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Exploring the Challenges of the Historical Development of Islamic Banking System in Afghanistan Using Document Analysis

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Abstract

The banking system of Afghanistan has experienced various conditions since the establishment of the first bank in 1933 and could not develop enough due to the civil war. This study investigates the historical development of the banking sector especially Islamic banking in Afghanistan. In addition to civil wars, Afghanistan's banking system has faced many challenges in terms of modernization, the low number of depositors and borrowers, regulations, and so on. It is found through qualitative research approach using documentary analysis that there was significant progress in modernizing the banking sector in Afghanistan with the help of international donors since 2001. Afghanistan has a dual banking sector and there is a full-fledged Islamic bank, the Islamic Bank of Afghanistan (IBA), and some banks with Islamic banking windows. However, according to findings the number of banks decreased compared to 2018 from 14 banks to 12 banks in 2020. The implication of this study is to provide information for the policymakers and Islamic banking institutions in Afghanistan to learn from these challenges and to improve the Islamic banking system in the country. Moreover, this study will fulfill the literature gap regarding the Islamic banking system in Afghanistan.

Keywords: Banking system, Islamic banking, Afghanistan

1. Introduction

The Afghan banking system started with the establishment of the Bank-e-Millie Afghan (National Bank of Afghanistan) in 1933, which handled Afghanistan's state banking affairs before the establishment of the Da Afghanistan Bank (Central Bank of Afghanistan). After the establishment of the Da Afghanistan Bank (DAB) in 1940, the state-owned banking responsibilities were transferred from Bank-e-Millie (BMA) to DAB (Da Afghanistan Bank, 2019a). The development of the banking system continued until 1975 with the establishment of four other banks such as Agricultural Development Bank (1954), Pashtany Tejaraty Bank (1955), Industrial Development Bank (1973) and Export Promotion Bank (1975) (Pernia et al., 2005). Banks have not been able to make significant progress over the past three decades due to political unrest. An informal system was created in addition to the banking system, which engaged in banking transactions such as buying and selling currency and offering short-term loans. This was the golden age of the informal money transfer (*Hawala* system) (Taqipor, 2017).

During the Taliban regime from September 1996 until November 2001, the commercial banking operations has stopped, because banks did not allow paying or charging interest (*riba*) according to Islamic law and consequently, banks stopped all lending activities (Katzman and Thomas, 2017; Pernia et al., 2005). The banking system was re-established and revitalized in December 2002, with international support and made significant progress. Besides, banking regulations, especially on loans, were issued in 2003 and early 2004. This recovery continued until 2010 when Kabul Bank, one of the largest commercial banks (CBs), faced

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bankruptcy. The stability of the financial system was threatened by the crisis. The main reasons for the bankruptcy were corruption, solvency, incapability, and political interactions (Taqipor, 2017).

According to the Afghanistan Central Bank website online data, currently there are 12 licensed banks, of which three are state-owned, seven are private CBs, and two are foreign banks. However, Islamic banking was introduced between 2008 and 2009, the first full-fledged Islamic bank (FFIB), IBA was launched only in April 2018 (Da Afghanistan Bank, 2019b).

Promoting Islamic banking is one of the DAB commitments by introducing a legal and regulatory framework for Islamic banks. Consequently, to control and regulate Islamic banking activities, DAB has issued specific Islamic banking regulations which include many categories such as, guidelines, Islamic banking regulations, product descriptions, Shariah parameters, and so forth (Da Afghanistan Bank, 2019c). So far, DAB has licensed several Islamic banking windows of conventional banks offering Islamic banking products and services. However, the existence of Islamic banking windows is not enough just to meet the needs of the country (Da Afghanistan Bank, 2018b).

Nowadays, CBs offer a variety of services such as opening various bank accounts, lending, money transfers, especially using Swift and Western Union networks, issuing various bank cards including Visa card and Master card, issuing bank guarantees and letter of credit for businesses, launched e-banking services such as mobile banking, internet banking, and ATMs.

2. Literature Review

Afghanistan banking law has some definitions for bank, Islamic bank, and conventional bank. The term "Bank" means "a legal entity engaging in the business of receiving money deposits or other repayable funds from the public and making credits for its benefit, and includes Islamic bank and conventional bank," while "Islamic Bank" means "a bank which operates following Islamic Shariah*," and* "Conventional Bank" means "a bank operating under traditional banking practices" (Da Afghanistan Bank, 2015).

2.1 The Differences between Islamic Banking and Conventional Banking

There are some differences between the practice of Islamic banking and conventional banking and the details of a comparison between them are shown in Table 1 below.

