

Islamic Banking and Finance

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Edited by

Mondher Bellalah and Omar Masood

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PREFACE

Islamic banking has seen rapid growth during the last two decades. There are many contributory factors for such growth, most notable of which are the liberalisation of financial regulation; the globalisation of financial markets; changes in technology; product innovation; the birth of several new Islamic states; and the growing Islamic presence in the West. Product innovations have helped economists and religious scholars to bring new products to almost all areas of banking and insurance, some of which were previously thought to be extremely controversial. There is no accurate data on the extent and volume of Islamic banking. Islamic banking assets are currently estimated at being between USD 500 and 800 Billion, and there are nearly three hundred Islamic Financial Institutions worldwide, including “Islamic windows” of conventional banks. The Islamic *sukuk*, (equivalent to bonds in Western finance) are the fastest growing product on the financial market, and the *sukuk* market has increased at an average annual rate of 40 per cent, with a current size of more than USD 82 billion. In Pakistan and Malaysia, Sharia-compliant funds have exceeded over 50% of total market capitalization. Today, Islamic banking is growing at approximately 15% per annum, as a result of economic expansion in the Islamic world, fuelled primarily by oil wealth. This growth has created an expanding middle-wealth segment and hence made banking a necessary service to a larger segment of the population rather than a service for a minority, as had been the case for the preceding ten to fifteen year period. The Islamic banking system is popular with not only Islamic banks themselves, but also well-known international and other conventional banks. Presently the majority of international banks are adopting Islamic banking to serve their new clients and their specific needs. Examples of such banks are Citibank and HSBC, both of which have started Islamic operations worldwide to expand their businesses. Although interest in Islamic banking has grown considerably during the last decade, Islamic banking today continues to evolve as an industry. The financial world has set conventional banking as a standard practice driven mainly by the profit maximisation principle. However, Islamic banking principles have attracted attention from academic researchers and regulators both in developing and developed countries as a result of their distinguished micro-operating fundamentals. The prohibition of interest payments by Islamic Sharia (Islamic law) has instead made equity and profit sharing the

cornerstones of its operational structure activities. This ban on interest does not mean that capital is costless in an Islamic system; in fact, it recognises funds as a factor of production but does not allow the fund-providers to make a prior or pre-determined claim in the form of interest. This risk-sharing principle provides theoretically better long-term allocation of funds to investments with higher risk-return profiles and subsequently greater economic growth.

This book addresses the main issues of concern within Islamic banking, namely the conceptual framework and viability of interest-free banking and the assessment of its performance and future. In a world where conventional interest-based finance is the dominant framework, Islamic banking faces many challenges that must be addressed. This book discusses the contemporary issues and challenges confronting the Islamic banking system and was written for both researchers and practitioners. It analyses the past experiences of Islamic banks worldwide and provides an objective assessment of their successes and failures.

Adnan Ahmed Yousif
President and CEO of Al Baraka Banking Group
President of Union des Banques Arabes

INTRODUCTION

General Introduction

What distinguishes Islamic finance and banking from the conventional financial system is based on a comprehensive system of ethics and moral values stemming from the Islamic religion. Unlike conventional finance, Islamic finance is founded on overarching principles that constitute the guidelines governing any Islamic economic or financial dealings.

The principles that underline the distinguishing features of Islamic finance and banking as well as Islamic economics as a whole stem from the Sharia of Mu'amalat or Islamic law governing human relationships. Islamic Law refers to the divine injunctions in the Koran and the prophet's (PBUH) traditions that regulate the conduct of human beings in their individual and collective lives. In this regard, it is worth pointing out that Islam does not refer only to the Islamic religion but encompasses a comprehensive social system where people live in accordance with divine guidance.

Islamic finance was developed from a conceptual idea in regard to an evolving and fast reality. With the involvement of many actors in the industry and the culmination of economic, political and demographic factors, Islamic Finance has shown a strong growth.

Basic Sharia-compliant contracts have been used innovatively in structuring various Islamic financial and deposit products for banking, project finance, capital market, insurance products and risk management instruments. The structuring of innovative finance and derivative Sharia-compliant instruments plays an important role in the enhancement of Islamic financial markets and Islamic risk-management practices.

For future challenges, the immediate need is to develop instruments that enhance liquidity, and to develop secondary, monetary and inter-bank markets; and to perform asset liability and risk management.

My personal view is that it is a "huge mistake" to use the LIBOR as a benchmark. The benchmark must be the "real cost" or "Actual costs" incurred by Islamic banks and mainly information costs to which a margin must be added. These costs are well known in the literature (the reader can refer to Bellalah [2008, 2009]). These costs are defined in Appendix 1 of Chapter 1.

This Book is organized as follows.

Chapter one draws attention to the important development that Islamic Finance and banking have known from a conceptual idea to an evolving and fast reality. It deals with the different principles governing Islamic financial dealing and transactions and gives an overview of the added value of Islamic finance to the international financial system. The chapter covers the main Sharia-compliant structured project finance solutions and the *sukuk* market, and presents new practices in the industry such as *sukuk* restructuring, credit enhancement, redemption and convertibility.

