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Faithful Finance: Unlocking Banking Islamization in Afghanistan

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Abstract: This paper explores the challenges and prospects associated with the adoption of Islamic banking in Afghanistan. Despite the global growth and acceptance of Islamic banking by approximately 50 countries by 1997, Afghanistan only embraced it between 2008–2009. The decision to convert conventional banks to Islamic ones, driven by the involvement of interest rates (*riba*) in the prevailing system, necessitates a thorough examination of the challenges and the need for an appropriate response. The study employs qualitative, analytical, and exploratory methods, reviewing secondary sources and conducting unstructured interviews with key stakeholders, including officials from the Da Afghanistan Bank (DAB), staff of Islamic banking institutions, experts in Islamic banking and finance, and consumers. The findings reveal that the challenges in promoting Islamic banking in Afghanistan are more complex and multi-layered than commonly understood, stemming from the legal system, regulatory capacities and mindset, banking services, and public perception. The paper emphasizes the importance of addressing these challenges comprehensively to safeguard the already fragile economic and financial sector. Failure to do so may lead to further deterioration. This research contributes to the existing body of knowledge by shedding light on the unique challenges and prospects of Islamic banking in Afghanistan, providing valuable insights for policymakers, regulators, and practitioners in shaping an effective transformation strategy.

Keywords: Islamic banking; financial sector; banking reform; Afghanistan; IEA

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1. Introduction

Muslim-majority Afghanistan is home to a tribal society who are proud of their tribal roots and the customs they have practiced since time immemorial. The custom-based tribal mindset is so predominant that, occasionally, customs prevail over *Shari'ah*, such as cases related to revenge, retaliation, and women's rights, regarding education, health, and work. In such states of affairs, trade and commerce are also conducted in an unorthodox manner peculiar to Afghanistan, where the concept of legal personality has little to no value and businesses are conducted in an informal manner, without the need to bother about written contracts or registrations of deeds. The laws formulated and implemented in Afghanistan during the last two decades of international intervention were neither aligned with international best practices, nor were they enforced, due to their inconsistency with the prevailing mindset in the country. Overall, the tradition continues to be a crucial component of Afghanistan's business and financial sector.

As far as banking services are concerned, Afghans did have access to banking institutions at least since 1933, when the Bank-e Millie Afghan (BMA) was established in the country. However, they were familiarized with the modern banking system post-2001. Despite progress in the field of banking and finance, the public trust in the banking sector has remained low. Only 4% of Afghans had access to banking services in 2012 (Khaama Press

2012), increasing to 15% in 2019 (Ross 2020; Khan 2021). The interviews conducted suggest that banking was not institutionalized in Afghanistan, since people and organizations used banking facilities only when they had to.

The reasons for this weak relationship between Afghans and banking services are manifold. The Afghan cultural mindset assumes that one owns what they have in their hand; thus, they avoid depositing their fortunes in places they do not believe they have control over. The majority of the people have, therefore, preferred to keep their money at home or with friends and family, rather than depositing in banks. Some of them, sarcastically, claim that Afghan Afghani (AFN) banknotes stuffed in pillows hold more value than US dollars in bank accounts. Khazan (2013) asserts, based on World Bank data, that the world's poor, keeping their money with relatives or in alternative investments, are more prone to being "unbanked", while emphasizing the substantial disparity in adult account ownership between high-income and developing countries. In addition to cultural perceptions, the common religious understanding is that banks deal in *Riba*; therefore, availing their services is tantamount to collaboration in a proscribed act and, thus, should be avoided.

Moreover, the people of Afghanistan have endured a profoundly distressing experience. Revolutions and political transitions have taught them not to trust a regime with their belongings; rather, they should take care of themselves and their assets. Therefore, they have used banking services only when it suits them, or if they are compelled to do so. Afghans have maintained an informal economic and financial sector at their disposal, to use whenever they require. The Sarai Shahzada, for instance, is a local, largely unregulated, yet influential, money and forex market that has been governed for decades by informal legal norms, where hundreds of millions of dollars circulate each day, making it the financial hub of the country (Choudhury 2022). In addition to the above, the collapse of the Kabul Bank in 2010 inflicted a fatal blow to people's trust in the banking sector. At the time of the collapse, approximately 1 million Afghans had accounts in the Bank, with a total value of around $ 1.3 billion. The case remains a textbook instance of flagrant corruption, fraud, embezzlement of public funds, impunity of political elites, and collusion and/or incompetence of regulators (McLeod 2016).

It is reasonable to affirm that the 15% of the Afghan population who have maintained accounts with banks have done so primarily due to the government's obligatory policy regarding salary disbursement. Furthermore, legislation has prohibited cash payment to contractors and has instead necessitated payment through bank accounts. Thus, government employees and contractors were forced to open and maintain bank accounts. However, they did not use these accounts regularly and withdrew their money as soon as it was credited to the account.

