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A STUDY OF THE PRINCIPLES AND DEVELOPMENT OF ISLAMIC FINANCE

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ABSTRACT

Islamic Banking professes ethical principles in lending and prohibits payment and receipt of interest (Riba) as it misallocates resources and results in created money and inflation. Islamic Banking is faith based banking, based on the principles enunciated by the Shariah (Islamic law). The Shariah compliant banking is essentially targeted for the Muslim population, who account for over 1.7 billion people in the world. However, some of the principles of this type of banking attract non-Muslims as well. This paper attempts to study the basic principles, origin, and institutional development of Islamic finance. Besides this, the paper also provides insights into the recent trends in Islamic banking and presents a distinction between Islamic banking and conventional commercial banking.

Keywords: Ethical principles; Interest; Islamic finance; Shariah law; Development

INTRODUCTION

Islamic banking (sometimes also called as participatory banking) is the banking activity that is consistent with the principles of Islamic law (*Shariah*) and its practical application through the development of Islamic economics. Islamic banking in the modern world generally aims to promote and develop the application of Islamic practices, law and traditions to transactions of financial banking and related business affairs. It is also to promote investment companies to engage in such business activities that are acceptable and consistent within the Shariah percept. Socio-economic justice is central to the Islamic way of life. In an Islamic environment, an individual not only lives for himself, but his scope of activities and responsibilities extend beyond him to the welfare and interests of society at large. Islamic laws (Shariah) promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity.

Whereas the Islamic banker has a much greater responsibility, this leads us to a very fundamental concept of the Islamic financial system i.e., the relation of investors to the institutions is that of partners whereas that of conventional banking is that of creditor-investor. The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or the other. Shariah (Islamic law) prohibits the fixed or floating payment or acceptance of specific interest for loans of money.

OBJECTIVES OF THE STUDY

The present study has following research objectives:

1. To study the basic principles of Islamic finance
2. To study the origin, institutional development and growth of Islamic finance
3. To study the difference between Islamic banking and conventional commercial banking
4. To study the recent trends in Islamic Finance

RESEARCH METHODOLOGY

The present study is mainly based upon the collection of secondary data. The secondary data was collected from various sources of publications such as Magazines, Journals, Research articles, Internet and un-published thesis.

Basic Principles of an Islamic Financial System

Prohibition of Interest

Prohibition of interest (Riba), a term literally meaning “an excess” and interpreted as “any unjustifiable increase of capital, whether in loans or sales,” is the central tenet of the system. More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of principle (that is, guaranteed regardless of the performance of the investment) is considered riba (interest) and is prohibited. The general consensus among Islamic scholars is that riba covers not only usury but also charging of “interest” as widely practiced; a direct implication of the prohibition of interest is that pure debt securities with predetermined interest rates are also prohibited.

This prohibition is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined ex post, symbolize successful entrepreneurship and the creation of additional wealth. By, contrast, interest, determined ex ante, is a cost that is accrued irrespective of the outcome of business operations and may not create wealth if there are business losses.

Risk Sharing

Since interest is prohibited in Islamic financial system, pure debt security is eliminated from the system and therefore suppliers of funds become investors, rather than creditors. The provider of financial capital and the entrepreneur share business risks in return for shares of the profits and losses.

Assest-Based

The prohibition of debt and the encouragement of risk sharing suggest a financial system where there is a direct link between the real and the financial sector. As a result, the system introduces a “materiality” aspect that links financing directly with the underlying asset so that the financing activity is clearly and closely identified with the real-sector activity. There is a strong link between the performance of the asset and the return on the capital used to finance it.

Money as Potential Capital

Money is treated as “potential capital-that is, it becomes actual capital only when it is combined with other resources to undertake a productive activity. Islam recognizes the time value of money, but only when it acts as capital, not when it is “potential” capital.

Prohibition of Speculative Behavir

An Islamic financial system discourages hoarding and prohibits transactions featuring extreme uncertainty, gambling, and risk.