Chapter two studies the productivity growth in the GCC Banking Industry for the period 1999-2007. It compares conventional versus Islamic banks. This study examines the impact of financial liberalization on banking productivity growth in the Gulf Cooperation Council (GCC) countries during the period 1999-2007. Employing a non-parametric approach (DEA), productivity change has been measured by computing total factor productivity index for two groups of banks: conventional and Islamic. The findings indicate that during the period of deregulation, GCC banks have experienced a gain in productivity change of about 1.8%, attributed mainly to the progress of technical change rather than increase in efficiency change. We also found that conventional banks tend to outperform Islamic banks in most productivity measures. In this chapter, we also investigate the determinants of bank productivity. The results show that bank size has a positive impact on productivity growth for all models, while capitalization is related negatively to efficiency change for the model of Islamic banks only. Finally, the regression findings also demonstrate the strong links of macroeconomic and financial sector indicators with bank productivity.

Chapter three presents an analysis for the growth and rise of smaller Islamic banks in last decade. Chapter four studies the development and scope of Islamic bank bonds (known as *Sukuks*).

Raising finance through investment *Sukuks* is becoming more and more popular in the Middle East, Europe and the Far East. *Sukuk* is a thriving new market in many Islamic Economies, especially in GCC countries and Malaysia This is attracting a lot of interest from European countries like the UK, Portugal and some other major countries like Japan and Singapore.

Given their novelty and unique characteristics and varieties, *Sukuks* can be researched extensively and discussed from various angles. However, under this heading, the focus will be on the definition of *Sukuk* types, nature and salient features distinguishing each type of *Sukuk* from

others, and consequently offering a critical appraisal of *Sukuk* as Islamic alternatives to conventional Bonds or securitization.

The other chapters investigate Islamic banking and finance in several countries.

Chapter five develops Iran's Islamic banking experience. The practice began in Iran in 1984, and the transformation from a conventional form of banking has been a subject of debate among scholars. Analysis of Islamic modes of financing shows that bank authorities and economic policy makers have followed the same path of traditional banking and switch their funds towards a more profitable type of contract. This chapter describes that due to the heavy concentration of the banking assets on short term deposits, and the private sector's reluctance to commit funds for long term financing, bank loans were also utilized to mainly finance short-term trade transactions, for example hire purchases, forward purchases and service contracts. Long-term partnerships for project financing and direct investment by the banking system in the long term undertakings constituted a small percentage of the total operation.

Chapter six studies the Islamic banking structure and growth in the Sudanese Islamic banking sector. Goes back to 1977 when the Faisal Islamic bank of Sudan was established in the country. With the introduction of Sharia law in 1984, the entire banking industry converted to Islamic Sharia principles. The Sudanese Islamic banking industry now encompasses more than thirty banks, and some of them, like the Faisal Islamic bank of Sudan, have twenty-eight branches alone.

This chapter seeks to analyze the financial performance of selected Sudanese Islamic banks and highlight their growth using financial statement analysis (FSA). The procedure involves calculating numerous financial ratios and categorizing them into five key groups in order to examine profitability, earning potential, liquidity, credit risk, and assets activity.

Findings revealed that the Sudanese Islamic banks are doing very well in terms of generating reasonable profits. In addition we discovered that the liquidity earning performance and assets activity performance of the three selected bank was satisfactory. Finally, while analyzing credit risk we found that Sudanese Islamic banks are taking excessive risks.

Chapter seven looks at Islamic mortgages. Mortgages are considered to be a major determinant factor not only for the UK, but for other Western economies as well. Therefore, we thought it fit to conduct an empirical study on Islamic mortgages in the UK. In this chapter, we critically analyse the Islamic mortgage system in the UK and also find out if it might help to create a stable financial environment. The chapter gives a

preliminary empirical assessment of role of Sharia board and corporate governance with reference to the UK. The information was gathered through a well-designed questionnaire assessing a professional banking point of view on Islamic mortgage. This study also sought two important answers to: (1) whether Islamic banking is based on Islamic economic principles or is just a replica of conventional banking, and; (2) if we would still be facing a financial crisis if the market was regulated by Islamic Sharia.

Chapter eight investigates the role of Islamic mortgages in the UK. Mortgages are considered a major determinant factor not only for the UK, but for other Western economies as well. Therefore, we thought it fit to conduct an empirical study on Islamic mortgages in UK. In this chapter we study and elaborate principles behind the overall Islamic banking system, main focus in the role of Islamic mortgages in the UK. This chapter gives a preliminary empirical assessment of the role of sharia board and corporate governance with reference to the UK. This study also sought to find out whether Islamic banking is based on Islamic economic principles or just a replica of conventional banking.

Chapter nine studies the “Islamic bank of Britain” in a case study analysis. There is no specific difference between Islamic and conventional banking on a functions basis. Both provide and perform almost the same functions. The only difference between them is for the Islamic bank to follow the rules and principles of Islam in all their transactions (Henry and Wilson 2004; Iqbal and Mirakhor 2007). Many conventional banks also have started to open branches, which operate in accordance with Islamic Sharia principles. The Islamic banking system is expected to face strong competition not only from the Islamic banks but also from well-established conventional banks offering Islamic products and services. In this study, we focus on the Islamic Bank of Britain, the only indigenous bank of its kind in United Kingdom. An assessment of the degree of customer awareness satisfaction is made, as well as selection criteria. A sample of two hundred respondents took part in this study. The responses show a certain degree of satisfaction, and a few respondents also expressed their dissatisfaction with some of the Islamic bank's services. Chapter ten studies the growth of Islamic banking and employee satisfaction in Bangladesh.

