



**AN OPERATIONAL MODEL OF ISLAMIC BANKING  
FOR AFGHANISTAN:  
PROSPECTS AND CHALLENGES**

By

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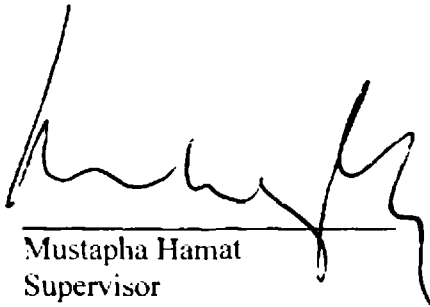
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## ABSTRACT

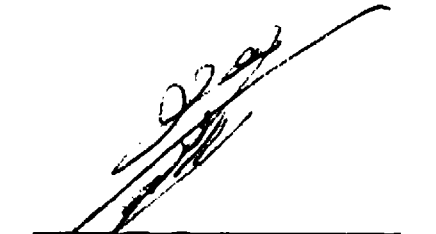
The banking system plays an important role in economic growth and development through the process of financial intermediation. A well-established banking system is the backbone of an effective economic system. However, the lack of confidence in the banking system, uncertainties and obstacles faced by people in Afghanistan let them to rely mostly on informal banking system such as *Hawalah*, which is based on trust and reputation. As reported only 3-10 percent of the Afghanistan population have accounts with banks and the rest relying on *Hawalah* system. Afghanistan with its more than 99 percent of Muslim population is a potential country for Islamic banking. As for now, only 7 private banks are offering selected Islamic products via window. The purpose of this study is to propose a suitable model of Islamic banking institutions for Afghanistan. A combination of qualitative and quantitative research approach was used to get a better understanding of the issues. The qualitative data were collected via interviews while quantitative data through questionnaires. The SPSS software was applied and the data were analyzed in accordance with the research questions. The findings revealed high demand for Islamic banking in Afghanistan and with regards to the hypothesis of this research, the dual banking model of Malaysia was proposed as suitable model for Afghanistan.

## APPROVAL PAGE

We certify that we have supervised and read this Project Paper and that in our opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a Project Paper for the degree of Master of Business Administration.




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Supervisor



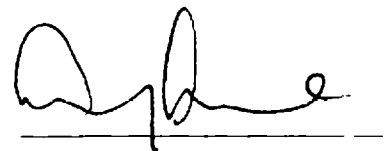
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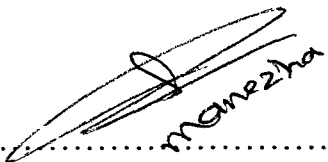


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## DECLARATION AND COPYRIGHT

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I hereby declare that this research is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Signature..........

Date 7 July 2011

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## **DEDICATION**

I solely dedicate this work to my beloved parents who have thought me the real meaning of patience and for their never ending love, care and support.

## ACKNOWLEDGMENT

I would like to take this opportunity to acknowledge many respected people for their various contributions to this project paper.

First and foremost, I would like to extend my sincere gratitude to my respected supervisors, Mr. Mustapha Hamat and Dr. Mohammad Yusuf Saleem for their valued supervision, never ending support, motivation and encouragement during this process. I am very thankful to them, that they have given me the pleasure to use their valued experience and suggestions while they have presented a new world for my future academic research.

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Last but not least, I humbly ask Allah (swt) to help us to implement and benefit from what we learn and protect us from what is not beneficial.

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## **List of Abbreviations**

AFA	Afghani Currency
BNM	Bank Negara Malaysia
CIPE	Centre for International Private Enterprise
DAB	Da Afghanistan Bank
MIFC	Malaysia International Islamic Financial Centre
PLS	Profit and Loss Sharing

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# CHAPTER 1

## INTRODUCTION

This chapter begins with the background of the study, followed by the significance, objectives and questions. Finally the delimitation and disposition of the research paper are represented.