Sanctity of Contracts and the Preservation of Property Rights

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Islam places great importance on the preservation of property rights, defines a balance between the rights of individuals, society and the state, and strongly prohibits encroachment on anyone’s property rights.

Modern History and Development of Islamic Banking and Financial Services

Although Islam has provided a blueprint of how a society is to be organized and how the affairs of its members are to be conducted in accordance with its prescriptions, with the exception of a brief period following its inception the system itself has not been applied in its entirety. The economy at that time was, of course, much less complex than the economies of modern times. The business practices of the day conformed to the principles of Islam and the element of “interest” was minimized. Indeed, the practice of interest was also condemned by other major religions and the institution of interest had yet to be developed. It is only in the recent decades, when the element of interest becomes integral part of economic life, that Muslims have been forced to become more conscious of its existence at a time of growing interest in the wider implementation of Islamic teachings.

The developments of Islamic finance since the nineteenth century towards implementing a Shariah-compliant economic, financial, and banking system can be divided into three phases.

PHASE I: PRE-1960

Throughout the nineteenth century and through a good part of the twentieth century, several Muslim countries were under colonial rule, during the colonial period, these Muslim societies to varying degrees lost touch with their old traditions, values and cultural heritage. It was only after the end of the colonial period that Muslims began to re-discover their identities and manifested the desire to regain the lost values I all aspects of life, especially in the economic sphere.

A formal critique and opposition to the element of interest 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. The establishment of such an interest-based bank in a

Muslim country attracted opposition from its inception. In India, a minority community of Muslims in southern India took the first step towards their desire to pursue an Islamic mode of economic activities by establishing interest-free loans as early as the 1890s. This was mainly a welfare association collecting donations and animal skins from the public to provide interest-free loans to the poor. An interest-free credit society was also established in Hyderabad in 1923.

During the first half of the twentieth century, there were several attempts to highlight the areas in which the emerging conventional economic system conflicted with the Islamic values. The need for an alternative economic system conforming to the principles of Islam soon came to the fore and economists began to explore Shariah-compliant contracts, especially equity partnerships. By 1953, Islamic economists had offered the first description of an interest-free bank on a two tier mudarabah and wakala (agency) basis. By the end of the 1950, Islamic scholars and economists had began to offer theoretical models of financial intermediation as a substitute to interest-based banking.

PHASE II: 1960s-1980s

By the start of the 1960s, the demand for Shariah-compliant banking was such that it resulted in the establishment of the Mit Ghamr Local Savings Bank in Egypt in 1963 by the noted social activist Ahamd al-Najjar. This is widely considered to be the first modern Islamic bank.

It is worth nothing that Dr. Najjar chose to promote this institution as a social welfare institution rather than as an Islamic bank. Around the same time, there were parallel efforts in Malaysia to develop a scheme that would enable Muslims to save money to perform the Pilgrimage without the contamination of interest that regular commercial banks were charging. The Pilgrims' Savings Corporation was established in 1963 and was later incorporated into the Pilgrims Management and Fund Board in 1969.

The Nasir Social Bank in Egypt, established by presidential decree in 1971, was the first state-sponsored interest-free institution. The establishment of the Dubai Islamic Bank in the UAE in 1975 is considered to be one of the earliest private initiatives.

In 1975, the Islamic Development Bank (IDB) was established on the lines of regional development institutions with the objective of promoting economic development in Muslim countries as well as offering Shariah-compliant development finance. The Jeddah-based IDB has played a key role in expanding Islamic modes of financing and in undertaking valuable research in the area of Islamic economics, fiancé and banking. During the 1970s, the concept of a financial murabahah (trust financing) was developed as the core mechanism for the placement of Islamic banks' funds.

The 1980s marked the beginning of a trend of rapid growth and expansion for the emerging Islamic financial services industry that continued through the 1990s. During that period, the Islamic Republics of Iran, Pakistan and Sudan announced their intentions to transform their overall financial systems to make them compliant with the Shariah. Other countries such as Malaysia and Bahrain instituted Islamic Banking within the framework of their existing systems.