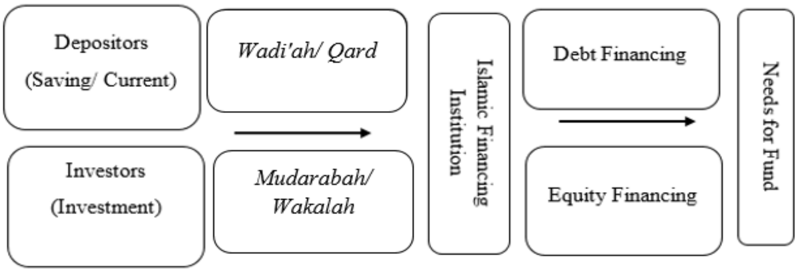
Table 1: Compression between Islamic and Conventional Banking

Islamic Banking	Conventional Banking
Free from *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling)	No prohibition of *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling)
Based on the Shariah	Based on man-made laws and principles.
Financing is based on Shariah-compliant contracts such as *Murabaha*, *Mudarabah*	Financing is based on a lending contract
Different kinds of relationships between the bank and customer such as buyer/seller or lessor/lessee	Only a creditor and debtor relationship between the bank and customer
Making profit out of Shariah-compliant contracts	Making a profit from the interest charged in the loan/lending

Source: Hassan et al. (2016)

According to the nature of Shariah contracts, the relationship between the customer and the bank is differentiated in Islamic banking. For instance, in the transaction based on trading, the relationship can be as a buyer and a seller; in leasing, it can be as lessor or lessee and in an investment, the relationship is as partners and the bank will gain profit that is derived from Shariah-compliant contracts (ISRA, 2016). An Islamic banking model is illustrated in the Figure 1 below.

Figure 1: Islamic Financial Institution



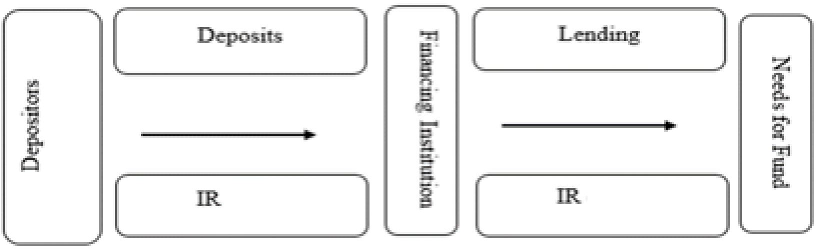
Source: Hassan et al. (2016)

Based on Figure 1, as debt-based or profit-sharing as equity financing, the deposit contract can be in the form of:

- *Wadi'ah/ Qard*: The customers deposit their money for safekeeping purposes, while the bank as an obligor is obliged to pay back the amount whenever the customer asks for a return.
- *Mudarabah/Wakalah*: Bank can act as an entrepreneur and invest the money on behalf of the investors.

However, in conventional banking, the bank and customer relationship is based on the principle of lending and borrowing. In this model, the bank will pay interest for the deposits and take interest from loans and will make a profit from the margin between the price of deposits and loans. The conventional banking model is illustrated in Figure 2 below.

Figure 2: Conventional Banking Model



Source: Hassan et al. (2016)

According to Figure 2, the relationship between the customer and the bank is based on the loan contract. Depositors deposit their money in the bank and the bank, as the borrower, promises to repay the principal on maturity with a certain amount of interest, for example, 4% to the customer periodically or as prearranged. The bank lends depositors' deposits to other customers who need capital, and borrowers pay the principal at an interest rate of, for example, 7% to the bank. The difference between the interest rate received by the bank at 7% and the interest rate paid at 4% constitutes the bank's profit (3%).

2.2 Salient Feature of Islamic Banking

Islamic banking has its salient features that differs from those of conventional banking. These features include *riba*-free banking, *gharar*-free, profit and loss sharing, money does not create money, Shariah-compliant contracts as clarified in the sub-sections below.

2.2.1 Riba-Free

Riba is an Arabic word that indicates an increase, addition, or extra (Bayindir and Ustaoglu, 2018). For a person who wants to raise money, it is recommended for him/her to enter into a business or partnership agreement. Claiming an extra amount of money over money is a kind of *riba*, which is the Islamic term for usury, as defined in Islamic teachings (Siddiqi, 2019). *Riba* is forbidden in the *Quran* in four stages. The first stage is in *surah al-Rum*, verse 39, in which *riba* is compared to zakat and charity, and in which zakat and charity are praised, not *riba*. The second stage is in *surah an-Nisa* verses 160-161, which illustrate the practice of *riba* by the Jews and declares it as iniquity. The third stage is the prohibition of practicing and charging double and multiple *riba* in *surah Ale- Imran* verse 130. The fourth stage is in *surah al-Baqarah* verses 275-281 which is forbidden all types of *rib*a, forbidding charging any extra amount of money over money.