### 1.1 Background of the Study

Joseph Schumpeter (as cited in Thorsten Beck, Ross Levine, & Norman Loayza.n.d) in 1911 argued that, banks play an essential role in economic development by alerting the path of economic progress and affecting the allocation of savings. Besides, it has been proved that, better functioning banks improve resource allocation and accelerate total factor productivity growth with positive consequences for long run economic growth (Thorsten Beck, Ross Levine & Norman Loayza).

However, opening bank accounts and depositing money is not a common culture in Afghanistan (CIPE 2006). As reported only 3 percent to 10 percent of Afghans are currently holding accounts with commercial banks in the country (Steven A. Zyck2011). Based on my personal observation, people are saving their money through buying gold or land. There are three main factors driving deficit in the banking sector and acceptability of banking service. Important and ongoing among all

is the strong adherence to the Islamic law, the Muslim people of Afghanistan avoid investment in the interest bearing schemes and the idle funds are mostly being consumed to meet unproductive family demands which mean no saving.

Secondly, most of Afghans do not trust banking service due to banks failure to fulfill their responsibility as trustee (Kabul bank as a recent case), while honesty and trust worthiness is the backbone of banking system, and the Prophet (pbuh) has declared dishonest transactions as illegal and he often used to say in his sermons: "Remember, there is no faith in him who is not trustworthy; there is no place for him in religion who cares not for his pledged word or promise."

Lastly the three decades of war destroyed the infrastructure of banking system in Afghanistan. As a result, large segments of Afghan's assets are not kept in banks but rather remain stored at homes or deposited with a range of money traders such as *Hawalah* dealers.

As stated by economists, a country's Gross Domestic Product (GDP) measures its economic performance. Mathematical representation for GDP using the Expenditure Approach is:

$$\text{GDP} = \text{C} + \text{I} + \text{G} + \text{X} - \text{M}$$

The above formula indicates that, economic growth is a factor of Consumption spending (C), Investment (I), Government purchase (G) and net export (X-M). Afghanistan with real growth rate of 8.9 percent (FY 2010) and 29,121,286 populations has been ranked as the poorest country of the world. The economic performance of the country indicates that, the above contributor factors of GDP have been less emphasized in the country.

Savings play an important role in capital formation, income-generation and creation of employment opportunities while contribute towards the increase in wealth of the individual and nation through profitable investments. In general, people save their income to protect themselves from future financial hardship, while enhancing their earnings. Meanwhile, Islam encourages savings, and emphasizes in channeling the fund by investment to productive activities which will pave the way for further employment, development and prosperity of the nation.

Nevertheless, bank saving in Afghanistan is at its minimum level, people are very much religious and committed to the Islamic way of life, therefore they avoid deploying their fund in conventional banks due to the presence of *Riba*.

As a consequence of three decades of war, all infrastructures of the country are deteriorated. Now that the country is on the recovery stage, there is a rapidly emerging market for the financial industry and the government is planning to accomplish various projects including infrastructural development, road development, energy development and agricultural development. Since March 2010 the banking sector has granted USD 1.26 billion loan to various segments such as airlines, construction companies, hospitals and education institutes. However this amount would have been larger with the presence of Islamic banks, according to a recent World Bank report on investment, 26 percent of Afghan traders and investors do not use conventional banking services due to the religious constraints (DAB report, March 2010).



Afghanistan is known to have major deposits of coal, salt and substantial oil deposits which are identified but not yet quantified<sup>1</sup>. According to the World Bank report 2010, the long term vision in Afghanistan is to develop an economically vibrant mineral sector which creates jobs, develops infrastructure, enhances domestic revenue and ensures economic growth for the benefit of all Afghans. However, due to low level of capital accumulation, the country is not able to exploit those untapped resources. The absence of trust, religious concern towards the current conventional system and destructive war are the main reasons behind the low acceptability of banking system which lead to low level of saving and capital accumulation. It has been stated that, Islamic banking system generates favorable socio-economic consequences which facilitates the establishment of growing egalitarian economy. Therefore it can be concluded that, the introduction and implementation of Islamic Banking is the only effective solution.

