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History of Islamic Banking

Performance Comparison to Western Banking

Diploma thesis

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I thereby declare that I produced this thesis by myself and all sources used are cited correctly in the reference list.

Jan Kolštrom

In Prague 13. 5. 2013

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Abstract

This diploma thesis is focused on comparison between conventional (interest based) and Islamic (profit-loss sharing based) banking systems. I examine historical and institutional development of the Islamic banking sector, from its very beginning up till today. I am paying great attention to development of the institutions related to stability of banking system, mostly regulative ones and I focus on the impact of these regulations on the Islamic banking system in period of subprime mortgage crisis. Main questions of the thesis are; how differences between both banking systems influence their performance during financial crisis and what factors are the most important ones in this divergence. Main hypotheses stand as follow: Performed Islamic banking sector better during period of the financial crisis and if, then why? I verify this hypothesis both theoretically and empirically. I study above mention problem from postmodern critical point of view based on economic history methodology.

Abstrakt

Tato diplomová práce se zaměřuje na srovnání konvenčního (na úroku založeného) a islámského (na sdílení zisků a ztrát založeného) bankovního systému. Ve své práci zkoumám historický a institucionální vývoj islámského bankovnictví od jeho prvopočátků až po současnost. Věnuji pozornost především vývoji institucí spojených se stabilitou bankovního systému, převážně pak regulativních a soustředím se na dopad těchto regulací na islámský bankovní systém v období finanční krize způsobené podřadnými hypotékami. Hlavní otázky práce jsou; jak rozdíly mezi oběma bankovními systémy ovlivňují jejich výkonnost během finanční krize a které faktory v tomto procesu hrají největší roli. Hlavní hypotéza práce je: Vedl si sektor islámského bankovnictví během období finanční krize lépe, a pokud ano tak proč? Tuto hypotézu testuji jak teoreticky tak empiricky. K problému přistupuji kriticky z postmoderního úhlu pohledu založenému na metodologii hospodářských dějin.

Klíčová slova

Islámské bankovnictví, úrok, finanční krize, sdílení zisků a ztrát

Key words

Islamic banking, interest, financial crisis, profit-loss sharing

JEL klasifikace / JEL classification

G01, N25, G21, Z12

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Introduction

My goal with this project is to research the Islamic banking industry. It is an opinion of the author, that such a vast topic cannot be covered with a simple dissertation work, because an extent is too small. Therefore only particular issue will be taken into account. The western banking sector plays an irreplaceable role in our society. The banking services play an important part in our daily life situations. We can hardly imagine any other mean of financial intermediation. It is also to assume, that most societies all around the world share the same perception, and that such opinion is not only common in the western one. Therefore Islamic society is not an exception. The banking system is considered necessary to support commerce, capitalism and prosperity of the whole society. Therefore making research about banking system is the most suitable to support these aims is very important. Generally, Islamic issues are current trend in scientific literature. With the increase of importance of the oil industry over last five decades[1], Arabic (and subsequently Islamic) world has moved into center of interest. During this shift, Islamic banking did not stand aside. Alternative and apparently viable system of banking has to be examined in detail in order to assess its possible application not only in the Islamic world, but globally. In the last two decades, western world underwent several periods of recession followed by turmoil in financial markets. These mostly hit in the banking sector. Especially one the last ones, so called "subprime mortgage crisis" hit some of the biggest players in the western banking sector pretty hard.

My goal with this dissertation is to provide a research on the Islamic banking sector during particular crises. If there is an evidence to be found, that Islamic banking is more stable and outperforms a western banking system, the reasons behind has to be found. So, the thesis of the dissertation goes as follows:

Target of this work is to characterize the historical and institutional development of Islamic banking and to prove its better performance during subprime mortgage crisis. It is necessary to discover key breaking-points in such development and to find reasons why Islamic banking developed as a synthesis of western commercial banking and Islamic culture (especially Shariah law), further to analyze current system of Islamic banking, especially to find and define stabilizing factor and to determine its significance for

[1] Hassan, Lewis (2007) p.12

performance of Islamic banking in comparison to western commercial banking as we know it.

