2007). In general, Islamic Bank is a new field are and they don’t have enough and mass funds for investing in research and development of new products in comparison with a conventional bank. Considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products. Conducting basic research and development collectively may save some of the costs required to build this infrastructure individually. A good example of such collective effort would be to sponsor research in the development of analytical models, computer systems, and tools to analyse the risk and return on different instruments (Iqbal, 2007).

UNIQUE REGULATORY INSTITUTIONS

The unique regulatory institutions are inevitable in exploring, experimenting, and issuing proper harmonized Shariah rulings in this competitive global cross-border transaction for both Islamic and conventional banking. An ineffective supervisory board framework is one of the central weaknesses of the prevailing system and deserves serious attention(Ahmad et al., 1998). The roles of both the Shariah advisory boards and the Central banks need to be streamlined and strengthened(Ahmad et al., 1998, Iqbal, 2007).

Most of the country's central bank has supervised all types of banking activities and Islamic banks are also controlled by the same act of central bank as like conventional banks (Barth, Caprio Jr, & Levine, 2001; Hassan & Dicle, 2005, Tahir & Bakar, 2009). Some countries issue special Islamic banking Act to govern the operations of specific Islamic banks and their relationship with the central bank (Tahir & Bakar, 2009). Thus, it is a big difficulty for an Islamic bank to adjust within the same regulation with traditional interest-based convention banking. Even, to protect public safety most governments have created elaborate regulatory bodies for the smooth operation of traditional banking over the cross-countries separately. As a result, the banking industry has become one of the most heavily regulated industries all over the world (Ahmad et al., 1998). In-Line with this background, it is an opportune requirement to establish a strong supervisory framework as the extension of the sharia council of Islamic banks. It would be provided the right observation for all the regulatory obligations with the central bank and Islamic Bank. Then it will help to find a safe and smooth way of opportunity for Islamic Banking activities from the existing rules and regulations of the central bank respectively. The following issues can be solved by supervisory authorities:

i. Islamic banks are bound to keep a certain amount of statutory liquidity reserve of their deposits with central banks as like all other commercial banks doing the same. Against those deposits, the central banks usually pay interest which is prohibited for Islamic banks. An alternative is needed to ensure that Islamic Banks keep some of their deposits with central banks with a reasonable return based on sharia complaints (Ahmad et al., 1998, Iqbal, 2007, Grais, 2008).

ii. As in the cross-countries issues where the central bank conducts open market operations, Islamic banks are unable to participate in these operations because of the interest-based nature of the securities brought and sold. Thus, Islamic banks are constrained by the fact that financial assets that could be liquidated quickly are not available to them. This introduces some rigidity in the asset structure of the Islamic bank's operations (Ahmad et al., 1998, Iqbal, 2007, Grais, 2008).

iii. Sometimes the central bank does not comprehend clearly regarding the issues Islamic shariah complaints because of not having proper Islamic shariah based banking expertise. As Islamic banks are operating under the central bank, all the issues should be clarifying by the Islamic Bank. This is particularly true of *musharakah* and *mudarabah.* In debt financing, granting a loan by a bank is a one-time activity, no matter what the size of the loan is. But *musharakah* and *mudarabah* are on-going activities and participation of an Islamic bank in these activities continues as long as the project financed is in operation. This may have important implications for reporting as well as control and regulation of Islamic banks by the central banks in cross-border transactions (Ahmad et al., 1998, Iqbal, 2007, Grais, 2008).

iv. The proper accounting practices are imperative issues for any financial institutions in the context of cross border activities. In general, the conventional banks are practicing

Generally Accepted Accounting Principles that are used as a reference and facilitate cross border assessments, and accordingly financial flows and investments (Ilias, 2010). To introduce standardization in the accounting practices of Islamic financial institutions, some Islamic banks, under the guidance of the Islamic Development Bank, have established an organization called Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The organization is functioning based in Bahrain, is composed of a Supervisory Committee and a Financial Accounting Standards Board responsible for preparing, issuing, and amending the accounting standards of those Islamic banks and financial institutions that have agreed to apply the standards set up by the Board. The AAOIFI is a voluntary organization and has no binding powers to implements its standards but just to observe the accounting practices of the Islamic Bank over the countries(Ahmad et al., 1998). In the same way, these have not yet received the general recognition to be references that facilitate cross-border information sharing and financial flows. Accordingly, diversity without a set of common references is likely to compound the challenges of cross-border comparisons and may put Islamic banking services at a competitive disadvantage (Ahmad et al., 1998, Amihud, Delong, & Saunders, 2002; Ilias, 2010). In such a situation to address the above issues, all Islamic Banks over the world should maintain common accounting standards that are provided by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI should also work to find out the way of solution for the conflict between the accounting standard conventional Bank and Islamic Bank based on the shariah principles. The specific objectives of AAOIFI are:

a. To develop accounting and auditing thoughts relevant to Islamic financial institutions;
b. To disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, the publication of periodical newsletters, carrying out and commissioning of research and other means;
c. To prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
d. To review and amend accounting and auditing standards for Islamic financial institutions.