Twenty-five years ago, Islamic banking was virtually unknown. Now, fifty-five developing and emerging market countries have some involvement with Islamic banking and finance. In Bangladesh, the Islamic banks are in a minority and operate alongside conventional banks. The objective of this research is to provide a brief analysis of the performance

of Islamic banks in Bangladesh. The Islamic banks in Bangladesh show strong growth. The products range from consumer credit to long-term finance for big investment projects using Islamic modes of financing such as *Marahaba*, *Bia-Muazzal* and *Ijarah*. Currently, in Bangladesh, the higher import cost of commodity prices, price hike in international oil market as well as money and credit growth resulted in higher inflation. As a result, the economy of the country showed every sign of recession. Despite numerous adversities, Islamic banks made significant pre-tax profit in the last few years. Islamic banks maintained and achieved a strong position in the key areas like capital adequacy, liquidity, assets quality, management and earnings. Moreover, Islamic banks in Bangladesh are keeping pace with the advancement of information technology by providing online banking, debit card facilities and money transfers. The research is based on primary data collected through a questionnaire to the employees of four selected banks on a random basis.

CHAPTER ONE

INTRODUCTION TO ISLAMIC FINANCE AND ISLAMIC BANKING: FROM THEORY TO INNOVATIONS

SHAYEH ZINEB AND MONDHER BELLALAH

Islamic finance is founded on overarching principles that constitute the guideline governing any Islamic economic or financial dealings. The reader can refer to the cited websites. This chapter is organized as follows. The first section tries to draw attention towards the important development that Islamic finance and banking have known from a conceptual idea to an evolving and fast reality. The second section deals with the different principles governing Islamic financial dealings and transactions and gives an overview of the added value of Islamic finance to the international financial system. The third section starts with a summary on the different basic Islamic financial contracts and points out the importance of financial innovation. We shed light on the main Sharia-compliant structured project finance solutions. Moreover, we focus on the sukuk market and present new practices in the industry such as sukuk restructuring, credit enhancement, redemption and convertibility. We point out the importance of the Waad as an interesting instrument, leading to the development of Islamic derivatives and innovative hedging and financing Sharia-compliant structures. We present the main Sharia-compliant derivative based on instruments along with recent Sharia-compliant portfolio insurance practices. Finally, we highlight the major challenges facing the development of Islamic capital market standing from the need for liquidity and risk management-innovative structures to the urgent need to an international central regulatory body ensuring international standardization and uniformity.

Section 1: From a Conceptual Idea to an Evolving and Fast Growing Reality

1.1. Islamic Finance Industry Growth

The infancy of the Islamic finance and banking was in Egypt and Malaysia during the 1960s. The establishment of the first Islamic bank, pioneered by the Mit Ghamr Local Saving Bank, can be traced back to 1963 in Egypt. In the same year, the first Sharia-compliant fund was established in Malaysia known as the Pilgrim's Savings Corporation.

According to the 2009 Banker report, the number of Islamic financial institutions worldwide is about 626 in approximately fifty countries in 2009, compared to 525 in 2007, with total balance sheet assets estimated to be about \$822 million in 2009 compared to \$500 million at 2007. The global total of Islamic assets grew at rate of 28.6% in 2009 for the preceding year. The Middle East and North Africa region accounts for the largest share at 81.3% of total global Islamic assets in 2009.

Islamic banking had a real boom at the beginning of the twenty-first century with an increasing number of Islamic banks and Islamic windows (see table. 1.1 above) and exponential growth of its geographical spread (see fig. 1.2 above). The top twenty banks in the GCC countries have seen their combined assets grow by 24% in 2008. The diversification of market players in the Islamic bank resulted in a growth of geographical reach and the emergence of new financial centres for Islamic banking, different from the historical ones such as Dubai, Bahrain and Kuala Lumpur. The emergence of an increasingly broad range of retail products and services has largely contributed to make Islamic banking as competitive as the conventional method.

The *Takaful* or Islamic Insurance industry, introduced in the 1990s, is expected to reach \$8 billion by the end of 2012 at an annual growth rate of 35%, especially for the life *takaful* industry. The Gulf Countries council represents 60% of the market size followed by Malaysia with 21%. Gross *takaful* contributions have grown from \$1.4 billion in 2004 to over \$3.4 billion in 2007. There still exists a large, expanding and untapped Muslim population on almost every continent (the World Takaful Report 2009).