There are many work problems regarding main thesis, which has to be answered in order to prove or disprove it. What is the Islamic banking? When was the first Islamic bank started? What are the basic principles? What were institutional grounds for Islamic banking? Which institutions played most important role in shaping it? What is the role of the Sharia Law? What is the role of Islam as the religion and subsequently the Holy Quran in the Islamic finance? Do religious elements make the system more stable? What were the incentives behind establishing Islamic banks? Why there were no Islamic banks prior to the 60s? What caused a rapid boom in the last four decades? Which products are provided by Islamic banking? Are they similar or different to western ones? What aspects of the sector make it more stable? Do Islamic banks perform better because they are better in terms of efficiency or because of religiously based principles they apply?

Given quite a short history of Islamic banking sector, the author decided to compare the performance of banking systems during the biggest lately crisis – 2007 subprime mortgage crisis[2]. It will be proven that the Islamic finance industry and subsequently its banking part showed surprising resilience to first-round effects[3] of the crisis. Islamic banking did not experience a series of bank runs, bankrupts or governmental bail-outs as we saw them in the USA and in Europe lately. This resistance of Islamic banks comes from basic principles implemented into Islamic banking – profit-loss sharing, prohibition of interest and emphasis on the real economy. Application of this principle protected Islamic financial sector from excessive lending, debt trading and other practices which stood behind the subprime mortgage crisis.

The work will be divided into four major parts. In the first chapter, methodology, current state of research and sources are discussed. Special attention is paid to the methodology of Islamic economy, which creates a broader framework in which I will operate in the course of research. Current state of research of Islamic finance is somewhat problematic and sometimes contradictory. These issues will be further elaborated in the section called Evaluation of sources. In the second chapter, historical and institutional

[2] Hassan, Driddi (2010)

[3] We will divide effects of the crises into two rounds further on. First round effects are effects related to initial downturns in financial sector, second round effects are related to real economy downturns which followed problems in financial sector.

development of the Islamic banking will be examined. There are over 14 centuries[4] of Islamic culture and some of the traditions regarding business and banking matters could be traced back to the very beginning. Especially studying the Holy Quran and hadiths[5] is needed. We can divide the history of Islamic banking into three sub-chapters. In the pre-colonial era, the basic institutional framework of ancient Islamic modes of trade will be discussed in connection with present practice. The second sub-chapter will cover probably the most important era of development - after the Second World War[6] and this period will be examined more thoroughly. Especially dissolution of the colonial powers and creation of new Islamic countries played a significant part in the later creation of Islamic banking. Special attention will be paid to the very beginning of the modern Islamic financial sector, starting in the 60s and further on. In the third sub-chapter, we will discuss the very first projects of the Islamic banking. They shaped the face of the whole industry and set up several guidelines followed till today. In this period basic principles of the Islamic banking were implemented on real financial institutions.

Third chapter will deal with the current state of the Islamic finance industry. We will discuss its global division, then its product differentiation. We will pay attention to banking sector mostly, but to provide a complete preview of Islamic finance industry, insurance, bonds and investment funds will be shortly discussed as well. Islamic banking is the main interest of ours, so there it will be broadly examined in the sub-chapter. We will describe the basic principles of Islamic banking and assess them with respect to global financial markets. Special attention will be paid to Islamic Moral economy – utopian system which creates a theoretical base for Islamic economy. There will be further research on products of Islamic banking with respect to their importance for the industry. In the final subchapter a comparison of ideal versus real Islamic banking will be compiled, showing that reality differs significantly from its theoretical framework.

The fourth and the last chapter will consist of a comparison of the conventional (interest based) and Islamic (non-interest) banking sector. There are two complete and complex systems, based on different grounds, exhibiting quite a performance in times of an economic upswing. What differs both, is the performance during turmoil in financial markets and that’s where, given the first-look evidence, Islamic banking highly overcomes

[4] Ahmed (2002)
[5] Prophetic narrations
[6] Islahi (2008)

western banking. The major crisis will be taken into the account sub-prime mortgage US crisis starting 2007. It hit global markets hard. There is a lot of scientific evidence about how hard hit these crisis western banks, but further broader comparison with the Islamic banking is missing. Therefore performance comparison with Islamic banking during these periods will be compiled in the last part.