PHASE III: 1990s –PRESENT

By the early 1990s, the market had gained enough momentum to attract the attention of policymakers and institutions interested in introducing innovative products. Recognizing the need for standards, a self-regulatory agency –the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) –was established. This was instrumental in highlighting the special regulatory needs of Islamic financial institutions and in defining accounting and Shariah standards, which were adopted or recognized by several countries. However, with the growth of the market, the regulatory and supervisory authorities, with the help of the IMF, established a dedicated regulatory agency, the Islamic Financial Services Board (IFSB) I the early 2000s to address systemic stability and various governance and regulatory issues relating to the industry.

Further, progress was made in developing capital markets, Islamic asset-backed certificates, sukuks, were launched successfully in Bahrain, Malaysia and other financial centers. During the equities market boom of the 1990s, several equity funds based on Shariah-compatible stocks emerged. The Dow Jones and Financial Times launched Islamic indices to track the performance of Islamic equity funds.

The number of conventional banks offering Islamic windows grew. Citibank was one of the early Western banks to establish a separate Islamic bank –Citi Islamic Investment Bank (Bahrain) in 1996 –and the Hong Kong and Shanghai Banking Corporation (HSBC) now has a well established network of banks in the Muslim world. With the objective of promoting Islamic asset securitization and private equity and banking in OECD countries, HSBC Global Islamic Finance (GIF) was launched in 1998. The list of Western banks keeping Islamic windows includes the American Express Bank Ltd., ANZ Grindlays, BNP-Paribas, Deutsche Bank USB, and Kleinwort Benson. The leading non-Western banks with significant Islamic windows are National Commercial Bank of Saudi Arabia, United Bank of Kuwait, and Riyadh Bank.

Several institutions were established to create and support a robust financial system. These institutions include the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (CIBAFI) and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI).

Islamic finance has begun to go global. Although Western financial centers and financial intermediaries have always played an important part in executing and innovating Islamic transactions, such activities have been mostly carried in the private sector and in a discreet fashion. By early 2000, this trend had begun to change, with several non-Muslim countries taking an interest in this emerging financial market. This can be attributed to several factors such as booming oil revenues leading to accumulation of investible funds looking for attractive investment opportunities; an increased awareness of regulatory issues relating to Islamic financial intermediaries; and the desire to tap into alternative funding resources by sovereign and corporate entities.

The presence of Islamic finance is beginning to be felt all over the world and multilateral institutions are also engaging with the market. The World Bank and the IMF have made contributions to this field through research, and other institutions are also getting involved.

The International Finance Corporation (IFC) –the private-sector arm of the World Bank –has executed several Shariah-compliant transactions. In 2009, IFC issued sukuk to the value of US$100 million for funding Islamic finance projects in key sectors such as health, education, and infrastructure in the Middle East. In 2007, the World Bank affiliated Multilateral Investment Guarantee Agency (MIGA) provided its first-ever guarantee for Shariah-compliant project financing, worth US$427million.

Recent Trends in Islamic Financial Markets

There is no formal or systematic source of statistics on Islamic finance but several estimates are often quoted by different commercial and non-commercial sources. According to the 10-Year Master Plan for Islamic Financial Industry prepared by the IDB and IFSB, by the end of 2005, more than 300 institutions in over 65 jurisdictions were engaged in Islamic finance. In a broad sense, the Islamic financial industry consists of a number of components such as Islamic banks, Islamic windows, capital markets, Islamic insurance (takaful) and other non-bank financial institutions. Islamic banking usually refers to offshore and onshore deposit-taking commercial and investment banking and is the most dominant sector of the market. Islamic are specialized windows available through conventional banks catering to the demands of Islamic products. Historically, Islamic banking and windows have been the most active sector but in the last decade other forms of financial products and services have been gaining momentum. Activities in the capital markets in the form of Islamic funds or Islamic bonds (sukuk) are increasing and there are institutions specializing in asset management, mutual funds, and brokerage houses. Islamic non-bank fiananacial institutions, which include specialized institutions offering financial services through leasing (ijarah) or partnership (mudarabah), perform a similar function to conventional fund-management companies. There is a limited but growing number of institutions engaged in micro-finance, venture capital and private equity financing.