The aforementioned observations reveal a widespread lack of trust in the Afghani banking sector, including both conventional and Islamic banking. Therefore, the challenges addressed in this paper pertain to both types of banking. However, an important question arises: if individuals lack trust in the banking system as a whole, will they trust the conversion of conventional banks to Islamic ones? This raises the need for the Islamic Emirate of Afghanistan (IEA) to address general obstacles to banking engagement, as well as the specific challenges associated with Islamic banking, if they intend to carry out such a conversion. In this context, it is imperative to critically evaluate the reasons why Afghans have avoided banking services, including Islamic banking and finance. Although attempts have been made previously to understand these challenges, this paper tends to answer questions such as: What are the major challenges in the face of the promotion of Islamic banking and finance in Afghanistan?; and, What approaches and strategies should be employed to promote Islamic banking and finance in the country?

2. Literature Review

2.1. State of the Financial Sector of Afghanistan

The DAB is entrusted with the responsibility of regulating the banking sector, as well as adopting the monetary and fiscal policies of the country. Provisions in the Banking Law of Afghanistan (2015) and the DAB Law (2004) vest powers in the DAB to carry out inspections of banks and perform oversights. DAB Regulations and Circulars and the Limited Liability Company Law (2018) regulate activities concerning the banking and finance sector.

The financial system is currently operating in an uncertain state of affairs in the aftermath of the political transition of August 2021 and IEA's capture of Kabul. The DAB has lost its ability to manage payment systems and conduct monetary policy, due to the freezing of offshore assets and its inability to print new AFN notes (World Bank 2022). Nonetheless, the AFN has preserved its value against major currencies, inter alia, due to the United Nations' (UN) cash shipments of $ 40 million per week for humanitarian and basic service support to the Afghans. This amount has been a major factor behind currency stability (World Bank 2022). Overall, the Afghani currency has preserved its value, with a slight decrease in its worth, against the USD ($1 = Afs. 86) compared to August 2021 ($1 = Afs. 78).

The financial system of Afghanistan is dominated by the banking industry, which has 12 banks. Following the political transition in August 2021 and the collapse of the Islamic Republic of Afghanistan, inter alia, the country's international reserves were frozen and international settlements were suspended, causing a dramatic adverse shock in the financial and payment systems (UNDP 2021).

According to the World Bank (2022), projections indicate that the Afghan economy is expected to transition to a low growth path, estimated to be between 2.0% and 2.4%, over the next two years. These projections have a direct nexus with IEA's decisions in the coming days and months, as well as the response of the international community. Foreign aid and cash payments of $40 million per week, as highlighted by the World Bank (2022), play a vital role in managing inflation and stabilizing the exchange rate. A major concern, however, revolves around the undue pressure on the banking sector caused by the non-resolution of payment issues and the "unmanaged" transition to Islamic banking.

2.2. Islamic Banking in Afghanistan

The global growth of Islamic banking has been remarkable over the past four decades. As of 2019, the number of Islamic financial institutions has significantly increased to 428, compared to 85 in 1996, 200 in 2000, 300 in 2008 (Statista 2023). According to Statista (2023), the global Islamic finance markets had an estimated total asset value of around $3.95 trillion in 2021. It is projected that the total asset value for the global Islamic finance markets will increase to $5.9 trillion by 2026. The improvement in Islamic banking assets in certain nations, particularly the GCC area, which witnessed mergers of Islamic banks to boost efficiency, attract steady deposits, and intensify competition, have contributed to the development we witness (IFSB 2020).

In the case of Afghanistan, promoting Islamic banking is one of the DAB's commitments to fulfill by introducing a legal and regulatory framework for Islamic banks. To regulate Islamic banking activities in the country, the DAB has issued specific Islamic banking regulations, guidelines, product descriptions, and *Shari'ah* parameters (The DAB 2019). Thus far, the Central Bank of Afghanistan (DAB) has granted licenses to six Islamic banking windows operated by conventional banks, enabling them to offer Islamic banking products and services, alongside one full-fledged Islamic banking license (Rostan et al. 2021). The BMA and Afghan United Bank (AUB) introduced Islamic banking and finance products as Islamic banking windows in 2008. Subsequently, Maiwand Bank, Ghazanfar Bank, and Kabul Bank obtained their licenses in 2009, while Afghanistan International Bank (AIB) established its Islamic banking window in 2014. Notably, the establishment of the Islamic Bank of Afghanistan (IBA) in 2018 marked a significant milestone as the first fully operational Islamic bank in the country. It is vital to note that the country, despite a boom in economy since 2001 and public demand for Islamic banking and finance, has been able to establish only one fully-fledged Islamic bank and six Islamic windows (Rostan et al. 2021). Vizcaino (2018) reported that IBA holds 40% of the $365.5 million (AFS. 27.8 billion) of the total investments in Islamic banking products. The remaining 60% was held by the Islamic windows of six banks, collectively.

The investment value of $610 million in Islamic banking products in Afghanistan is significantly small compared to the global market size of $2 trillion. Certain experts argue that, given the fact that 99% of Afghanistan's population is Muslim, the introduction of *Shari'ah*-compliant products could significantly stimulate the growth of Islamic banks (Rostan et al. 2021). They support their claim by highlighting the doubling of assets by the Islamic Bank of Afghanistan (IBA) from AFN 11.19 billion in 2018 to AFN 29.86 billion in 2020 (IBA 2020). Moreover, they believed Islamic banking is expected to appeal to a larger number of Afghans and encourage them to utilize banking services, due to the following reasons:

- The vast majority of Afghans are followers of Islam and *riba* (interest) is considered amongst the gravest sins in *Shari'ah*;
- The wave of Islamic financing will contribute to improved financial inclusion and trigger greater economic growth;
- The establishment of Islamic banking windows will launch a surge of deposits, providing depositors and/or borrowers a unique banking vehicle for intra- and extra-Afghanistan bank transfers (AACC 2020).