1. Methodology

The Islamic banking is from a historical point of view quite a new phenomenon. We can date first theoretical works to fifties and establishment of first true Islamic banks to the beginning of the sixties. Therefore we can talk about five or six decades of the history at the best. If we considered the fact that conventional banking has over six hundred years of history (starting in the 14^{th} century North Italy), there is definitely a lag in the Islamic banking methodology. Surely a couple of hundred years of research are missing in the case of Islamic economy and subsequently banking in the field of methodological development. In the last few years, we can observe an effort of foremost economic experts (not only Muslim ones) to conduct a research in the field of methodology connected to Islamic economy. As long as there are significant social, cultural, religious and political differences in the Islamic world, this task is not easy to complete and it is an opinion of the author, that it will take probably more than a decade to reach some consensus on methodological approach in this field of study. I would like to sum up some of the most important ideas made so far and add some of my own opinions about the methodology as well.

I would like to mention some of academicians who are active in the field of Islamic economic methodology and from whose works I derived the most. Mohamed Aslaf Haneef, professor at the Department of Economics at the International Islamic University, Malaysia, conduct an excellent research on the current typology of method in Islamic economy and proposed several possible ways forward.[7] Muhammad Yusuf Saleem, from Islamic University of Malaysia, pointed at an inseparable relationship between Islamic economy and Islamic jurisprudence. His work on the methodology of the Fiqh[8] and its adoption by Islamic economy provides a different viewpoint on the issue.[9] One of the most respected writers in the field is Waleed Addas, Chief of programs and portfolio monitoring in the Islamic

[7] Haneef, Furqani, (2011)
[8] Islamic jurisprudence – an expansion of the Quran, supplemented by tradition or interpretation of Islamic jurists.
[9] Saleem (2010)

Development bank. His book, Methodology of economics: Secular vs. Islamic provides and extensive comparison between both approaches since the Greek philosophers[10] till today.[11] There are also western scientists, who are contributing to the matter. They are bringing in slightly different point of view. In the post-modern spirit, cultural and religious background is influencing viewpoint of every person involved. It is true that the majority of western academics involved in Islamic economy research has Islamic roots as well, but the influence of the different environment is significant. Mehmet Asutay, Durham University[12], UK, focuses on systemic issues in Islamic economy and applies a political economy approach.[13] Of course there are many more I could mention, but as long as this study does not focus on methodology that much, but rather on empirical research on the subject, there is no need to do that.

The general methodological framework of this work is set as post-modern study of economic history. Economic history, whether recent or past, displays economic experiments whose results and dimensions become known facts. Economic history can be used in the analytical process by reviewing the events and their sequence over the time to understand their causes and effects. Even though economic events do not repeat themselves, yet to learn their logic as to "why events happen" circumstances that accompanied them and their consequences can be very useful in explaining other events of similar nature and making some predictions on their possible effects. This is the essence of the logic of economic history.[14] The study of economic history reveals connection between studying issues and other phenomena and helps to connect economics with other sciences, mainly political, but social as well. There are over fourteenth centuries of history regarding the Islam. If we study its rise and decline over time, we can obtain much of an experience. Potentially there are many lessons to learn through this experience when it is studied in historical context. Knowing successes or failures of historical financial institutions is very useful in assessment of present and possible future of Islamic finance. As long as four decades are not "much of

[10] There are opinions suggesting that Islamic economic thoughts are filling the gap between Greek and Scholastic thoughts. For more details please see A.A. Islahi (2007) (http://mpra.ub.uni-muenchen.de/18102/)
[11] Addas (2008)
[12] Durham has been a centre for research and education in Islamic economics and finance for over twenty-five years. Islamic Finance programs at Durham University offer postgraduate research and taught degrees in Islamic economics, banking and finance. Durham University program represents United Kingdom´s increasing interest in Islamic finance. There is also quite amount of research on the topic going on.
[13] Asutay (2007)
[14] Ahmed (2002), p.44

the history" deeper historical research is needed to provide such and experience as a source of knowledge.

Postmodernism is a term used for evolution of scientific thinking which took place in western society since 1970s. Postmodernism replaces classical modern approach and set up a new intellectual framework to asses examined issues. In the case of history we are talking about much more critical approach. History should be treated critically either through critical methods or critical instruments. Postmodernism also abandons the assumption of total positivism of historical science and declares that every scientist´s personal preference is mirrored in the research. The community creates narratives about history from its specific point of view. Therefore we will address one specific narrative in this work – narrative created by community of Islamic scientist. We will conduct research on the story about Islamic economy, alternative and better system than western capitalism and its real manifestation – Islamic banking. As the author comes from the western world, quite critical approach will be implemented.

