

A Second Generation of Islamic Banks: Riding the new wave

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ABSTRACT

This paper provides an assessment of the degree to which Islamic Bank earnings can be compiled and reported according to the SNA 2008. The author proposes that there are two reasons which may challenge the use of the SNA 2008, in its current form, for compiling Islamic Bank earnings: First, the advent of a second generation of Islamic banks which will likely focus on PLS modes of finance which will generate earnings of a fluctuating and unstable nature, and second, the incompatibility, in principle, between the SNA 2008 conventional, deposit-based system of fixed payment flows and the Islamic, investment-based system of unfixed payment flows.

Keywords: Islamic banks, SNA 2008, statistical compilation, national accounts, second generation

PRESENTATION

Good afternoon, and thank you for being here.

PREVIOUS INSIGHT

I would like to share with you a previous study that I published a while ago on Islamic banks in the Mena Non-GCC region, with evidence from Lebanon (Bizri, 2014). The main *purpose* of my study was to identify the factors that influenced the adoption of Islamic banks in my country. My *method* was quantitative, with a survey instrument of 38 items, almost 199 respondents, and several statistical tests including factor analysis and regression analysis. The *factor* analysis identified 5 factors, with 65% of variance explained. The *regression* analysis produced a significant model with an adjusted R-square of 0.7. Not surprisingly, the deciding factor in Islamic-bank adoption was *Trust in sharia-compliance*.

Many studies, qualitative and quantitative, have actually reported similar results, conveying people’s *distrust* in the genuine Sharia-compliance of Islamic banks, yet little has been done to make a change in the status quo. In fact, I recently conducted another study about Islamic banks, in two Arab nations, that I will be presenting at another conference in Turkey, in a few days (Bizri, 2017). The results of the new study direct the blame at the industry, in that Islamic banks offer the instruments that *they* themselves prefer to use, instruments that are “easier” to administer, that do not involve much risk, better still, instruments that do not involve *more* risk than those used by conventional banks – instruments like *Murabahah*, where the payment-flows resemble those of interest-paying deposits at conventional banks. It seems that *this* is the preference of the industry at this point in time!

THE CHALLENGE

According to some scholars, Islamic banks are set up as financial intermediaries, not Profit/Loss Sharing institutions. Because of this, Islamic banks are facing high costs of compliance, and the need to re-think Accounting standards for PLS. This is not surprising, as the Islamic banks have long been set up to cater to debt-based contracts, not PLS contracts. Islamic banks have not developed their ability to mitigate the various types of risk associated with PLS contracts, not because they couldn’t, but because they wouldn’t.

Admittedly, Islamic banks had to leverage on the existing conventional-bank infrastructure, but Islamic banks have reached the end of the line. That infrastructure can serve them no more! They can no longer offer a replicated product-line with a “Halal” label. The public will not accept that. The customers will not accept that. And the *competition* will not allow that. Islamic banks need to break away from the status-quo they have placed themselves in, and move forward *toward* what they were *meant* to be.

THE NEW WAVE

Many brave scholars in the field are now calling for novel instruments that better reflect the true identity of Islamic finance. There are calls for Private Equity, Participation Banking, Venture

Capitalists, and Crowd funding as forms of PLS contracts. The digitization of the banking sector presents ground-breaking opportunities for the industry, leading to a *new generation* of Islamic banks, which will *bear* closer resemblance to the original paradigm, the paradigm that could really make an impact on development and growth.

THE CALL

I call for a *second generation* of Islamic Banks where the focus is the customer of the Islamic bank, not the industry. I call for a *second generation* of Islamic banks which reach out to the un-bankable, are *willing* to invest in startups, while adequately *mitigating* unconventional risks rather than avoiding them altogether.

My call is not solitary. Already, scholars are echoing a similar call for a *detour* in the industry. Work is underway in that direction, which *brings* us to the theme of this workshop.

THE QUESTION

A lot of hard work and serious thought has been put into the question of how to treat the "*income*" earned by Islamic banks, and whether that income could be treated like "Liability-based" payment-flows, thereby *facilitating* the recording of that income in the national accounts.

I must admit, I have tremendously enjoyed reading the Notes by Mr. Russell Krueger, and I applaud his efforts to rationalize the *comparable* treatment of conventional-bank "interest", and Islamic-bank "income" earned by Investment Account Holders (Krueger, 2017).

However, I must say that this treatment would be a bit irrelevant in the *second generation* era of Islamic banks. The new paradigm itself will not support such treatment; and it *shouldn't*.

Under the *second generation* era of Islamic banks, the predominant mode of finance is PLS, in a Fintech environment, where the concept of fixed and stable payment-flows is *not-applicable*, and comparable treatment of "interest" and "earnings" is *unrealistic*.

SPECIALIZATION IS KEY

A key success factor in the second generation of Islamic banks is the specialization of Islamic Banks. Not all banks need to offer all products. Some banks would become experts in Musharakah

contracts, others in Mudarabah, others still in Crowdfunding. Specialization would limit the number of tools of differing terms, owners, and rates of return, thus facilitating the recording and compilation of Islamic bank earnings.

Under the new paradigm, *Islamic financial intermediaries* are outdated and so is their function. To treat conventional-bank "interest" and Islamic-bank "income" in the same manner is just as unrealistic as trying to fit an oversized piece into a small-sized puzzle. *It just won't fit!*

THE PROPOSAL

The proper treatment of Income earned by Islamic banks is to treat it for what it is: Profit – as unpredictable and fluctuating as the word conveys. Under the paradigm of the *second generation* of Islamic banks, the income statement will be as unstable and unpredictable as ever, and the Broad approach would be irrelevant. A legitimate question might be: "What do we do in the meantime?" and the answer would be: "*LET'S START WORKING*".

I now call for working avidly together to develop a system for the accurate estimation and recording of those profits, so that we are ready when the *second generation* era arrives.

I look forward to having further discussions of all the efforts in this direction. I thank the organizers for inviting me. And I am ever so grateful to you for listening.

Thank you.

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