Regional and Global Growth totals : Islamic Financial Asset (\$m)							
	2006	2007	% change	2008	% change	2009	% change
GCC	127,826.6	178,129.6	39.4	262,665.4	47.5	353,237.5	34.5
Non-GCC/MENA	136,157.6	176,822.2	29.9	248,264	40.4	315,090.5	26.9
MENA total	263,984.2	354,951.7	34.5	510,929.4	43.9	668,328.5	30.8
Sub-Saharan Africa	3,039.3	4,708	54.9	6,662.1	41.5	8,369.7	25.6
Asia	98,709.6	119,346.5	20.9	86,360.3	-27.6	106,797.3	23.7
Australia/Europe/America	20,300.2	21,475.7	5.8	35,105.2	63.5	38,654.8	10.1
Global total	386,033.3	500,481.9	29.7	639,076.9	27.7	822,135.1	28.6
% of MENA Total to global Total	68.4	70.9		79.9		81.3	

Table 1.1. Regional and global growth totals—Islamic financial asset (\$m). Source: Maris Strategies & The Banker (November 2009)

Geographical Distribution of Islamic Banking

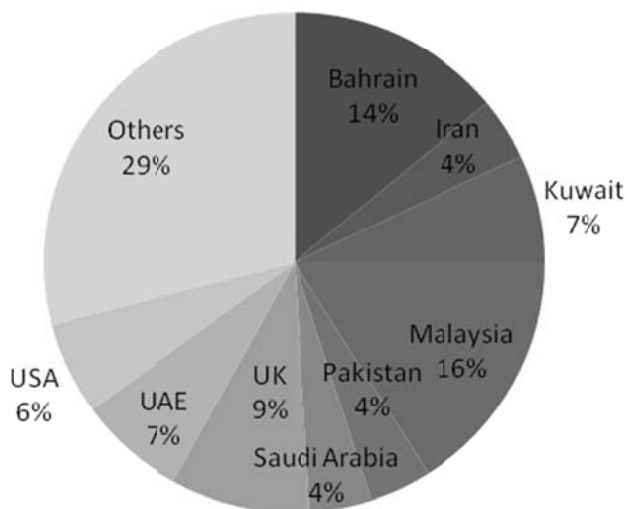


Fig. 1.1. Geographical distribution of Islamic banking
Source: May Bank (May 2009)

With respect to the Islamic capital market, which has gained momentum in recent years, the *sukuk*, or Islamic asset, market has backed certificates introduced in the early 2000s has been one of the fastest growing financial markets the last five years and is expected to continue expanding at an even faster rate. Different structures of *sukuk* were launched with the objective of catering to an increasing Muslim and non-Muslim finance and investment needs. With a depth exceeding \$133 billion, the market of Islamic bond experienced exceptional growth in 2007 with a rise of over 50% (IFIS, 2009). However, the *sukuk* market has not been spared from the current economic crisis, as shown below.

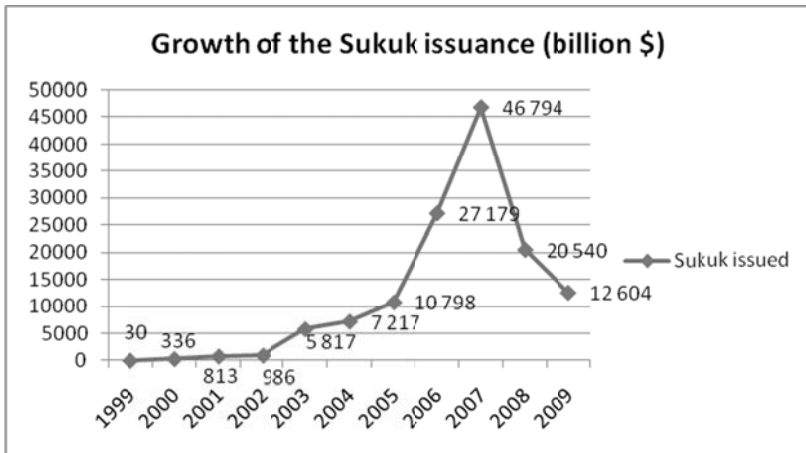


Fig. 1.2. Growth of *sukuk* issuance (\$ billions)
Source: IFIS (2009)

The Land Germany's Saxony-Anhalt has already used this financing instrument. The United Kingdom has already issued sovereign Islamic Bond. Japan and even France have announced their desire to proceed to issuing sovereign *sukuk*. Malaysia counts as one of the most active countries in the Global *sukuk* market with a 76.2% of market share of about USD \$13,000 million. The majority of *sukuk* rates range from A to Baa, due to their asset-backed and based features.

Islamic investment funds have had a major impact on global Islamic finance. Indeed, the Islamic fund industry in global financial institutions is estimated to be about \$1.3 trillion and is projected to reach \$2.7 trillion by 2010, at an annual growth rate of 15–20%.² The number of Sharia-compliant investment funds is estimated to be over five hundred by the end of 2008, and new fund issuance has increased significantly, with 153 established in 2007 alone. It is also estimated that the total Islamic fund universe could easily reach one thousand funds by the end of 2010.³ These funds are a portfolio of different asset classes, such as commodity funds, equity funds, *Ijara* or lease funds, Money market funds are actually used as a crucial liquidity risk management instrument in the interbank market and real estate funds. The largest concentration of Islamic funds remains in the Middle East and North Africa. The equity funds lead the field for

² www.failaka.com

³ Ernst and Young «The Islamic Funds and investment report ». 2008.

choice of asset type with 40–60% depending on the region of the total assets.⁴ Several Islamic Equity funds emerged during the equities market boom of the 1990s and the introduction of the Islamic stock index in the 1999, the Dow Jones and FTSE Sharia index has largely contributed to this industry.