1.1 Methodology of the Islamic economy[15]

The Islamic economy is a relatively new discipline. The methodological study plays a role in developing the discipline itself. In addition, if most of Islamic economists claim that conventional economic theories are infused with vision or values that are not in-line with Islamic vision and values, then, one main task is how to develop economic theory that can be, and is, infused by Islamic vision and values. Without a proper methodology of Islamic economy this task could not be done properly.[16] Islamic economy and all its subsequent parts should be based on Islamic values. Therefore, methodological approach has to take into account sources of these values and be based on them in order to be compatible with religious and cultural demands of the Islamic world. The Islamic economy aims at a world order, where it's ontological and epistemological sources, namely the Qur'an and Sunnah, determines the framework of the economic value system, the operational dimension of the economy and the economic and financial behavioral norms of the individual Muslims.[17]

[15] Islamic economy is economical system based on Islamic values. It is also utopia, perfect system proposed by scientists. The Islamic banking is an expression of the Islamic economy (and Islamic values) into a reality, so a methodological approach holds for the both.
[16] Haneef, Furqani, (2011) p.2
[17] Asutay (2007) p.5

Therefore the Quran and Sunnah[18] and all subsequent norms derived from them both are the cornerstones for methodological approach.

We can set seven basic axioms of Islamic economy with respect to the Quran and Sunnah[19]:

- First, the axiom of Tawhid (God's unity and sovereignty). The Islamic World view is based on Tawhid, or the Oneness of God.
- Secondly, the axiom of Al-'adl wa'l-ihsan (Equilibrium and Beneficence or Socioeconomic Justice). Individuals are expected to establish justice ('adl) and promote beneficence (ihsan).
- Third, the axiom of Ikhtiyar (freewill). In the Islamic economic systemic understanding, humans are believed to be endowed with freewill.
- Fourth, the axiom of Fard (Responsibility). This axiom states that although 'responsibility' is voluntary, individuals and society must recognize their mutual obligations for public good (masladah).
- Fifth, the axiom of Rububiyyah. This implies the necessity of sustainable economic growth and development in terms of having harmony between various components of economic and social life.
- Sixth, the axiom of Tazkiyah. This axiom is concerned with growth towards perfection through purification of attitudes and relationships. It directs the individual towards self-development, which leads to economic and social development in harmony.
- Seventh, the axiom of Khilafah and human accountability before God. The implications of the principle of Khilafah include the notion of universal solidarity, sustainable consumption of resources, which are trusted from God, pursuing a humble lifestyle and having human freedoms to conduct daily life.

As you can notice, there is an emphasis on social solidarity, harmony, free will and self – development. In the framework of the Quran, these are basics of Islamic economy. The Quran serves as a foundation of the legal system – the Shariah.[20] Each person should

[18] It is necessary to note that Shia Muslims are working with different set of source, not based on the Sunnah. But as long as majority of research is based on the Sunnah, this work will be based on it as well.
[19] Asutay (2007) p.7
[20] In comparison with western legal system, the Shariah does not stand as a "human law", but rather as infallible Law of God – in opposition to human interpretation of law – Fiqh. It also varies between different

conduct its daily matters in compliance with the Shariah. The objectives of Shariah (Maqasid al-Shariah) then constitute the framework for axioms stated above. All together they serve as a guideline for everyday life in Muslim society, financial and banking issues including.

We can observe three types of approaches to methodology of Islamic economy today. First is Usul-al-Fiqh[21]. Originally it covers only juridical issues, but with the rise of Islamic banking, need for legalization raised as well. Islamic economy is nothing more than the result of applying the Islamic rules and injunctions, i.e., Islamic Fiqh, to the prevailing secular theoretical structure of economics to separate the permissible from the non-permissible, as well as to ascertain the position of the Shariah on economic acts, and current business events.[22] Contemporary body of knowledge of Islamic economy is dominated by Fiqh. There is a relevant critique of this issue. Methods of Fiqh are designed to find out whether something is permissible or prohibited, but as long as economics is a social science, proper unit to analyze such a science is society itself, not a set of rules based on ancient principles. While in Fiqh, rules are permanent in nature and for all individuals; economic descriptions may change from time to time and from society to another.[23] The Fiqh reasoning creates one of the cornerstones of the methodology however as society evolves through time further research on the issue is needed.