2.2.2 Gharar Free

Gharar has a wide range of negative concepts, including uncertainty, risk, deception, ignorance, hazard, etc. The existence of *gharar* may deprive the contracting parties from equal bargaining power. Hence, it causes the inability to make informed decisions as they may not be properly understand the characteristics or consequences of the contract. *Gharar* can be divided into types of major and excessive (*gharar fahish*) and minor and tolerable (*gharar yasir*). Excessive *gharar* affects the validity of the contract, and it will make it void (*batil*) or voidable (*fasid*), which depends on the degree of *gharar*. While the minor or tolerable *gharar* will not affect the contract validity (Engku Ali, 2010). The prohibition of *gharar* could be deduced from *surah an-Nisa verse* 29.

"O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful".

2.2.3 Profit and Loss Sharing

The prohibition of *riba* is one of the most important differences between Islamic banking and conventional banking. The prohibition of usury in Islam raises the question that what can be replaced for it. The profit and loss sharing (PLS) can be a good replacement for usury (Efendić et al., 2017). While the existence of *Murabaha, Musharakah,* and *Mudarabah* contracts can be other important contracts in Islamic finance. Some profit and loss sharing contracts were also common in pre-Islamic times and at the time of the emergence of Islam, for instance, *Mudarabah* and *Musharaka*h. At the time of the emergence of Islam, the Prophet Muhammad S.A.W. himself acted as agent (*mudarib*) for his wife Khadija. However, his second successor Umar ibn Khattab invested orphan money with the merchants involved in the trade between Medina and Iraq. It is described that banks and borrowers should share the risk and profit in any business transaction (Hassan and Lewis, 2007). Therefore, we can see the differences in conventional banking where the customers are liable for any losses, because of no profit and loss sharing principle; the customers are liable to pay the principal and interest regardless of the success or failure of his business (Ahmed, 2018).

2.2.4 Money Does Not Create Money

Money is a medium that defines the value of material things. Hence, the fiat money by itself has no value and it is only a medium for exchange. A government decree determines its value, and the creditors must accept the fiat money to settle the debt, and referred to as "legal tender - refusal" to accept payment is considered illegal. Legal tender such as paper notes and coins is a means of payment recognized by a valid legal system to settle a financial obligation (Abdullah, 2018, p. 18). Thus, just because money is lent to others or kept in a bank, it should not be allowed to generate or give rise to more money. In the Islamic financial system, money has no return without legal conversion into real capital (Abdullah, 2018, p.18). To avoid any unjust enrichment, Islam requires collaboration between capital and effort to obtain some profit from the investment. There is a Hadith from the Prophet S.A.W. that says *al -ghurm bil ghunm* (no reward without risk), which proves that any return without taking any risk is not permissible. Therefore, the practice of conventional banks, giving loans, and charging interest show that money earning is without taking any risks. The customers who deposit their money in such banks should not earn any fixed return from their deposits (Hassan et al., 2016).

2.2.5 Shariah Compliant Contracts

Shariah has a significant impact on every aspect of Muslim culture. Some scholars have stated to some extent that Islam is very comprehensive, as it influenced the business with its particular provisions (Cerimagic, 2010). According to *Surah al – Baqarah*, 2:275, it is clear that Allah permits trade and forbids *riba*. However, it should be noted that trade in this verse does not include only selling and buying, and based on this verse the wisdom is practicing economic justice by mankind. Islam does not accept the contract of the interest-based loan nor is it considered a fair business contract. If a customer, with a savings account, expects a fixed return from it, it is not allowed because Islamic banks do not deal with the contract of debt. There are some contracts such as *al – Wadi'ah* and *Mudarabah,* that are used for replacing the contract of debt in conventional deposits. Islam encourages people to earn a return by taking a risk in their business ventures. Hence, customers are aware that based on Islamic banking and finance (IBF) services they may lose money without any fixed interest rate. While taking more risk, they can expect a higher return in contracts such as in the *Mudarabah* contract (Hassan et al., 2016).

Riba contract is described as being non Shariah-compliant contract. The term "Shariah" is defined as "the path to the watering place" (Siddiqi, 2019, p.24-25). In technical and legal usage, however, Shariah refers to the commands, prohibitions, guidance, and principles derived from the primary sources of Islam, the Quran and Sunnah. Hence, A product that is Shariah compliant indicates a product that is acceptable from an Islamic point of view (Siddiqi, 2019).

3. Methodology

This sudy uses a qualitative research method based on document analysis and various sources such as publications, and websites of banks (state-owned banks, foreign banks and private banks), websites of international organizations, on-line databases, policies, manuals, books, articles, working papers, and periodic reports were used to provide information on the challenges of the historical development of the Islamic banking system in Afghanistan.