v. The Islamic Financial Services Board (IFSB) has established in 2002, Kuala Lumpur, Malaysia. The prime objectives of the Islamic Financial Services Board are to harmonize the Islamic financing industry as an international standard-setting body of regulatory and supervisory agencies that have an interest in ensuring the reliability and stability of the Islamic financial services industries. Moreover, it is concerned with the standardization of the Shariah committee rulings on Islamic banking practices. The IFSB also aims at standardizing the approach in Good Governance of Islamic financial institutions and identifying risks in Shariah-compliant products and services and in assigning risk weights that meet internationally acceptable prudential standards.

vi. Islamic finance has been developing in many jurisdictions and is governed by different legal. the economic system and professed different *madhhab* (Otto,2010). Though civil court recognized Shariah law as Glorious Shariah, it does not mean that civil law could not be applied in Islamic finance case as stated in the case of Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd [2004] 1 Lloyd’s Rep 1 28 (Nor, 2017).

vii. It is interesting to note that Islamic Banking and finance have been developing under the framework of conventional banking whereby its essence is money borrowing and lending with interest (Nor, 2015). The nature of the relationship between the client and bank is debtor and creditor as mentioned in the case of Foley V Hill (1848) 2 HLC 28, 9 ER 1002. Islamic banks are under pressure to follow the basic requirements set by central bank (Muhammad, 2008). It somehow negates the essence of the Shariah contract in Islamic banking products. That is the nature of financial intermediary under conventional finance. Islamic finance, however, that nature of financial intermediary under Shariah is based on the contract of mudarabah, musharakah and wakalah (Nor, 2017).

viii. *The fatwa* is the engine of growth for Islamic finance development. The *shariah* committee exercising its collective *ijtihad* based on the real issue raised upon them (Lahsasna, 2010). The nature of *fatwa* is not binding (Calder, 2010).To give consideration to the compilation of the *fatwa* issue on one subject, highlight the points of agreement, and work to unify Islamic institutions towards what seems to be proper for transacting business, more compatible with the objectives of *Shariah*, more authentically connected to the *Shariah* text(*al Quran* and *al-Sunnah*) and open the possibility of steering the institutions to play their economic role (Muhammad, 2008)

CONCLUSION

As the main aim of this paper is to identify major's challenges are facing for the establishment of proper harmonization of Shariah rulings in the operation of Islamic Bank over the world in the cross border activities, The study has provided the regulatory boundary that should be developed by Islamic Bank authorities over the world to face the existing challenges for the smooth operation. Especially for maintaining the proper harmonization of Shariah rulings, Islamic Bank has to focus on the development of a unique model of finance based on sharia principles that foster market integration and attract investors and entrepreneurs to the risk-return characteristics of the product rather than to the fact of the product being Islamic or non-Islamic. Even considering the importance of financial engineering, Islamic financial institutions should seriously consider making joint efforts to develop the basic infrastructure for introducing new products.

Moreover, the study also emphasis to develop unique regulatory institutions that will provide proper harmonization of Shariah rulings in the competitive global cross border transaction of Islamic Banking. It would help to produce integrated and unique sharia decisions that can minimize time, effort, and confusion for innovative new products. In such situations, Islamic scholars agreed to develop common Shariah standards organizations as similar to the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). It is the time required to establish a strong supervisory framework for ensuring of harmonization of Shariah rulings as the extension of the shariah council of Islamic banks. In such a situation to address the above issues, all Islamic Banks over the world should maintain common accounting standards that are provided by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The AAOIFI should also work to find out the way of solution for the conflict between the accounting standards of conventional Bank and Islamic Bank based on the shariah principles. Moreover, it will also be useful to build bridges between existing Islamic banks and those conventional banks that are interested to do banking on Islamic Principles. Such strategic alliances will benefit both sides in the financial sector.

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