However, the anticipated success did not materialize, leaving researchers to question the underlying reasons for this failure. Safi et al. (2020) conducted a study in Kabul to investigate customer satisfaction with Islamic banking products. The research revealed that the primary reasons for selecting Islamic banking services and products were religious beliefs, followed by factors such as confidence and reputation. Interest-free banking, compliance with *Shari'ah* Law, and the contribution of banks to social welfare projects were also identified as important features. It must be noted that Safi et al. (2020) does not delve into the challenges experienced by Islamic banking or the banking sector as a whole; instead, their focus is primarily on evaluating the satisfaction levels of current customers.

2.3. Challenges to Growth of Islamic Banking in Afghanistan

A number of studies have explored the challenges that hinder the establishment and growth of Islamic banking in Afghanistan. In their examination of the factors contributing to the delay in establishing Islamic banking in Afghanistan, Salim and Qoyum (2021) identify six significant factors: political instability, a weak economy, inadequate legislative support, limited public information, lack of endorsement from religious scholars, and a scarcity of specialists in the field. While their study has limitations in terms of depth and coherence, it provides valuable insights into these challenges. Omar and Tyagi (2021) argue that Islamic banking has the potential to contribute to macroeconomic stability in Afghanistan, due to its compatibility with the predominantly Muslim population. However, their assertion that the lack of law and regulation is the sole reason for the limited development of Islamic investment in Afghanistan should be approached with caution, as the issue is more complex than their claim suggests. Naseri and Sharofiddin (2020) focus on the challenges encountered during the historical development of the Islamic banking system in Afghanistan. While their study primarily distinguishes between Islamic and conventional banking and describes Afghanistan's financial sector, they highlight issues such as liquidity constraints, a shortage of human resources in Islamic financial institutions, and limited financial inclusion for SMEs and the general population. The discussion, at times, is mixed up with recommendations, which makes it difficult to understand their views and argument. Naimi (2017) identifies several challenges hindering the growth of Islamic banking in Afghanistan, including lack of public awareness, inadequate knowledge and human capacity, absence of consensus among *Shari'ah* scholars, unavailability of Islamic insurance, insufficient attention and support from decision makers, and lack of capital investment. He, however, does not explain the basis of these challenges and poses them without details or any recommendations as to how these should be addressed. Amiri (2013) examines the challenges faced by Islamic banking in Afghanistan, emphasizing a lack of public awareness, political instability, corruption, difficulties in understanding Islamic banking contracts, and a shortage of competent human resources in the banking sector. A survey conducted as part of the study indicates that the combined effect of lack of public awareness, political instability, and corruption are the major challenges identified by respondents, while, currently, the political scenario has changed and the country has improved its rank on the Corruption Perception Index by occupying 150th place among 180 countries of the world in 2022, whereas it was in 174th position in 2021 (Transparency International 2022). Al-Razni et al. (2013) stress the need for an Islamic Banking Act to establish a well-functioning Islamic banking system in Afghanistan. They discuss existing laws and the challenges that the regulatory authority, the DAB, will face in introducing Islamic finance. The authors have used Islamic banking and Islamic finance interchangeably and, therefore, have led to creating confusion in the minds of readers as to their intention. Also, the paper suffers from self-contradiction in more than one place and contains information that does not hold ground. Hamdard (2011) explores the practical aspects of Islamic banking in Afghanistan, identifying challenges such as lack of public awareness, absence of legislation and regulatory frameworks, insufficient knowledge and human capacity, inadequate investment capital, and the absence of Islamic insurance. Factors hindering the growth of Islamic banking, as outlined by Hamdard, include the absence of an Islamic banking law, lack of regulations, inadequate technical support, limited public knowledge and awareness, and insufficient human capacity.

The literature reviewed above suggests that the primary challenge in promoting of Islamic banking in Afghanistan is the absence of law and regulation specifically tailored to Islamic banking. This paper concurs with this finding and reiterates its significance. However, it is important to recognize that the challenge at hand is multifaceted and, therefore, requires a comprehensive approach. Merely adopting an Islamic Banking Law will not be sufficient to resolve the issue entirely, as the problem is deeply rooted in the regulator's approach and the general perception of banking among the public.