Document analysis refers to evaluating and reviewing documents to extract their meaning, gain understanding, and develop empirical knowledge. Documents that may be used for analyzing can include agendas, meeting minutes and attendance registers, background papers, books, printed outlines of an event program, diaries, and journals, newspapers, and so forth. Basically in historical research, a prior study can be the only way to get resources (Abdul-Baki and Uthman, 2017). Kamla and Rammal (2013) in their study on social reporting by Islamic banks used content analysis as well through using the web sites and 19 annual reports of banks, tried to obtain disclosure concepts, and assign them to appropriate categories. Abdul-Baki and Uthman (2017) and Sutrisno and Haron (2020) also used content analysis with data collected from previous studies. Following the previous literature, this study therefore employed document-based qualitative research to study the challenges of the historical development of Islamic banking system in Afghanistan.

4. Findings and Discussion

4.1 Financial Sector of Afghanistan

Afghanistan is faced with many economic challenges. The most considerable of these is the reconstruction and reform of its institutions and the placement of its financing in a sustainable way (Akhtar et al., 2009). The banking sector in Afghanistan has seen a significant reconstructions since the collapse of the Taliban regime in 2001 (Turner, 2014). With the beginning of 2002, Afghanistan remained with a banking system that was physically demolished, technically outdated, and operationally inoperable. Six CBs owned by the government remained in poorly conditioned buildings. They did not have the basic infrastructure to support any kind of business, and the country was often financially bankrupt. DAB under the Taliban regime was abandoned under the weak legal and regulatory framework under the Money and Banking law of 1994. In addition, for serious operational weaknesses, the law also imposed barriers and was largely inconsistent with best international practices. There was no function of the monetary policy framework and it was not possible to provide monetary and fiscal stability. Besides, high inflation with multiple versions of the same currency destroyed the value and credibility of the currency (Pernia et al., 2005).

Pernia et al. (2005) also went on to comment on the state of Afghanistan post-Taliban. According to them, because of the absence of regulation caused the central bank failed to oversee the operations of six state-owned commercial and development banks. They did not have the skills and training needed to run modern financial institutions. From an accounting perspective, banks continued to rely on handwritten books and the accounting records had not been prepared for many years. These factors reduced public confidence in the banking system. The people did not use banks for placement of deposits or other transactions, which reduced the base of bank resources for lending. Except for a few part-directed lending deals and a special lending program in one of the cities, banks had suspended all lending operations. They were left with loan portfolios that in most cases were created more than 15 years ago.

Charap and Pavlovic (2009) provided some interesting insights into the financial situation in Afghanistan. The absence of confidence on the banking system, uncertainty, and the problems faced by the people and businesspersons led to a relatively unique *Hawala* system, which was very effective and informal, based on the trust and credibility of the participants. The *Hawala* system substituted CBs, including deposits, credits, and foreign exchange operations.

However, there were numerous failings (weak management, poor practices, and banking law violations), but these banks still managed to be profitable. Since 2005, the majority of the banks have provided essential services and their operations have been strictly limited because of the lack of sufficient laws and regulations (including bankruptcy, contract law, and mortgage). Some issues such as uncertainties and security restricted the performance of CBs in remote areas. In March 2008, the Afghan financial system included 15 licensed CBs that had 183 branches in 20 provinces, 332 foreign exchange dealers and 100 licensed money service providers.

Table 2: Afghanistan Banking Sector Data

Afghanistan Banking Sector Data (In millions of U.S. dollars)					
Year	2004	2005	2006	2007	2008
Total Assets	261	386	614	1083	1674
Cash and Bank Balances	139	212	259	431	578
Loans and Advances	18	58	162	439	805
Total Deposits	60	182	394	812	1278

Source: Charap and Pavlovic (2009)

The development of CBs' balance sheets during 2004-2008 can be seen in Table 2 which shows a sharp rise in bank deposits and also in loan provisions and advances. In terms of deposits, local private sector bank growth improved faster than both state-owned and foreign-owned banks .

4.2 The Central Bank after 2001

In 2001, DAB faced immediate problems, including its legal independence problems; inadequate efforts to improve international and domestic payment systems; and a number of the obstacles in its efforts to build domestic and technological capacity. All these issues significantly slowed the pace of reforms of the 2002 and 2003 innovations (mainly designed to solve the urgent problems regarding payment systems) and failing to achieve the initial goals of the reformers. In 2003, DAB was still far from meeting the basic criteria of modern central banking. Many comprehensive reforms were needed (Pernia et al. 2005).