Conscious of the rapid growth and dynamic of the Islamic Finance sector, many large Western financial institutions including Citibank, Barclays Capital, Morgan Stanley, Merrill Lynch and HSBC have established subsidiaries that provide financial Islamic products. Moreover, the major French banks have also actively developed Islamic banking activities, mainly in the Gulf but also at a lesser scale on French territory. BNP Paribas, Credit Agricole and Societe Generale are the most advanced in this field. Today, the number of conventional financial institutions with Islamic windows is about 191 worldwide (The banker, 2009). Western regulators, investors and other agents have also shown a greater interest in and a receptive attitude towards Islamic banking and finance (M. Khan et al. 2008). It is interesting to note that among the top twenty-five countries by size of Sharia-compliant assets include such non-Muslim countries such as the United Kingdom in ninth place with \$19.4 million and Switzerland in twentieth place with \$4.6 million. Recently, France is gaining momentum in its bid to become a centre for Islamic finance. In fact, the French government has taken a comprehensive approach to understanding how to seamlessly assimilate Sharia-based finance into the existing regulatory and legislative structures. An amendment to article 2011 of the French Civil Code, passed on by the French National Assembly, shows the determination to adjust French legislation to the requirements of Islamic finance.

Many important players from both the conventional and Islamic finance stream have pooled their expertise and knowhow to devise more ethical and efficient Islamic financing and hedging solutions. For instance, the launch of the *Tahawut* (Hedging) Master Agreement (TMA) in March 2010 by the Bahrain-based International Islamic Financial Market (IIFM), in cooperation with the International Swaps and Derivatives Association, Inc. (ISDA), gives the global Islamic financial industry the ability to trade Sharia-compliant hedging transactions such as profit rate and currency swaps, which are estimated to represent most of today's Islamic hedging transactions.

While the first steps toward the materialization of the idea to pursue an Islamic mode of economic and financial dealings were taken by a minority community of Muslims in India in the early twentieth century (Interest

⁴ Ernst and Young 2009

Credit Society 1923), real state sponsorship of the establishment of an interest-free institution can be traced back to the 1970s, mainly in Egypt and Iran when a presidential decree in 1971 in Egypt gave birth to the Nasir Social Bank. The introduction of President Zia UIHaq in 1977 was an important step in the process of establishing interest-free banking in Iran. These initiatives were followed in the 1980s by the Islamization of economies in the Islamic Republics of Iran, Pakistan and Sudan where banking systems are converted to interest-free banking systems. The GCC countries and Malaysia worked for the promotion of Islamic banking parallel with the conventional banking system. The Malaysian Islamic banking industry has seen the most spectacular expansion with the enactment of the Islamic banking act in 1983 and the establishment of the Bank Islamic Malaysia as well as important government involvement.

In 1974, the first Islamic modern commercial bank, the Islamic Dubai bank, was established. The Islamic Dubai bank, one of the earliest private initiatives in the UAE, could be considered one of the first proofs of the feasibility and efficiency of an Islamic banking system. The bank continues to prosper and be involved in the development of Islamic finance. The IDB is not a unique example in this regard, as the major Islamic banks have proved to be as efficient and profitable as conventional banks.

One year later, in 1975, the Islamic Development Bank was established in Jeddah. This institution has played a crucial role in expanding Islamic modes of finance and in fostering interesting research in Islamic economics, finance and banking.

In 1977, the Kuwait Finance House was founded as the first Islamic bank in the country. Recently, the KFH accounted for about a quarter of all deposits in the Kuwaiti market and continues to expand its overseas dealings.

1.2. Determinants of Islamic Finance and Banking Spread

Many factors have contributed to the development of Islamic finance and the spread of Islamic banking. The growth in Islamic financial services may be attributed to the important growth that the GCC countries and Asian economies have seen as well as the increasing numbers in the Muslim community. (IMF 2009) has investigated the determinants of the pattern of Islamic bank diffusion around the world using country-level data for 1992–2006. It was argued that the huge influx of petrodollars from the late 1970s, as well as the consistently high oil prices in international markets, has provided a strong impetus for the development of several Islamic banks in the Middle East. Islamic banking is spreading

wherever there is a sizable Muslim community and is not restricted to Muslim countries. The probability for Islamic banking to spread in a given country rises with the share of the Muslim population, income per capita, and whether the country is a net exporter of oil. Trading with the Middle East and economic stability are also conducive to the diffusion of Islamic banking. Proximity to Malaysia and Bahrain, the two Islamic financial centres, does matter. The interest rates' decrease enhances the development of Islamic banking because they reduce the opportunity cost for less pious individuals to put their money in a conventional bank. According to the authors, the terrorist attacks of September 2001 were not important to the spread of Islamic banking. However, they coincided with rising oil prices, which are the real drivers of Islamic banking growth. Moreover, because the Islamic banking is guided by Sharia law, the quality of institutions, which traditionally count for conventional banking, is not important for the diffusion of Islamic banking.

In addition, the major determinants of the development of Islamic banking and finance include the continuation of serious conceptual and theoretical work both in academic and professional circles. The involvement of international institutions in the development of serious research in Islamic finance and banking was of great interest to the industry. Many well-regarded academic institutions in both Western countries such as Harvard University, Durham University, La Sapienza University & ISME and in Muslim countries such as the Cass Business school, the Faculty of Islamic Studies (Qatar), Effat Women's University (Saudi Arabia), Bahrain Institute of Banking and Finance, International Institute of Islamic Finance Incorporated (Malaysia) organized seminars and conferences and offered degree programs and scholarships in postgraduate Islamic finance study.