The experience in Afghanistan has underscored the importance of not only conceptualizing solutions, but also effectively implementing them. To achieve successful implementation, continuous communication, widespread dissemination of information, and dedicated advocacy efforts are crucial, in order to reshape public perception. Alongside these measures, comprehensive training programs, advocacy initiatives, and systemic reforms are essential to bring about a fundamental shift in the regulator's approach to address the challenges at hand. It should be emphasized that the establishment of trust among depositors, investors, and traders necessitates the creation of a business-friendly environment, which cannot be solely accomplished through the enactment of legislation (Aysan et al. 2017; Disli et al. 2023). Another challenge identified in the literature is the lack of customer awareness regarding Islamic banking and its financial products. The technical language of contracts, the complexity of policies, and the inadequate ability of bank staff to explain the processes and policies to customers contribute to this challenge. Customers often perceive Islamic banking as a deceptive tactic, rather than genuinely Islamic. Furthermore, a significant challenge lies in the shortage of qualified staff, specifically *Shari'ah* experts well-versed in Islamic economics, Islamic finance, and Islamic banking, with a sound understanding of the banking sector. The available specialists in the Afghan market tend to be experts in either *Shari'ah*, Islamic law, or economics and banking, resulting in a gap between the demand and supply of experts. Efforts to train bank staff within and outside of Afghanistan have proven insufficient, leading some banking institutions to hire non-Muslims to fill the gap. This, in turn, has created further confusion and misunderstanding among customers. The literature also highlights the absence of a comprehensive *Shari'ah* model as a notable challenge. Other challenges mentioned include low financial inclusion, political instability, a weak economy, lack of government support, and liquidity shortages.

In summary, the literature review underscores the complex challenges faced by Islamic banking in Afghanistan. It emphasizes the need to address these challenges holistically to foster the growth and development of Islamic banking in the country. Collectively, these studies shed light on the multifaceted challenges faced by Islamic banking in Afghanistan and emphasize the importance of addressing these issues to foster its growth and future prospects. Some of the literature reviewed above proves to be a classic case of "visiting-economist syndrome", a term coined by Albert Hirschman (1984). The perception that, since Afghanistan is home to 99% Muslims, Islamic banking will flourish there, sounds theoretically sound; however, in practice, it did not prove to be well-founded and, thus, Islamic banking and finance has thrived in jurisdictions with a lesser percentage of Muslims than it has in Afghanistan.

A research gap that this paper intends to fill is the fact that the literature has focused on identifying challenges in a mixed financial sector where conventional banking and Islamic banking both co-exist, whereas the IEA has now decided that conventional banking will be replaced by Islamic banking and the country will follow only the Islamic banking and financial system. Thus, this paper focuses on challenges that the IEA will face and should respond to before attempting to replace the entire system.

This paper is subject to limitations as it does not provide an in-depth analysis of the IT infrastructure and other associated technological requirements essential for the efficient operation of a financial system.

3. Methodology

By adopting an unstructured approach, our research embraced the significance of incorporating the personal experiences of diverse stakeholders, allowing for the exploration of unique insights and observations from their individual perspectives. Unstructured interviews offer distinct advantages in research by facilitating detailed and nuanced insights through participants' responses (Zhang and Wildemuth 2009). The adaptability of this approach enables the exploration of unexpected topics, enhancing the relevance and depth of the findings. Additionally, the conversational tone of unstructured interviews creates a relaxed and comfortable atmosphere, enabling participants to provide authentic and comprehensive information (Patton 2014). This approach values the input of participants, empowering them to actively shape the interview process, fostering a sense of engagement and ownership. Moreover, unstructured interviews provide valuable contextual understanding, contributing to a comprehensive view of the research topic. In our study, we conducted unstructured interviews, engaging a total of 123 participants, with 73 of them representing the industry. This subgroup consisted of 15 personnel from the DAB, 28 individuals affiliated with different Islamic banking institutions, and 30 experts encompassing academics, Shariah scholars, and opinion makers with an affinity for Islamic banking and finance. Additionally, we interviewed 50 Islamic bank customers residing in the Kabul province. The diverse composition of our participant pool aimed to capture a broad range of perspectives and insights from key stakeholders within the Islamic banking landscape, enabling a more comprehensive analysis of the subject matter. While we did not follow a specific interview guide, we utilized an interview aide memoire to ensure the inclusion of relevant topics during the discussions (Minichiello 1990). The agenda for the study was constructed by drawing insights from the literature review, centering on the significant challenges encountered by the Islamic banking industry in Afghanistan, encompassing aspects of laws and regulations, customer awareness, the *Shari'ah* framework, and human capital considerations. To foster open and spontaneous dialog, participant responses were documented through contemporaneous note-taking, instead of audio recording (Halcomb and Davidson 2006).

4. Findings

This section aims to enrich the existing literature by integrating perspectives from practitioners and customers, categorizing their insights into six key areas derived from interviews. These areas include the legal framework, deficiencies in banking services provision, adherence to Islamic principles, regulatory capacity limitations, lack of customized financial products, and challenges related to different schools of Islamic jurisprudence. By merging these perspectives, we aim to offer a comprehensive analysis of the present condition of Islamic banking and finance in Afghanistan.