With the assistance of international and bilateral organizations, the central bank's rebuilding and modernization began in mid 2002, despite the challenges faced, with the following initiatives:

- The new central bank law was in place, which was the autonomy of the central bank guarantees.
- There was a new commercial banking law that required banks to perform banking operations and withdraw from the financial sector.
- Following the successful release of a new currency, a major monetary policy would eventually emerge.
- A new banking-monitoring agency was underway and started inspections on the state banks.
- The SWIFT central bank connection was feasible - one-third of the central bank branches were connected electronically to domestic payments.
- The operational capacity of the central bank has improved significantly (Pernia et al. 2005).

Today, the central bank of Afghanistan has made great strides, including the creation of the "dab.gov.af" website with the publication of rich resources and information in three languages: Dari, Pashto, and English; including reports, banking, and financial laws and regulations, policies, manuals, etc. The central bank of Afghanistan has issued the Islamic banking regulations and is trying to expand Islamic banking by publishing various guidelines, policies, manuals, and procedures for them.

4.3 Licensed Financial Institutions

One of the key tasks of the central bank of Afghanistan is licensing and regulating banks, forex dealers, and money service providers (MSPs). Afghanistan's financial system consists of banks and non-bank financial institutions. Also, other than the banks, there are forex dealers, financial service providers, electronic money institutions, and forex exchange companies, as part of non-bank financial institutions. This is one of DAB's responsibilities for licensing and supervising non-bank financial institutions and banks (Da Afghanistan Bank, 2019b).

Table 3 shows the list of licensed banking institutions in Afghanistan, with 12 banks. From those banks, one of them is a full-fledged Islamic bank, which is the IBA, four conventional banks, and seven conventional banks with Islamic banking windows.

Table 3: Licensed Financial Institutions

No	Name	Type	License Date	Type of Bank
1	Bank-e-Millie Afghan	State-Owned Bank	Relicensed 26 July 2004	Islamic Banking Window
2	Pashtany Bank	State-Owned Bank	Relicensed 26 June 2004	Conventional Banking
3	New Kabul Bank	State-Owned Bank	18 April 2011	Islamic Banking Window
4	Azizi Bank	Private Bank	June 13, 2006	Conventional Banking
5	Afghanistan International Bank	Private Bank	March 22, 2004	Islamic Banking Window
6	Islamic Bank of Afghanistan	Private Bank	18 March 2009	Full-Fledged Islamic Bank
7	Maiwand Bank	Private Bank	31 December 2008	Islamic Banking Window
8	Afghan United Bank	Private Bank	4 October 2007	Islamic Banking Window
9	Ghazanfar Bank	Private Bank	1 March 2009	Islamic Banking Window
10	The First MicroFinance Bank	Private Bank	18.March.2004	Conventional Banking
11	National Bank of Pakistan	Branch of Foreign Bank	Permitted 1st October 2003	Islamic Banking Window
12	Bank Alfalah Ltd	Branch of Foreign Bank	21 May 2005	Conventional Banking

Source: Da Afghanistan Bank (2019b)

According to Table 4, as at end of 2018 there were around 14 banks (state owned, private, and foreign bank branches in Afghanistan). While in 2019 the number of banks decreased to only 12 banks. Additionally, the number of depositors increased from 3,396,629 in 2017 to 3,837,216 in 2019 and borrowers from 64,103 in 2017 to 67,376 in 2019, indicating an encouraging uptrend including some increases in depositing and lending activities.

Table 4: Quarterly Financial Sector Financial Statistics

Quarterly Financial Sector Financial Statistics					
	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q3, 2019
No. of banks	15	15	15	14	13
State-owned banks	3	3	3	3	3
Private CBs	9	9	9	8	8
Branches of foreign banks	3	3	3	3	2
No. of branches	416	416	416	414	410
No. of branches: State-owned banks	130	130	130	130	130
No. of branches: Private CBs	281	281	281	279	276
No. of branches: Branches of foreign banks	5	5	5	5	4
No. of depositors	3,396,629	3,422,670	3,515,377	3,589,972	3,837,216
No. of borrowers	64,103	66,427	68,545	71,165	67,376

No. Of ATMs	248	249	68,545	332	356
No. of Credit Cards	1,516	1,742	1,957	2,016	1333
No. of Debit Cards	335,274	370,288	415,399	455,376	643734
Amounts in Million AFN					
Total Assets	316,137	295,089	307,650	309,157	298,276
Total Gross Loans	41,801	38,163	42,122	43,205	42,373
Total deposits	270,256	250,230	263,305	264,924	253,919
Non-bank					
No. Of MSPs	1108	1,102	1,155	1,289	1561
No. Of FXDs	1748	1,666	1,647	1,697	1639

Source: Da Afghanistan Bank (2018a, 2019d)