Second approach can be described as methodological plurality. We can observe using both Islamic and western methodologies in research. The conventional methodology is developed in a secular worldview that excludes religion in the scientific realm. In Islamic methodology, not only religion is linked to scientific endeavor, but, it is its epistemological basis and foundation.[24] Such a plurality is in place considering the fact that Islamic epistemology recognizes multiple sources of knowledge.[25] Therefore various theories could be applied. There are also voices stating that the Islamic economy has a much greater task

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Muslim cultures which makes it decentralized and leads to various confusions with regards to international affairs, finance including. (What is permissible in one culture is not necessarily permissible in another). Therefore the Sharia creates rather framework than explicit legal system.

[21] Legal methods of reasoning in Islamic jurisprudence

[22] Addas (2007) pp.5,97

[23] Saleem (2010) p.1

[24] Haneef, Furqani (2011) p.5

[25] The Quran, Sunnah, hadith (prophetic narrations), the Shariah and Fiqh.

than conventional as it aims at promoting human well- being, rather than just explaining each individual behavior in a scarce resource environment.[26]

The third approach is the methodology in the Islamization of economics (IOE) project when the scholars attempt to interact and integrate the mainstream economics with Islamic principles/heritage in economics and vice versa. The program is part of a bigger project of Islamization of knowledge[27] that attempts to recast the whole legacy of the body of knowledge from an Islamic perspective by adopting the best that mainstream economy offers, then to imbue these with Islamic principles and to inform further developments with Islamic values.[28]

The best way to understand the methodology of Islamic economy is to compare it to neo-classical framework to distinguish it.[29]

<u>Neoclassical methodology:</u>

- The starting point is methodological individualism.
- Behavioral postulate: self-interest oriented individuals who (a) seek their own interests, (b) in a rational way, and (c) try to maximize his/her own utility;
- Market exchange.

Hence, the conventional economic system is based on a one-dimensional utility function, which leads to homo-economicus - the economic individual in a market system. On the other side, the Islamic economy methodology goes as follows:

- Socio-tropic individual, for whom not only individualism but social concern is a prerequisite.
- Behavioral postulates: socially concerned God-conscious individuals who
    A. In seeking their interests are concerning the social good,

[26] Chapra (1995) p.5
[27] Islamization of knowledge (IoK) is a term which describes a variety of attempts and approaches to synthesize the ethics of Islam with various fields of modern thought. Its end product would be a new ijma ("consensus") among Muslims on an appropriate Fiqh ("jurisprudence") and scientific methods that did not violate Islamic ethical norms. However, there are modern issues which cannot be connected with Islamic ethical principles (anti-globalism movement, terrorism). Therefore IoK program is considered not suitable to be applied generally, but it has been pretty successful especially in field of economics.
[28] Haneef, Furqani (2011) p.6
[29] Asutay (2007) p.12

B. Conducting economic activity in a rational way in accordance with Islamic constraints regarding the individual and social environment and the hereafter; and

C. In trying to maximize his/her utility, they seek to maximize social welfare as well by taking into account the hereafter.

- Market exchange is the main feature of economic operation of the Islamic system; however, this system is filtered through an Islamic process that produces a socially concerned environmentally friendly system. In this process, socialist and welfare state oriented frameworks are avoided not to curb incentives in the economy.

As you can see, methodology fully complies with seven basic axioms stated above. It is an opinion of the author, that there is consistent methodology concerning the Islamic economy. The consistency does not necessarily mean that this methodology is right and proper. Especially Fiqh issues have to be addressed more deeply.[30] It is also necessary, for the purpose of this work, to state that Islamic economy is theoretical system. It was proposed in the middle of the 20th century by Islamic scientists as a theoretical alternative to Western capitalism. By its definition, Islamic economy is somehow perfect utopia to which Islamic world should converge.[31] In this sense, we can describe Islamic banking as a manifested aspect, real experiment of viability of Islamic economic theories. Within this, Islamic financial institutions, in the form of modern banks, have been established to function according to the values, axioms and principles of the Islamic economy system. The growth in the development of Islamic finance has been remarkable with over three hundred Islamic banking and financial institutions operating not only in Muslim countries but also over seventy countries in the world.[32]

2. Current state of research

Islamic economy and its subsequent parts, like banking, are rising stars in the academic field. It is promoted as an alternative and better system to western capitalism. In the light of the current crisis of the western world – not only economical, but cultural as well, possible alternatives are naturally attracting much attention. More and more experts,

[30] For more details about Fiqh issues please see M. Y. Saleem (2010) (http://irep.iium.edu.my/450/)

[31] It is very similar to perfect competition market in neoclassical theory. We will discussed this issue more in detail below.