1.3. Research Breakthrough

The emergence of an opposition and reluctance to the interest rate started in Egypt in the late nineteenth century when Barclays Bank was established in Cairo to raise funds for the construction of the Suez Canal (Iqbal at al. 1998, 2001). Several formal critiques have been conducted to highlight, on the one hand, the main critical areas where the conventional economic system conflicted with Islamic values, and on the other to lay out alternatives to interest-based financial systems and banking that have started to gain momentum in Muslim countries. The contributions of Qureshi 1967, Siddiqi (1983, 1985, 1988), were considered important in this regard. Their works focused on studying how Islam could propose a

framework to organize an economy and providing a formal definition of *Riba*, as well as explanations and rationales behind the prohibition of interest. The main studies proposed a comparison framework between the economies based on Islamic tenets, socialism and capitalism and emphasized the operational and organizational model of an Islamic bank based on partnership.

Interest grew in undertaking theoretical work and research to understand the functioning of an economic and banking system designed to be an interest-free system, in line with the tenets of Islam, with the first international conference on Islamic economics held Saudi Arabia in 1976. The involvement of institutions and governments led to the application of theory and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process. Parallel to the research initiatives taken by Islamic international institutions such as the IDB and its research arm the Islamic Research and Training Institute established in 1981, the World Bank as well as the International Monetary fund were among the first conventional institutions initiate research on understanding the macroeconomic efficiency and financial stability of an interest-free economic system as well as the financial implications of a loss and profit sharing mechanism (Khan 1986, Khan and Mirakhor 1990). There has also been an outpouring of continuous research on the nature and operation of interest free banks by Muslim economists such as Siddiqi (1983), Bashir (1983, 2000), Chapra 1982, 1985). By exploring the different Islamic contracts, these researches led to the laying out of alternatives to the conventional banking system. In fact, the main results of their efforts were to provide a framework to the early theoretical models of Islamic banking based on the concept of Profit and loss sharing through the *Musharakah* and *Mudarabah* contracts. The two-tier *Mudarabah* financial intermediary model was thus designed and its efficiency and performance assessed.

While academic research on Islamic economics has taken back seat and interest has increased toward the Islamic finance and banking field due to the growing demand for Islamic products and services and the important spread of Islamic banks all over the world, research on corporate governance, Islamic accounting, asset liability management, risk management, capital adequacy and regulation of Islamic banking as well as Islamic financial engineering and innovation in Sharia-compliant derivatives have drawn attention to what Islamic financial institutions and academic researchers need to watch out for in the rapidly changing and competitive financial world.

Chapra (1995) initiated discussions on corporate governance in Islamic financial institutions. They underlined that Sharia compliance in Islamic banks will lead to differences in governance mechanisms in Islamic banks compared to conventional banks. They pointed out that the core element of corporate governance framework for Islamic banks is the Sharia Supervisory Board (SSB) and the internal controls which support it. Chapra provided an overview of corporate governance from an Islamic perspective, focusing on the Islamic financial institution and presented a model defining stakeholders in Islamic banks. They argued that, in contrast with the conventional bank's corporate governance mechanism where in the depositors' interest does not receive much attention, Islamic banks' corporate governance should give emphasis to protect depositors' interest in their business. Z. Hasan (1996) brought out the basic elements of Islamic corporate governance with the Western counterpart in the aspects of conceptual definition, episteme, corporate objective, nature of management and corporate structure.

There is some need for special regulations for Islamic banks for special capital adequacy framework. Drawing from the specific features of Islamic finance and its inherent features of risk sharing, questioned the relevance of the Basle norms and d certain modifications and alternative ways to compute capital adequacy measures for Islamic financial institutions.

As Islamic financial institutions endeavour to cope with the challenges of globalization, efficient risk management has assumed particular importance. This requires the development of not only a more suitable regulatory framework, but also new financial instruments and institutional arrangements to provide an enabling operational environment for Islamic finance. The recent establishment of the Islamic Financial Services Board, facilitated by the International Monetary Fund, addresses this need.

han (2001) highlighted the unique risks of the Islamic financial services industry and the main regulatory concerns with respect to risks and their treatment. They identified a number of Sharia-related challenges concerning risk management.

As far as the asset liability management is concerned, interest toward the development of Sharia-compliant derivative, securitized and structured based instruments has gained momentum. Iqbal (1999) pointed out that the Islamic system of contracting allows for designing risk management solutions using the framework of financial derivative products. The paper analyzes and discusses the case of a specific Islamic contract, *istijrar*, and highlights its possible use in managing certain forms of risk. Iqbal (1999) argued that Islamic finance provides the basic building blocks that can be used to construct more complex financial instruments that will enhance

liquidity and offer risk management tools. With the introduction of asset securitization and swap transactions conforming to Islamic principles, the issues of secondary markets and risk management can be addressed.

1.4. Regulating and Supervising Islamic Finance and Banking Industry

The Institutional Development

For the sake of supporting the development of Islamic banking and finance, an institutional infrastructure has been evolving since the emergence of the Islamic Development Bank in 1975 as one of the major actors in the enhancement of the Islamic financial industry.