4.4 Islamic Banking

Although Islamic banking services began in mid 2008 and 2009, IBA is the first fullfledged Islamic bank in Afghanistan.The IBA (formerly Bakhter Bank) serves as a merged banking organization under the Afghan Banking Law and the license of the DAB. Since 2009, the IBA 100% owned by Azizi bank. Currently, IBA has established 62 branches throughout the country with more than 800 trained and skilled employees. DAB granted in-principle approval for the Islamic banking business for IBA in January 2016. After that, IBA started the process of procurement of banking system for Islamic banking. When the conversion process was completed the DAB granted the full-fledged Islamic banking license to IBA in April 2018. Nowadays IBA offers some Islamic banking services and products such as *Murabaha, Ijarah, Musharakah, Istisna and Salam.* IBA provides many facilities for its customers such as the Guarantee (*Kafalah*, Surety) Facility (Performance Guarantees, Advance Payment Guarantees, Bid Guarantees, Guarantee for Release of Retention Money, Credit Sale Guarantees), Opening Accounts (*Qard-ul-Hassan* Current Account, *Mudarabah* Saving Account, *Mudarabah* Fixed Term Account), products such as *Murabaha* (*Murabaha* to Purchase Order, Spot *Murabaha,* Deferred Payment *Murabaha*, LC *Murabaha*), *Ijarah*, *Musharakah*, *Istisna*, *Salam* and treasury (*Shariah* Compliant Money Market Services, *Sukuk* Portfolio Management, *Shariah* Compliant Foreign Exchange Services) ("Islamic Bank of Afghanistan (IBA)," 2019). In the following section, will discuss some banks having Islamic banking windows.

4.4.1 Bank-e-Millie Afghan (BMA)

BMA is the first financial institution of Afghanistan established in 1933, which was a public-private partnership. It was 72 % share held by a private sector. BMA introduced formal banking services to the people and government as the first bank in Afghanistan. Later in 1976, it was completely nationalized by the government of Afghanistan. BMA has 15 city branches in Kabul and 21 branches in other provinces with equity investments in the United States of America and England. It is offering Islamic banking products as well such as Islamic current deposit, *Mudarabah* savings deposit, *Mudarabah* fixed deposit, *Musharakah,* and *Istisna* and it has Home Financing, Car Financing, Trade Financing as well that is based on *Murabahah* contract ("Bank-e-Millie Afghan (BMA)," 2019).

4.4.2 New Kabul Bank (NKB)

NKB has launched the Islamic banking window that provides Shariah-compliant products and services in mid-2010 and within one year, the Islamic banking window business has more than 70 branches throughout Afghanistan. It includes Personal Banking (deposit and financing), Business Banking (deposit and financing), and Cards (Islamic cash card and Islamic Debit Card (Master Card)) (New Kabul Bank, 2019).

4.4.3 Afghanistan International Bank (AIB)

AIB was established in 2004 and now has 35 branches and two cash outlets. It has Islamic banking windows that offer personal banking (*Qard* current account, *Mudarabah* savings account, *Mudarabah* term investment deposit), business banking (Qard current account, *Murabaha* financing), and Islamic Shariah compliance certificates (Credit card certificate, Debit card certificate, *Haj,* and *Umrah* prepaid card certificate, current account certificate, savings account certificate, term deposit investment account certificate, corporate financing certificate, vehicle financing certificate) (Afghanistan International Bank (AIB), 2019).

4.4.4 Maiwand Bank (MB)

This bank was established and has begun the banking operations from January 2009. Now it has 24 branches and 18 extension counters in different parts of the country. Further licenses for the opening of more branches are under process. The bank has its presence in 17 provinces and intends to mark its presence in all provinces. Mawaind Bank considers Islamic banking as one of its services and it has an independent functional department for it. However, no extra information can be found about Islamic banking services and products from its website (Maiwand Bank, 2019).

4.4.5 Afghan United Bank (AUB)

AUB commenced its operations in 2007 and received the license for the Islamic banking window from DAB in April 2008. AUB has 26 branches with two full-fledged Islamic banking windows. It provides Islamic Shariah-compliant banking services and products based on Shariah rules and principles. In the Global Finance world's best Islamic financial institutions, AUB has been awarded as "Best Islamic Financial Institution" for two consecutive years 2014 and 2015. This bank has two categories of facilities for individuals and businesses. The depository accounts for individuals include Islamic current account, Islamic savings account, special Child Saver account, and Islamic time deposit account. The business facilities are divided into investment facilities such as *Murabaha* and *Ijarah*/Lease, non – funded facilities such as Islamic bank guarantees and Islamic letter of credit (LC) (Afghan United Bank (AUB), 2019).