4.1. State of the Legal System

In addition to the aforementioned challenges, it is crucial to comprehend the unique characteristics of Afghanistan's legal system, particularly under the IEA, as the trust of consumers cannot be achieved if the uncertainties surrounding the legal system remain unresolved. Interestingly, Afghanistan currently operates without a constitution, and the status of previously adopted laws is uncertain. The IEA has consistently viewed the laws enacted by the Republic as unworthy of adherence, deeming them as products of an unjust and incompetent government elected through un-Islamic means and serving foreign interests (Haqqani 2022). Consequently, a review process was initiated to assess the laws passed during the Republic and ensure their compliance with Islamic Law. The legitimacy of these laws would be secured through the approval of the Supreme Leader (Islamic Emirate of Afghanistan 2022a). The decree establishes the criteria for reviewing the laws, stipulating that all laws must be examined by the relevant ministries, and must be rectified if they contain provisions contradictory to Islamic *Shari'ah*, the Hanafi school of thought, and/or public interest. A two-month timeframe was provided for the completion of this process (Islamic Emirate of Afghanistan 2022a). However, due to a lack of technical knowledge and expertise, it appears that the process was not completed within the given period, leading to reports indicating that the Supreme Leader, albeit verbally, declared all previous laws to be superseded. Nevertheless, the banking and financial sector in Afghanistan continues to be regulated by the laws enacted during previous regimes, with some minor modifications. In response to the challenges, and to ensure a smooth transition from the conventional banking and finance system to an Islamic system, the IEA established the Center for Research on Islamic Banking and Contemporary Issues (Islamic Emirate of Afghanistan 2022b). The primary objective of this center is to Islamize Afghanistan's banking and financial sector. Additionally, it is tasked with developing a market strategy to promote the principles of Islamic economics and the Islamic banking system, as well as conducting research on Islamic banking and contemporary financial issues. The Center envisions encouraging, developing, and strengthening Islamic economics, banking, and finance in Afghanistan, with the crucial goal of replacing the interest-based banking and financial system with an Islamic system (ASA 2022). Until this change and conversion are implemented, the legal and regulatory framework will largely remain the same as during the Republic, resulting in prolonged uncertainty for the financial sector. The situation is unpredictable and subject to decrees issued by the Supreme Leader.

Therefore, the first challenge remains the necessity of adopting a clear, comprehensive, and standardized legal system that addresses the issues of the banking and financial sector, aligns with their requirements, and ensures a business-friendly environment for all. After analyzing the survey data, a large portion of respondents, primarily from the industry subsample, confirmed this observation. About 42% (52 out of 123 respondents) underscored the lack of a well-defined legal framework as the main obstacle in the process of Islamizing the banking industry. This finding underscores the challenge faced by the regulatory authority, namely the DAB, in determining the precise legal procedures to be adhered to during the transition phase of banks. Consequently, this situation poses a substantial barrier for the regulatory body, particularly in devising an efficacious strategy to facilitate the acquisition of Islamic banking licenses by conventional banks. The successful implementation of an Islamized banking and financial sector necessitates the enactment of a comprehensive set of laws. This legislative package should encompass crucial laws, such as the law on Islamic banking, the law on *Takaful* (Islamic insurance), the law on Sukuk (Islamic bonds), and other financial products.

4.2. Inadequate Provision of Banking Services

Among the examined participants, comprising 33% (41 out of 123), viewpoints from both the industry and customer subgroups highlighted the concern surrounding inadequate banking services. This finding is consistent with the evaluation that, despite the growth witnessed in the banking sector of Afghanistan from 2001 to 2021, the overall system has been perceived as deficient and vulnerable, as indicated in the AACC's report (AACC 2020). This deficiency can be attributed to a range of internal and external factors. Notably, banks in Afghanistan have primarily operated as intermediaries, relying heavily on deposits, rather than actively engaging in financing activities, primarily due to the perceived high risks associated with long-term financing products. This observation is particularly challenging because the quality of collateral, such as land titles, is often disputed in courts (AACC 2020). The lack of proactive investment strategies and an overreliance on static deposits further indicate the inadequacy of banking services in Afghanistan. Furthermore, despite global developments in processes, technology, and fintech, Afghan banks have failed to adapt and attract new customers. They have neglected advancements and continued to employ outdated banking methods, undermining public trust in the banking system. The banking network itself has discouraged the use of banking services, characterized by an "over-banked, under-branched" phenomenon. In major cities, multiple banks are located on the same street, with branches operating in close proximity, while, in provinces and districts, branches are situated far from the population. Accessing banking services often requires long and risky journeys, and customers face lengthy wait times, complicated procedures, and challenges meeting Know Your Customer (KYC) requirements, particularly for rural Afghans. Moving electronic value also proves cumbersome, posing obstacles to the growth of banking (Khazan 2013). A longstanding blame game between regulators and banks has persisted. Banks assert that the DAB interferes in their day-to-day affairs, instead of focusing on supervision and oversight. For instance, the DAB's granting of licenses for branch and ATM establishments is based on their discretion, rather than considering the demand perceived by banks in specific locations. The DAB is also accused of implementing complex, subjective, and vague regulations and criteria that can be arbitrarily used by staff and officials (AACC 2020). The absence of a *Takaful* institution to provide guarantees for investors or investees further contributes to the weakness of the banking sector. Banks argue that the lack of a *Takaful* mechanism undermines the trust of deposit holders within the Islamic banking industry (AACC 2020). These issues are not recent developments. In 2012, the Afghan Banks Association (ABA) highlighted various issues and barriers related to the proper utilization of bank liquidity by investors. The ABA also expressed concerns about the low percentage of Afghans with access to banking services. Omer Zakhilwal, the former Minister of Finance, acknowledged significant investments in Afghan banks, but identified a lack of confidence as the main barrier for investors in the country. He further noted that banks charge interest, but are not willing to accept risks (Khaama Press 2012).