The rapid expansion in the breadth and depth of Islamic banking and capital market activity as measured in terms of the number of institutions as well as by the variety, complexity and sophistication of products and services has triggered a strong awareness among scholars, professionals and regulators about the necessity to institutionalize Islamic finance through the establishment of international regulating and supervising organizations.

Undoubtedly, one of the biggest challenges for the Islamic financial system is the development of a framework for governing, supervising and regulating Islamic finance. For instance, Islamic banks have to be subject to a supervisory and regulatory regime of central banks that is entirely different from that of conventional banks as well as conventional central banks in order to promote a true and fair view of Islamic financial transactions.

The Islamic Development Bank

In this regard, it is meaningful to highlight the important role played by the Islamic Development Bank in developing internationally acceptable standards and procedures and strengthening the sector's architecture in different countries. The IDB was established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in December 1973.

Moreover, several other international institutions are working to enhance the regulatory framework and standardization of the Islamic finance and banking industry. These include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Islamic Finance Service Board (IFSB), the International Islamic Financial Market

(IIFM), the Liquidity Management (LMC), the International Islamic Rating Agency (IIRA), the Islamic Research and Training Institute (IRTI) and the International Sharia Research Academy for Islamic Finance (ISRA).

Auditing Organization for Islamic Financial Institutions

Thanks to the effort of the Islamic Development Bank, the Accounting and Auditing Organization for Islamic Finance was established and registered in 1991 in Bahrain as an international, autonomous self-regulation for the industry. The main objective of the organization is to prepare and develop accounting, auditing, governance and ethical standards relating to the activities of Islamic financial institutions, taking into consideration international standards and practices and the need to comply with Sharia rules.

The Islamic Finance Service Board

With the growth of the market, the IFSB was established in 2000 as a dedicated regulatory agency. The IFSB, together with the AAOIF, aims to promote the development of a prudent and transparent Islamic financial services industry and provides guidance on the effective supervision and regulation of institutions offering Islamic financial products. The IFSB has recently finalized standards on capital adequacy and risk management and has made progress in developing standards on corporate governance. Once developed and accepted, these international standards will assist supervisors in pursuing soundness, stability and integrity in the world of Islamic finance.

The Liquidity Management Center

As Islamic financial transactions increasingly become global in nature, there are concerns over the sufficiency of supply of appropriate instruments to address the global liquidity management needs of Islamic financial institutions. These concerns led to the establishment of the Liquidity Management Centre (LMC) in February 2002. The LMC is based in Bahrain and is part of a larger project to create an International Islamic Financial Market (IIFM). The LMC facilitates investment of the surplus funds of Islamic banks and financial institutions into quality short- and medium-term financial instruments. It aims to enhance the creation of

an Islamic interbank money market that would enable Islamic financial institutions to manage their liquidity.

The International Sharia Research Academy for Islamic Finance

The International Sharia Research Academy for Islamic Finance was established by the Malaysian Central Bank in Mei 2008 with the vision and mission of Integration of Sharia experts and industry practitioners as well as synergizing total human capital development in Islamic Finance. Furthermore, the academy contributes to the study of the potential market needs and innovation in research findings.

Section 2: An Overview on the Framework of Islamic Finance and Banking

Referring to Islamic banking or Islamic financial system as simply an interest-free system does not reflect the real image of the Islamic financial system. Undoubtedly, prohibiting the receipt and payment of interest is the nucleus of the system, but is supported by other principles of Islamic doctrine advocating social justice and risk sharing.

Islam recognizes the role of Markets and freedom of individuals and trade. History cannot deny, as expressed by Gordon Brown, that: “it was mainly through peaceful trade that the faith of Islam arrived in different countries.” The profit motive and private ownership are acceptable, but to a reasonable extent. In fact, the Islamic finance defines this extent regarding the Islamic Law, which upholds the principles of integrity, transparency, justice, fairness, solidarity and good corporate governance in financial dealings.

2.1. Materiality and Validity of Economic and Financial Transaction and Dealing

2.1.1. Asset Backed or Based Finance

One of the most important features of Islamic finance, of which the economic crisis has demonstrated relevance, is that Islamic finance is based on an asset-backed financing principal. In fact, Sharia law, which grounds the principles of Islamic finance, encourages business and trade activities that generate fair and legitimate profit through which business dealings must be accompanied by an underlying genuine trade and business-related activity. Any transaction in the financial sphere must

necessarily reflect a transaction in the economic sphere. The two spheres must increase or decrease in terms of value overall. This was not the case for the current financial crisis where the massive injections of money into the real economic sphere were not able to cope with the enormous gap that stood between the two.

Thus, every financing mode⁵ in the Islamic financial system enforces the close link between financial and productive flows and hence ensures that funds are channelled into real financial business activities, thus entailing the appropriate due diligence. It is worth noting that the asset-backed financing principal has widely contributed to insulating the Islamic financial system from the risks associated with excessive financial leveraging and speculative activities that have characterized the recent crisis.

2.1.2. The Three Main Prohibitions in Islamic Finance: the Prohibition of *Riba* (interest), *Gharar* (uncertainty) and *Maysir* (gambling)

Islamic finance does not deny that the transfers of credit and risk are at the heart of finance, without which an economic system cannot function. However, it is wise to state that these two vehicles are a double-edged sword. Although they can be used judiciously to reduce risk and enhance welfare, they can easily entice otherwise cautious individuals to engage in ruinous gambling behaviour, such as what we have seen with the current financial crisis.