4.4.6 Ghazanfar Bank (GB)

Ghazanfar Bank was licensed as a full-fledged CB and begun its operations in March 2009. The shareholders of the bank belongs to a business group in Afghanistan that do business activities such as import and distribution of petroleum/gas and other various important industrial sectors. Ghazanfar Bank is offering Islamic and conventional financial services. Its Islamic banking facilities are deposit products such as *Al Wadi'ah* current account, *Mudarabah* fixed deposit account, *Mudarabah* saving account, and Shariah credit facilities such as *Murabaha, Musharakah.* Now it has around 14 branches of Islamic banking in the country (Ghazanfar Bank, 2019).

4.4.7 National Bank of Pakistan (NBP)

NBP as one of the foreign banks offering some Islamic banking products and services in various deposit schemes and IBF facilities such as *Aitemaad Ijarah, Aitemaad Murabaha*, *Aitemaad Diminishing Musharakah*, *Aitemaad Salam*, *Aitemaad Istisna*, *Aitemaad Tijarat* (National Bank of Pakistan, 2019).

5. Challenges and Problems of Islamic Banking

Islamic banking, especially the nascent Islamic banking sector in Afghanistan, is facing some challenges and problems. For banks, the lack of liquidity is considered as one of the main reasons for failure. Liquidity term refers to the amount of capital that exist for expenses and investment, while the banks' liquidity is their ability to meet credit claims related to maturities and liabilities. Liquidity risk is the lack of liquidity needs by banks for their debts (İncekara and Çetinkaya, 2019). Khan and Bhatti (2008) noted, Islamic banks have about 40% more liquidity than conventional banks due to acute shortage in long-term Shariah-compliant investment tools and 95% of their funds are committed to short-term instruments such as *Ijarah*, *Murabaha*, and *Musharakah*. Establishing a secondary market for Islamic bonds, equities, government securities, mutual funds, and other instruments can be solutions to this problem. Even a low percentage of Afghans (10%) deal with banks, the Afghanistan banking sector, has high liquidity, it has failed to play a considerable role in economic and financial development (Rostom, 2018). It means it failed to properly allocate the deposits in the investment side of the balance sheet.

In developing the modern financial sector, there is a serious need for highly educated specialists in the fields of finance, economics, IT, and accounting. Besides, for a prudent and useful regulating and supervising of the financial sector it needs trained specialists (Askari et al., 2011). There is a severe shortage of human resources in Islamic financial institutions. Islamic banking financial managers and leaders are drawn from the conventional banking world. They have not been properly trained in Shariah-compliant banking. Hence, it is important to eliminate *riba* (usury) from IBF operations especially in the case of Afghanistan banking system. There are some important Islamic banking bodies such as the Institute of Islamic Banking and Finance (IIBF), IIUM Institute of Islamic Banking and Finance (II*i*BF) and International Centre for Education in Islamic Finance (INCEIF) that organize conferences, collections, special workshops, and trainings. Now is the time for the IBF industry to invest heavily in human resource development and research and training facilities, which can add solutions and real value to present IBF challenges and issues (Khan and Bhatti, 2008). There is also a severe shortage of specialized human resources in Afghanistan, especially in the areas of Shariah supervision, Islamic banking, and Islamic economics due to there is no specific institution that trains such scholars in these areas. Hence, it is common in Afgahnistan that a bank operates Islamic and conventional bank branches under one roof in a same building.

Islamic banks should develop a strong research and training base to nurture a corps of Shariah experts of high moral and professional integrity. In the field of Islamic banking, some scholars are often members of the Shariah board in many Islamic financial institutions. A small number of countries (for example, Indonesia and Malaysia) have restricted the membership number of scholars in Islamic financial institutions' Shariah supervisory board while other countries have not yet made any restrictions (Nomran and Haron, 2020). In fact, in many Shariah boards, particularly in the GCC countries, the names of Shariah scholars have been repeated. Also, three specific Shariah scholars have the membership of 26% of the total Shariah boards in these countries and 11 Shariah scholars have shared 68% positions in all Shariah boards (Grassa, 2016).

DAB issued the policy of the "National Shariah Governance Framework" and various Shariah guidelines such as "Terms of Reference for Shariah Supervisory Board", "Shariah Review Manual" and "Shariah Board Members' Assessment Manual" which might be the guiding principles of the structure of the Shariah governance framework of any Islamic financial institutions in Afghanistan. The "National Shariah Governance Framework" might be a guiding principle for the Shariah governance framework of Islamic financial institutions, to ensure that all Islamic bank's commercial activities and operations are Shariah compliance. Furthermore, due to the nascent stage of Islamic finance in Afghanistan, DAB temporarily authorizes banks to delegate any of their operational functions Shariah governance, as well as their Shariah Board, to a third-party Shariah consultancy (service provider) or an external Shariah Board or a Shariah scholar who approved on other banks Shariah board in Afghanistan. The outsourced Shariah scholars may attend any number of Shariah boards in Afghanistan as long as it deems appropriate. It is also recommended, which at least one qualified Shariah scholar be retained by the bank to be in charge of its Shariah department and to be responsible for complying with Shariah law (Da Afghanistan Bank, 2017).