4.3. Islamic Nature of Islamic Banking

Among the respondents, particularly from the industry, a notable proportion (38 out of 123 respondents) shared the viewpoint that the matter of Islamization poses a substantial challenge when it comes to the Islamization of the banking industry. This skepticism aligns with the viewpoint put forth by a subset of scholars who contend that Islamic banking is prohibited or deemed *haram* (Nyazee 2012), primarily stemming from apprehensions surrounding the employment of camouflage strategies and Arabic nomenclature, to conceal interest and markups. The recognition of this concern underscores the importance of addressing the legitimacy and compliance dimensions inherent in Islamic banking practices, in order to effectively navigate the challenges associated with transitioning towards an Islamic banking framework.

This perception has led to the belief that Islamic banking offers nothing new and is merely a replication of conventional banking. Furthermore, there is a common belief that banking, by its nature, is a means of accumulating wealth, which contradicts the principles of Islamic economics. Chapra (1992), for example, suggests that, in an Islamic system, the economy should be restructured based on the *Maqasid al-Shari'ah* to achieve four objectives: fulfilling needs, generating income from sources acceptable within Islam, ensuring equitable income distribution, and promoting wealth growth and stability. Ahmad (1994) argues that Islamic banking, within an Islamic economic framework, should be based on zero-based interest, equity participation, joint ventures, and profit sharing. Opponents of Islamic banking claim that the current Islamic banking practices do not serve any of these purposes. Furthermore, it is observed that Islamic financial institutions heavily rely on *hiyal* (stratagems, tricks, ruses) to operate within the conventional financial system, reinforcing the perception that Islamic banking is merely old wine in new bottles. Over-reliance on *hiyal* has led to a separation of morality from technicality and has undermined the noble objectives of Islamic economics (Syed and Omar 2017; Syahmi et al. 2022). The opponents of Islamic banking, particularly in the case of Islamic banking windows, argue that, at the end of the day, deposits are collected into the same pools as conventional deposits and are treated in a similar manner. Experts in Islamic banking in Afghanistan have noted that Islamic banking windows are predominantly managed by conventional banking officers and compliance mechanisms. This situation has hindered the development of Islamic financing as standalone financial enterprises within the banking system (AACC 2020). Therefore, unless *Shari'ah* windows are independent with separate departments, misperceptions will persist (Salh 2019). It is important to highlight that the controversy surrounding Islamic banking originates from differences of opinion within the Deobandi school of thought in Pakistan. Mufti Saleemullah Khan and Mufti Taqi Usmani have had differing views on the Islamic nature of Islamic banking, with the former rejecting the idea, and the latter being considered one of the most respected proponents and authorities in the field (Urdu Web 2008).

In Afghanistan, there is a lack of adequate literature on this issue, and consumer questions remain unanswered. Consequently, even if banks transition to Islamic banking, consumers will question the Islamic nature of these banks, and may be reluctant to engage with them. Addressing the ambiguity surrounding the nature and status of Islamic banking should be a priority for the IEA, as it represents a significant challenge that needs to be resolved before tackling other issues.

4.4. Insufficient Regulatory Capacity

A prevalent concern within Afghanistan's banking and financial sector is the government's unfriendly attitude towards the private sector, a mentality that has persisted under both the IEA and previous regimes. The public sector, particularly regulatory bodies, view the private sector as a competitor to be controlled and managed by any means necessary. Consequently, their focus shifts from supervision and oversight to interfering in the operations of the private sector. Economic and financial sector laws are tailored to enhance the regulator's control over the private and commercial sectors, rather than being based on international best practices. Furthermore, the regulatory body lacks the capacity to effectively manage the sector. The collapse of the Kabul Bank in 2010 serves as evidence of this deficiency, as the DAB failed to detect and address the issue in a timely manner. Although a proposed draft of the Law on Islamic Banking was finalized in 2015, the lack of expertise within the DAB led donors to reject the idea of implementing two banking systems in the country. Most DAB staff members have limited knowledge of the Islamic banking and finance system, rendering them incapable of effectively managing the sector. Consequently, the Banking Law of Afghanistan (2015), which included only four provisions on Islamic banking, was adopted to relieve the burden on the DAB staff. These provisions addressed topics such as issuing licenses to Islamic banks, converting conventional banks to Islamic ones, establishing a *Shari'ah* Board, and outlining the functions and activities of Islamic banks. This approach is unique, considering that the Afghan population are predominantly traditional and conservative Muslims, while the chapter on Islamic banking was incorporated into a law that primarily dealt with conventional banking and interest. Moreover, the weak services offered by banks in the country can be attributed, in part, to regulatory rules and restrictions. The government has not adequately addressed the needs of banks and banking clients in terms of dispute resolution. Neither banks nor consumers have access to an independent conflict resolution mechanism to address grievances or disputes with the DAB. Instead, the DAB, as a regulator, acts as party to, and judge in, disputes related to the banking and financial sector. This situation underscores the need for the establishment of specialized banking courts or tribunals, but no such initiatives have been undertaken. In cases where litigation is pursued and a formal case is lodged, matters are referred to commercial courts, where judges with limited knowledge of banking and finance preside over the cases. Furthermore, the DAB Law (2004) and the Banking Law of Afghanistan (2015) included provisions related to interest, fees, and commissions that were deemed non-compliant with *Shari'ah* and violated Article 3 of the Constitution of the Islamic Republic of Afghanistan (2004). Although these banking regulations were not passed by the parliament, due to non-compliance with the Constitution, they were enforced by the regulator. Consequently, the courts did not feel bound by these laws, as they did not meet the constitutional criteria or align with the conscience of the judges. Given the regulator's lack of qualifications and expertise in effectively managing the conventional banking system, even after being actively involved for at least 20 years, and considering the system's failure to support the private and independent nature of banking and financial institutions, it poses significant risks to convert all banks to Islamic banking simultaneously.