Table 1 shows the total size of different segments of the market, compiled from different sources. Given the lack of transparency in financial disclosure by financial institutions in developing countries, these estimates are, if anything, on the conservative side, and the actual size of assets under management is likely to be significantly higher.

Table 1. Total assets under management as of 2010

Sector	Amount (US$ billions)
Islamic banks	400
Islamic windows	250
Sukuk (Islamic Bond)	120
Islamic funds	45
Takaful	5
Total	820

Source: IFIS and other estimates

Islamic banks have experienced high growth, as shown in Table 2 Which lists growth rates of assets and deposits in selected countries in the Middle East and North Africa (MENA) region. From this, it is clear that the growth rate was high during the 2006-2007 and 2007-

2008 period but there were signs of a slowdown after that. This can be attributed to economic slowdown after the financial crisis.

Table 2. Growth rates of assets and deposits across countries

Country	Banks in Sample	Assets		Customer Deposits	
		Growth Rate (%)		Growth Rate (%)	
		2006–07	2007–08	2006–07	2007–08
Bahrain	12	48.54	39.00	58.33	32.07
Egypt	2	21.27	10.53	22.89	9.54
Jordan	2	(9.30)	25.86	(8.59)	16.34
Kuwait	2	47.04	19.33	51.05	24.94
Lebanon	1	362.09	145.54	(3.02)	21.43
Qatar	2	34.64	47.94	26.63	31.98
Saudi Arabia	3	23.16	27.94	28.65	22.32
UAE	5	40.28	17.07	46.16	19.56
Yemen	1	7.29	20.08	6.13	18.73
MENA Region	30	34.50	24.50	37.47	22.28

Source: Ali, Syed Salman (2011), Islamic Banking in the MENA Region, Washington, DC,USA. http://siteresource.worldbank.org/INTMNAREGTOPPOVRED/Resources?MENA FlagshipIslamicFInance2_24_11.pdf

In general, the trend is that competition is increasing for Islamic banks, as conventional banks are also pursuing this business aggressively. Several Islamic banks that once enjoyed a virtual monopoly in the market are now threatened by conventional banks that may have better marketing networks, name recognition, and economies of scale. For example, according to some estimates, Islamic banks accounted for 71 percent Islamic assets in 2008 as compared with the almost-100 percent share recorded in 2003.

During the subprime financial crisis, Islamic banks were largely immune because they did not have any investment in toxic debt-based assets. However, Islamic banks were not insulated from the regional economic slowdown arising from global economic recession. It was observed that, during the first half of 2009, banking assets in the GCC countries declined by 1.1 percent while assets of the five largest Islamic banks increased by 1.3 percent. This compares with the rise of 17 percent and 21.5 percent, respectively, in 2008.

Islamic capital markets which grew rapidly were also impacted by the financial crisis. This is evident from the drop in the issuance of Islamic bonds (sukuk) in the post-crisis period. There were also several cases of legal disputes concerning sukuk which sent negative signals in the market and put downward pressure on demand. However, as legal issues were sorted out in orderly fashion, the market has seen a rebound in demand. For example, the sukuk issued by the IDB in 2010 was well received in the market and its demand exceeded the amount offered.

Finally, in another positive move, several central banks signed an agreement in October 2010 to establish a liquidity facility for Islamic financial institutions with the objective of providing liquidity-enhancing products in the market and to offer liquidity through trading short-term financial instruments.

Growth of Islamic Banking Assets in the GCC

According to estimates by Ernst and Young's Global Islamic Banking Center, Islamic banking assets with commercial banks in the GCC reached US$ 445 billion at the end of 2012, up from US$ 390 billion in 2011, with the outlook for the industry remaining relatively positive in 2013.

This represents a 14% year-on-year growing market where Islamic banking assets are expected to have grown by more than 23% during 2012. While Islamic banking assets with commercial banks in the GCC grew by 14% in 2012, conventional banking assets grew by only 8.1%-indicating the relative resilience and potential of the industry.