According to El-Gamal, the two main prohibitions of *Riba* as well as *Gharar* and its subsequent *Maysir*, in Islamic law, are best characterized as trading in unbundled credit and trading in unbundled risk, respectively. In this respect, Islamic jurisprudence uses those two prohibitions to allow only for the appropriate measure of permissibility of transferring credit and risk to achieve economic ends. Moreover, while financial secular regulators seek to limit the scope of credit and risk trading to prevent systemic failures, Islamic law provides injunctions that also aim to protect individuals from their own greed and the potentially addictive nature of living beyond one's mean or addictive behaviour of gambling and corrupting intelligently.

⁵ The Islamic financing mode will be discussed in the next section, pointing out this prominent feature and how in spite of the fact that such financing modes as Murabaha and Leasing are not believed to be ideal they remain a real guarantee to keeping the two economic spheres synchronized.

2.1.2.1. The Prohibition of *Riba* (Interest) or Trading in Credit

One of the main features of the Islamic financial system is the prohibition of the payment and receipt of *Riba*, which refers to any conditional increase in the principal of a loan or a debt in return for deferred payment. Generally, *Riba* includes all gains from loans and debts and anything over or above the principal of loans and debts, and covers all forms of interest on conventional commercial or personal loans. This does not mean by any means that Islamic finance does not recognize that time has a strong influence on economic activity and decisions. In fact, the juristic consensus permits the possibility of increasing the item's price for deferred payment in the case of sale contract. However, the Islamic perception of the role of time differs from sale contract to loan or debt contract. This dual perception of time in financial transactions governed by Islamic law seems contrary to the uniform treatment of time in conventional finance that considers an instalment sale as a dual operation of sale-cum-loan.

2.1.2.1.1. The Concept of Time in Islam

In this regard, it is worthwhile to enlighten this different dual time perception and point out the rationale behind it.

On one hand, Islamic Law establishes the legitimacy of price increase in credit sale dealing by admitting that time has a value and recognizes the innate human preference of what is in hand to what is loaned and immediate to the deferred. In this respect, the justification of increasing price when payment is deferred is that the intervening time between passing on commodity and receiving its price involves possibilities of opportunity benefits which are waived in the interest of the buyer. Furthermore, the credit sale does not involve a contract or agreement to pay an equivalent to time as in the case of the credit loan. It is rather a contract to sell a commodity where time is observed as a factor in fixing the price. Here, time is dependent on the commodity and its presence contributes to the determination of the price, but is not, in itself, paid for. The equation in such a sale consists of a commodity tied to a time frame and a price which includes an element to compensate for time and that cannot be perceived as unjust as the dealing, concluded by mutual consent.

On the other hand, Islamic law bans dealing with *Riba* in the case of a loan contract. It is clear to see that the interdiction holds to the unproductive aspect of lending money for itself and adds an interest factor to it. Money, in Islam, is by no means a commodity and ought mainly to serve a productive means, the lender having to participate in the profit/losses from the money injection for a particular investment.

(2.275) "Those who eat *Riba* (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by *Shaitan* (Satan) leading him to insanity. That is because they say, "Trading is only like *Riba* or usury, whereas **Allah has permitted sales and forbidden *Riba***. So whosoever receives an admonition from his Lord and stops eating *Riba* shall not be punished for the past; his case is for Allah (to judge): but whoever returns to *Riba*, are dwellers of the Fire - they will abide therein."

From the above verse, we can touch the severity of the sin of *Riba* and to what extent Muslims are instructed by the Holy Qur'an to shun it. At the same time, however, they are encouraged by the Holy Qur'an to pursue trade. Furthermore, the word *Riba*, meaning "prohibited gain," is explained in the Holy Qur'an by juxtaposing it against (profit form) sale. It explains that all income and earnings can be categorized either as profit from trade and business along with its liability or return on cash or a converted form of cash without bearing liability in term of the result of deployed cash or capital. The former kind of return is permitted and well encouraged in the Islamic financial framework and the latter is severely prohibited.

2.1.2.1.2. Rationale behind Interest Rate Prohibition

2.1.2.1.2.1. Ethical and Religious View

The rationale behind the ban of the interest is well clarified by Al-Razi in his exegesis of the Qur'an, considering *Riba* as a cause of injustice that consists in the unbalanced equation linked to the interest-based loan: the increase, on one hand, and the opportunity cost, on the other. The variance in certitude between the interest over the principal which is certain and its amount is known, and the yield resulting from investing the loan by the creditor, who is not sure it will materialize or its amount is not certain in advance constituting the essence of the injustice of imposing interest on loans. Justice requires that the provider of money capital should share the risk with the entrepreneur. Thus, there is a basic difference between principals of the Islamic economic system and the conventional one in regard to the treatment of money capital as a factor of production. Whereas in the conventional system, money is treated on a par with labour and land, each being entitled to return irrespective of profit or loss, this is not so in the Islamic system which treats money capital on a par with enterprise. Hence the interest of highlighting, in the next section, the prominent feature of loss profit sharing that distinguishes the Islamic financial system from the conventional one.