According to the survey results, a considerable segment of respondents, exclusively from the industry subgroup, amounting to 23% (28 out of 123 respondents), indicated that inadequate regulatory capabilities present a significant challenge to the initiation and advancement of Islamic banking in Afghanistan. The concerns raised pertain to the regulatory authority's capacity to proficiently supervise and oversee the implementation of Islamic finance practices, as they may lack comprehensive knowledge in this specialized domain. This potential knowledge gap raises apprehensions about the credibility and reliability of the Islamization process within the banking industry, potentially eroding trust among stakeholders.

4.5. Lack of Tailored Islamic Financial Products

In the literature concerning Islamic banking in Afghanistan, it has been noted that, although 99% of the population is Muslim, the success of Islamic banking and products cannot solely rely on faith alone. It is a misconception to assume that customers will choose Islamic banking based solely on religious affiliation. Evidence from certain parts of the world shows that customers consider factors such as service quality, fair treatment, understanding of products, and a diverse range of offerings to achieve their financial goals, even when opting for Islamic banking as non-Muslims (Hamdard 2011). Since the introduction of Islamic banking windows in Afghanistan, banks have primarily focused on providing liability-side products for deposits, neglecting investment-side products for customers (Hamdard 2011). This suggests that the products launched by Islamic banks, both fully-fledged Islamic bank and Islamic banking windows, have not adequately catered to the needs of society and have, instead, prioritized institutional profitability. For example, banks have predominantly offered *mudarabah* on the liability side, but have shown little interest in providing products such as *salam* or *musharakah* and *Istisna'* to support the agriculture and industry sectors (Rostan et al. 2021). This approach has resulted in a limited and fixed number of depositors with whom they engage, rather than actively seeking to expand their reach and availability in response to societal needs. Based on the survey findings, a significant portion of participants (20%, or 25 out of 123 respondents) from both the industry and customer subgroups expressed that the lack of tailored Islamic financial products and services poses a substantial challenge in the endeavor to Islamize banks. These respondents assert that the sustainability of Islamic banks would be jeopardized without a diverse range of products. Presently, Islamic banks offer a limited selection of *Shari'ah*-compliant products that do not adequately cater to the diverse needs of both corporate entities and individuals. To surmount this challenge and propel the advancement of the Islamization of the banking industry, Islamic banks should undertake a comprehensive market gap analysis and introduce a broader spectrum of *Shari'ah*-compliant products to bridge the existing gaps. This predicament is regarded as one of the principal hurdles in driving the progress of the Islamization of the banking industry.

4.6. The Madhhab Dilemma

According to the survey results, a significant percentage of 13% (16 out of 123 respondents), primarily from the industry subgroup and, particularly, from the expert group, identified the Madhhab dilemma as a considerable obstacle in the process of Islamizing the banking industry. Respondents expressed concerns that the coexistence of multiple schools of thought serves as a deceptive tactic employed by banks to ensure their financial security and profitability, as well as to circumvent potential challenges. This issue carries significant weight, particularly in light of Afghanistan's steadfast declaration that the Hanafi school of thought will retain its official status as the Madhhab, despite granting individuals the freedom to adhere to other schools of thought. The persistence of this predicament calls for careful consideration and deliberation, in order to navigate the complexities surrounding the convergence of various Islamic legal perspectives within the banking industry. The Constitution of the Islamic Republic of Afghanistan (2004), established in the presence of the international community, specifically outlines the application of Hanafi jurisprudence in cases where the Constitution or other laws do not provide specific provisions. The courts are instructed to rule in a manner that upholds justice within the limits set by the Constitution. Similarly, the Civil Code of Afghanistan (1977) stipulates that, in the absence of legal provisions, courts should decide based on the general principles of Hanafi Jurisprudence of Islamic *Shari'ah* to ensure the best possible justice. If neither legal provisions nor Hanafi principles offer guidance, courts may consider common customs, provided they do not contradict the law or principles of justice. The 2017 Penal Code further confirms the dominance of the Hanafi school by specifying that it governs cases related to *Ta'ziri* (disciplinary punishments), as well as those involving *Hudood* (serious offenses with fixed *Shari'ah* punishments), *Qisas* (retaliation), and *Diyat* (blood money).