Providing Shariah-compliant financial products to meet customer demand is an important issue in Islamic banking. In this regard, banks should ensure that their product development processes are comprehensive to not subject to the challenge and possibility of invalidation from the Shariah point of view. To achieve this goal, DAB has issued the "Approval Procedure Manual for Financial Products" for the development of new products for Islamic finance to meet the demand of customers (Da Afghanistan Bank, 2019e).

There is no access to formal financial services by more than half of the adult population in the world, in part because of a lack of credit history and collateral. Advanced access to finance leads to economic growth and financial stability. In this context, access to financial services commensurate with the beliefs and ideas is important (Efendić et al., 2017). The most important issue in the Afghan banking sector is less dealing with banks as previously discussed. Afghanistan's low financial inclusion is due to supply and demand constraints. Disadvantages of the supply side include difficult loan conditions, including high collateral requirements, high-interest rates, lack of experience in SME loans in the banking sector, poor credit infrastructure, which are the main constraint in identifying and managing banks' lending risk, limited access to banks and micro finance institutions especially in rural areas, which includes the absence of digital transactions and branches and lack of business models in banks. Also, about 85% of adults in Afghanistan do not have access to a transaction account. Financial inclusion, income as well as intermediation in Afghanistan are low compared to the region, developing economies, and neighboring countries. This low income makes 54.5% of the country's population live under the national poverty line. The main reasons declared by Afghans for not having an account at a financial institution is, among others; most of them reported lack of funding, as well as some other reasons such as distance, lack of required documents or cost, lack of trust, religious beliefs, or someone else in the family having an account. This indicates the need for the supply side to expand access points, which in turn increases account ownership (Da Afghanistan Bank, 2020).

SME financing in Afghanistan lags behind some other conflicts such as developing economies and low-income. The outstanding SME loans share was only 0.17% of GDP in 2018 that is the lowest among regional and similar economies. Access to finance is one of the biggest barriers that companies face in Afghanistan. About 3.9% of Afghan companies rely on banks loan, and only 0.8 % use banks to raise capital. However, SME's potential credit needs are estimated at more than $4.7 billion, which is a significant opportunity in Afghanistan (Da Afghanistan Bank, 2020).

6. Conclusion

This study explores the challenges of the historical development of the Islamic banking system in Afghanistan using document analysis since the establishment of the banking system in 1933 and since the establishment of the new government in 2001. The country's banking system, which includes Islamic banking as well has been affected by civil wars over the past three decades and has failed to make significant progress. In 2002, the banking system, with the support of the international donors, has undergone significant changes, including the creation of various financial and banking laws, the establishment of new banks, and the re-licensing of previous banks. However, this progress has continued since the formation of the new government, but the banking system has seen a financial crisis in Kabul Bank in 2010 that was one of the Afghanistan's largest commercial banks (CBs). Islamic banking emerged in Afghanistan between 2008 and 2009 and the Islamic Republic Government of Afghanistan is trying to promote Islamic banking activities and have approved licenses for the banks which have Islamic banking windows to convert to full-fledged Islamic banks.

Based on the findings of this study, Afghanistan's banking system even it has seen some development but still faces many challenges, financial services are not available to all adults, and Afghanistan's low financial inclusion is due to limitations in both supply and demand side. Besides, excess liquidity, lack of specialists in the fields of Islamic finance, Islamic economics, and Shariah are the other challenges facing the banking system.

7. Recommendations

Recommendations are provided to improve IBF activities in the country. Universities, government, and financial institutions should focus more on organizing workshops, seminars, conferences or initiating exchange programs with other countries, particularly those known for their leading role in the current Islamic banking and finance industry as a way of motivating people to deal with Islamic banks and increasing their knowledge about Islamic banking and finance.

As the Afghan government has supported Islamic banking activities, but for improving the research activities and come out with some Shariah and IBF scholars it is suggested that the government should establish Islamic banking institutions, faculty, or even universities that are specifically focused on Islamic and Islamic banking studies. It is also suggested that the government should establish, support, and facilitate the Islamic capital market and Islamic money market facilities. This is because the improvement of the Islamic money market and Islamic capital market can increase the financial activities in a country and positively affect the development of a country, specifically for Afghanistan.

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