Based on the research findings of the Afghan Research and Evaluation Unit (AREU), it has been revealed that, Afghans are involved with the Islamic financial arrangements which are practiced outside of nascent commercial banking sector such as deferred payment, advance provision, interest free loan, mortgage of agricultural land and Business credit. Therefore we can say that, the practice of Islamic finance is not a new concept in Afghanistan, however it has been casually practiced by individuals and not institutionalized. Besides, the extensive application of *Hawala* system and the Microfinance projects based on interest free scheme is another indication of the practice of Islamic based products.

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<sup>1</sup> Reported by Federal Research Division, Country Profile: Afghanistan, August 2008

## **1.2 Objectives**

The objective of this research is to develop an appropriate model of Islamic banking institutions and to identify a suitable approach for implementing the model. To facilitate the research works, this high-level objective is broken down into the following sub-objectives:

1. To critically analyze the socio economic condition of the country
2. To critically examine the current status of the banking industry in Afghanistan
3. To critically examine the current Islamic banking models which are in practice in other countries
4. To propose an operational model of Islamic Banking for Afghanistan and analyze its suitability
5. To Identify the challenges and problems pertaining to the execution of the proposed model and suggest solutions to these challenges and problems

## **1.3 Research Questions**

In order to achieve the above mentioned objectives, this paper aims to address the following questions

1. Which of the following operational models is suitable for Afghanistan?
  - Full fledged Islamic banking system (Iran, Sudan)
  - Dual banking system (Malaysia, Indonesia Bahrain)

This question gives rise to the following sub-questions:

- 1.1. Can the proposed models be implemented at the current situation?

- 1.2 Is there a need for customization of the proposed model?
2. What are the challenges which would arise from the execution of the proposed model?
  - 2.1 How to overcome those challenges?
3. What measures should be taken to enhance the acceptability of banking system in the country?
  - 3.1 How to recuperate people's trust (after the recent collapse of Kabul Bank)?

## **1.4 Research Hypotheses**

The present study states three main Hypotheses as follows:

- H1:** Dual system of Islamic Banking is suitable for Afghanistan
- H2:** Full fledged model of Islamic Banking is suitable for Afghanistan
- H3:** None of the Islamic Banking models is suitable for Afghanistan

## **1.5 Significance of the Study**

Having a sound banking system is the backbone and integral part of an economic system which plays an important role in the well-being of the economy. Meanwhile a weak banking sector besides jeopardizing the long term sustainability of an economy can also be a starting point for a financial crisis which leads to economic crisis, as it was experienced by developing countries during the financial crisis such as Mexico in 1994, the Asian financial crisis in 1997-98, Russia in 1998 and Argentina in the year 2001 and the recent financial crisis which began in 2008.

It has been agreed by various studies that, a well-developed and sound financial system can contribute significantly to the economic growth by realizing the important role that financial intermediaries play in bridging the gap between saving and investment needs within an economy (De Gregario and Guidotti (1995) & Ross Levine and Sara Zervos(1998) . Through having a closer look at the current situation of Afghanistan, we can safely say that, the root of most problems can be attributed to the lack of an effective economic system. By having an effectual Islamic banking system the economic system will enhance, as a consequences the well-being of society will improve. As mentioned in the literature review, Islamic banking and finance presents significant new business opportunities and provides methods for capital formation and economic development.

Keeping in mind the failure of conventional system and the Asia Financial Crisis (1997) and the recent financial crisis, while talking about the important role of banks playing in extending credit for boarding of Business and investment opportunities, it is not save for Afghanistan Economy which is on the recovery stage, to rely entirely on the loans issued by conventional banks. Therefore the application of Islamic Banking could ensure to some extend the successful implementation of Islamic bond in the process of reconstruction and expanding businesses. In addition, the profit-loses sharing as a principle and backbone of Islamic banking, ensures the equitable distribution of income and wealth, which is the essential condition for sustainable growth (Toutouchian 2009).

The execution of Islamic banking system in Afghanistan would further help the overall economic of the country, in particular the agricultural sector through *Mudaraba*, *Musharka*, *Muzarah* and *Musawamah* contracts. Besides providing further

business and employment opportunities, the implementation of Islamic Banking would eliminate the practice of inefficient financial transactions (*sarafi*) which is in practice since long time.