Global Islamic Banking assets with commercial banks are now at US$ 1.55 trillion at the end of 2012 and projected to exceed $2 trillion by 2015. Ernst and Young's Islamic Banking Universe in its estimates represents banks across 22 major Islamic finance markets.

Islamic Banking Vs Conventional Commercial Banking

Like conventional bank, Islamic bank is an intermediary and trustee of money of other people but the difference is that it shares profit and loss with its depositors. This difference that introduces the element of mutuality in Islamic banking makes its depositors as customers with some ownership of right in it.

Islamic banking and conventional banking differs in that while the conventional banking follows conventional interest-based principle, the Islamic banking is based on interest free principle and principle of profit-and-loss sharing in performing their business as intermediaries. Moreover, Islamic profit-loss-sharing principle creates the relationship of financial trust and partnership between borrower, lender and intermediary.

Islamic finance is a financial system with the aim to fulfill the teaching of Holy Quran as opposed to reaping maximum return on financial assets. Conformity to norms of Islamic ethics is the main concern of Islamic financial system. These norms of Islamic ethics as enunciated by the Shariah govern all transactions in an Islamic financial system. At a fundamental level, an Islamic financial system can be described as a "fair" and a "free" system where "fairness" is the primary objective; however, it also circumscribes the "freedom" of the participants in the system. Though, in islam participants are free to enter into transactions but this basic norm of freedom does not imply rampant freedom to contract and is constrained by the other norms, such as, the prohibition of interest (Riba) and uncertainty (Gharar).

An Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment as compared to a conventional bank which is basically a borrower and lender of funds. Difference between the two banking systems also lies in terms of governance structure. Islamic banks must obey a different set of rules –those of the Holy Quran –and meet the expectations of Muslim community by providing Islamically acceptable financing modes.

Islamic banks are similar to those of non-Islamic banks in that both offer similar (financial) services and play a pivotal role in the economic development of their societies. But they are different in that Islamic banks, unlike non-Islamic banks, are bound to follow Islamic Shariah in their operations. Islamic banking is based on Islamic faith and its operations must be within the boundaries of Islamic law (i: e, Shariah). There are four rules that govern investment behavior:

1. The absence of interest-based (Riba) transactions;
2. The avoidance of economic activities involving speculation (Gharar);
3. The introduction of an Islamic tax (Zakat);
4. The discouragement of the production of goods and services which contradict the value pattern of Islam.

CONCLUSION

The concept of Islamic banking is essentially based on the idea that Islam prohibits interest, but permits trade and profit-loss-sharing arrangements. In an Islamic financial system, by definition, concerns about conformity to norms of Islamic ethics dominate all other concerns. All transactions in an Islamic system must be governed by norms of Islamic ethics as enunciated by the Shariah. At a fundamental level, an Islamic financial system may be described as a "fair" system and a "free" system. The objective of ensuring "fairness", however, is primary and it circumscribes the "freedom" of the participants in the system. While Islam provides a basic freedom to enter into transactions, this basic norm does not imply unbridled freedom to contract and is constrained by other norms, such as, the prohibition of interest and uncertainty.

Although the origin of the modern Islamic banking can be traced to the very birth of Islam, yet the interest-free banking seems to be of very recent origin. In the 1960 Muslim thinkers began to explore ways and means of organizing commercial banking on an interest-free basis, economists dismissed the idea as wishful thinking. However, the first modern experiment with Islamic banking was undertaken in Egypt (1960) followed by the establishment of Dubai Islamic Bank in 1975 as the first modern commercial bank based on Shariah principles.

The momentum in interest-free banking activity however, coincided with the worldwide celebration of the advent of the 15th century of Islamic calendar (Hijra) in 1976. Around the same time financial resources of Muslims particularly those of the oil producing countries received a boost due to rationalization of the oil prices which had hitherto been under the control of foreign oil corporations.

Islamic finance has recently received considerable attention in academics and policy making. Started over three decades ago in the form of commercial banking, the financial activities conforming to Islamic Law (Shariah) have spread to investment banking, project finance, capital markets, insurance, wealth management, and micro-finance.

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