According to the laws of the IEA, the Hanafi school remains paramount, and any provisions contrary to Hanafi thought are considered invalid. While this may appear irrelevant to international experts in Islamic banking and finance, it holds significant importance within Afghanistan. In fact, Haqqani (2022) goes as far as declaring that following any other school of thought is taboo in Afghanistan, and Afghans must adhere to the Hanafi school in their daily affairs. He argues that the Hanafi school should be the sole school of thought integrated into the country's judicial system, because incorporating other schools would weaken the system, as seen in the case of the Ottoman Empire. The Hanafi school distinguishes itself from other schools of thought in terms of its sources and approach. Unlike the Shafi'i and Hanbali schools, which are considered literalist and prioritize textual adherence, the Hanafi school emphasizes principles (Nyazee 1996). It is important to note that the Hanafi school prohibits its followers from adopting other schools of thought and considers adherence to a specific school as obligatory (Nyazee 2016). Addressing this challenge is crucial at the outset, because Islamic banking does not rely on a specific Madhhab and rejects the limitations imposed by schools of thought. Rafay et al. (2016) highlight the existence of discrepancies, both minor and major, resulting from multiple interpretations by various schools of thought. Therefore, it is logical to conclude that, without a "universal *Shari'ah* code", the acceptability of products introduced in Islamic finance will remain fragmented. To resolve this issue, the authors emphasize the necessity of converging different schools of thought to formulate a single *Shari'ah* code that is applicable universally. Essentially, they propose the development of a cosmopolitan or globalized *fiqh* that transcends the boundaries of individual schools.

In the context of Afghanistan, a society strongly influenced by the Hanafi school of thought, the concept of a globalized *fiqh* proposed by experts in Islamic banking and finance is not readily embraced. The society has adopted viewpoints from opponents of Islamic banking who argue that it deviates from Islamic principles, employs deceptive tactics, manipulates texts, and fails to serve the objectives of the Islamic economic system. Consequently, they advocate against its adoption. Considering this situation, it is important for the IEA to acknowledge that Islamic banking and Islamic finance products are not confined to any particular school of thought. Instead, they require a broader approach that encompasses various schools of thought. However, the likelihood of the IEA embracing such an approach seems unlikely, given the aforementioned opinion of the Chief Justice of the IEA, which, albeit impliedly, opposes Islamic banking. It is worth noting that the concept of a globalized *fiqh* itself presents challenges, further complicating the matter.

5. Conclusions and Recommendations

This paper explores the challenges that the IEA will face in its efforts to conform the banking practices to international Islamic standards through literature review and qualitative research methods of analysis and exploration. It finds that, in addition to the challenges identified by various researchers, there are challenges in the regulator that require attention and efforts to resolve. The challenges related to the regulator, i.e., the DAB, and regulations enforced by them, are the lack of a clear and comprehensive legal system, inadequate or weak advocacy for Islamic products, lack of clarity on Islamization of Islamic banking, lack of clarity on utilization of schools of thought, interference in the jurisdiction of the banks, weak regulatory and management system of the DAB, and lack of professional and technical capacity to manage and govern the financial sector of Afghanistan. Weaknesses in the banking sector, lack of customized/tailored finance products, and inability to offer long-term finances remain challenges related to the banks' operation and policy. Challenges related to people are the lack of awareness in relation to Islamic banking and products of Islamic banking and finance.

In order to address the challenges identified, the study proposes several recommendations for the IEA to consider before converting conventional banks and financial institutions into Islamic entities.

Firstly, it is crucial to establish a clear and comprehensive legal system that eliminates speculation and uncertainty surrounding its nature. This involves the development and enforcement of appropriate regulations to provide clarity and stability.

Secondly, fostering a business- and investment-friendly environment is essential. This can be achieved by introducing laws specifically related to Islamic finance, *Takaful* (Islamic insurance), private investment, and public-private partnerships.

Additionally, there is a need to review and amend existing laws that may impede the effective and efficient operations of the banking and financial sector. These include the Banking Law of Afghanistan (2015), Law on Income Tax (2009), Law on Tax Administration (2015), Customs Act Law (2016), and, more importantly, the DAB Regulations regulating the banking and financial sector.

Furthermore, ensuring the comprehensiveness of Islamic banking and finance law is vital. This means addressing conflicting guidelines issued by the regulatory authority (the DAB) and discrepancies in product approval by different *Shari'ah* boards. This has been a serious issue, since the lack of a standard Islamic banking law and non-binding nature of the regulations has permitted the *Shari'ah* boards to issue verdicts on products based on the members' choice. For instance, Commodity *Murabaha* is permitted absolutely as a product by BMA, but very serious conditions are placed on its permission by the *Shari'ah* Board of the IBA. In this context, it is crucial to establish a level playing field for all banks and reduce customer confusion by ensuring consistency in product standards, which is attainable through the adoption of a comprehensive law.

To enhance public understanding and acceptance of Islamic banking and finance, conducting workshops, training programs, events, and informative sessions is recommended. Collaboration with educational institutions, religious scholars, clerics, and other relevant stakeholders can help address common questions and concerns and promote awareness among the public.

In terms of human resources development, it is important to establish short-term programs and degree programs in universities and professional development institutes. These programs should focus on Islamic banking and financial institutions, aiming to train and nurture capable and qualified individuals who can contribute to the growth and success of the industry. Lastly, effective and impartial supervision of the banking and financial sector is crucial. While ensuring proper oversight, it is equally important to avoid undue interference from the government or the regulatory authority (the DAB) in the day-to-day operations of banks.

Overall, a diverse range of financial products should be made available to meet the needs of society, with particular emphasis on facilitating long-term financing options. By implementing these recommendations, the IEA can make significant progress in overcoming the challenges and pave the way for a robust and thriving Islamic banking and finance sector in Afghanistan.

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