To my knowledge, besides the draft of Islamic Banking law, the present study will be the first research paper on Islamic Banking in Afghanistan since no empirical research has so far been carried out in this regard. While contributing to the knowledge of Islamic finance and enabling the customers and professionals to enhance their knowledge, this paper would serve as a useful guideline for foreign banks who would like to extend their banking activities to Afghanistan. In addition, this research paper could serve as an effective assistance for the government of Afghanistan. Equally, this study will offer certain benefits to those banks which want to switch to Islamic Banking, and it will be a milestone for new banks to start Islamic operation in the country.

## **1.6 Limitation of the Study**

This research paper has certain limitations that need to be taken in to account for future research. Due to the limited Literature Review on the banking sector of Afghanistan and unavailability of updated country data, this study is not able to present a profound Literature Review on the country's economic system and banking industry. Besides, there are many facts pertaining to the banking sector of the country which have not been documented, such as the operation of Bank-E millie based on Islamic Principles, but being approved verbally by Banking authorities. Therefore the

author was not able to stress strongly on those facts, despite their importance for this study.

Furthermore, due to the time constrain and security concern we were not able to travel to other cities therefore only visited Kabul based branches and limited the sample size to 35 correspondents who were based in Kabul. However the result could have been more accurate and generalized if the sample size would have been larger and represents other cities besides capital.

## **1.7 Organization of the study**

The present study consists of six chapters. Chapter one gave an introduction and background to the research topic, the objectives and limitation of the study are also outlined in this chapter. Chapter two which consists of two parts, focusing more on the country's economic system and financial sector. Part one of this chapter, presents to the reader a brief background on the economic system, discussing briefly the main economic factors and presenting facts and figures to analyze the economic position of the country. The second part of this chapter presents a concise background on the financial sector of the country followed by brief description of banks operating currently in Afghanistan. This section also sheds light on the function of *Halwala* system and touched lightly on the Microfinance projects which are offering Islamic based products.

Chapter three divided in five sections. Section one presents a comprehensive introduction on Islamic Banking. Section three discuss briefly on the framework of

Islamic banking. For the purpose of operational framework of Islamic banking, section four is highlighting the characteristics of Islamic Financial contracts. Besides, to serve the second objective of the study, section five of this chapter discusses briefly the current models of Islamic banking which are in practice in other countries.

Chapter four deals with the research design and methodology. It begins with addressing the research design and approach, followed by the sampling process, and data collection technique and finally gives a brief explanation on the analytical tools being used in this project paper.

Chapter five presents the data analysis and findings in three sections. Section one begins with description of the sample such as demographics information of the correspondents. Section two of this chapter addresses the hypothesis of the study in more details. The main part of the finding which is the descriptive and quantitative analysis is presented in section three accompanied by the presentation of graphs and tables.

Chapter 6, which is the last chapter of this study, presents the conclusions and recommendations and divided in to four sections. Section one presents the main finding of the study according to the research questions. Section two provides a concrete conclusion followed by recommendation in section three and the last section of this chapter indicates direction and provides suggestion for future studies

## **CHAPTER 2**

### **COUNTRY BACKGROUND**

The previous chapter provides the background of the study. This chapter is presenting a brief background on the Economic system and financial sector of Afghanistan. This chapter separated in to three sections. The first section presents a brief background on the Economic system of Afghanistan, while the second section elaborates on the financial sector. The last section presents a concise explanation on the Banking Law of Afghanistan.

#### **2.1 Background of the Economic System**

During the 1930s, the economic modernization began, Afghanistan's economy experienced modest development by establishment of banking sector and introducing of paper money. However the economy suffered noticeably during the 1979 as consequences of Soviet invasion and civil war, the agricultural and industrial production declined and trade was disrupted. In early 1980s, the economy fragmented in to two parts. One part controlled by Afghanistan Government which was becoming increasingly dependent on the Soviet Union. The second part, which consisted of countryside, was unaffected by the Government and reverting to subsistence