[32] Asutay (2007) p.15

professors, PhD. students and even graduates are conducting research in this area and we are witnessing establishment of the whole educational programs aimed at Islamic finance.[33]

Given its history, Islamic world could not provide much of the consistent full-scale research on Islamic banking or finance. There are many works of ancient Muslim thinkers, like Abu Yusuf (113-182AH[34]), Al-Ghazali (451-505AH), or later Abdulrahman Ibn Khaldun (1332-1466) and Aldin Al-Maqreezi (1364-1416), but these mostly focus on general issues related to the essence of Islamic economy.[35] The evolution of Islamic thinking was interrupted by decades of the colonial occupation of the most of the Islamic world. We can observe some kind of rebirth during the second part of the twentieth century. Economic questions were at the center of interest of newly created countries and we can find works regarding finance ever since. But still with no hard data and only short statistical evidence, scientific research till 80s was more or less theoretical and very dispense. Hand in hand with the economic success, scientific research boosted as well. Several research institutions had been established in the Islamic world. Islamic Research and Training Institute (IRTI)[36], International Institute of Islamic Thought (IIIT)[37], Islamic Educational, Scientific and Cultural Organization (ISESCO)[38], Islamic Research Institute (IRI)[39], just to name a few.

[33] For example Harward´s Islamic Legal studies program. (http://www.law.harvard.edu/programs/ilsp/research/IFP.php)

[34] AH(anno hegirae) – years in Islamic calendar, it starts 622 AD by emigration of Mohammed to Medina (hijra)

[35] Visser (2009) p.2

[36] Established in 1981, the Islamic Research and Training Institute is an affiliate of the Islamic Development Bank Group responsible for leading the development and sustenance of a dynamic and comprehensive Islamic Financial Services Industry that supports socio-economic development in Member countries. IRTI's research activities aim at organizing and conducting basic and applied research with a view to developing models and methods for the application of Shariah in the fields of economics, banking and finance.(www.irti.org)

[37] Private non-profit organization established in 1981 in USA. It is highly controversial because there are connections to Muslim Brotherhood, organization often connected with terrorism. The Institute is an intellectual forum working on educational, academic and societal issues from an Islamic perspective to promote and support research projects, organize intellectual and cultural meetings, publish scholarly works, and engage in teaching and training. (http://www.iiit.org)

[38] Islamic Educational, Scientific and Cultural Organization, established in 1981, within the framework of Organization of Islamic Conference, aimed “at the traits of Islamic culture and education promoting them in the Islamic world as well as throughout the world, stressing the need to coordinate activities of Islamic scientific and educational institutions existing in various countries of the world, with a view to fostering full integration among them and establishing understanding and cooperation among institutions and eminent figures in the field of Islamic culture, on the one hand and other cultures, on the other hand, for the benefit of humanity and world peace“ (http://www.isesco.org.ma/)

[39] Islamic Research Institute is the Pakistan´s foremost institution for „ organizing research on Islam, to give it a rational and scientific interpretation in the context of modern age and to bring out the achievements of Muslims in the fields of history, philosophy, science and culture", established 1960. (http://iri.iiu.edu.pk/)

These institutions provide solid ground for theoretical research on Islamic finance issues and train scientist with most actual knowledge.

Together with research institutions, many academic programs were established as well. Contemporary whole study programs are open for candidates. Foremost universities focusing on the issue are International Islamic University in Islamabad, The University of King Abdul-Aziz in Jeddah and the International Islamic University of Malaysia in Kuala Lumpur. In December 1995, the Harvard Islamic Finance Information Program (HIFIP) was opened. In the Europe, mostly Great Britain with its large minority of Muslims is involved in scientific research about the topic. If we should name foremost contemporary authors – Munawar Iqbal, chief of research at IRTI, Mahmoud El-Gamal, professor at Rice University, Timur Kuran, professor at Duke University, Mosin S. Khan, IMF etc.

There is no doubt that Islamic culture at its peak was one of the most scientific societies of these days. There is even serious evidence[40] that Islamic scholars were closing the gap between antique and medieval science, economic issues including. Therefore institutions which originated in between 12-16th century has to be examined in detail compared to European ones. We are talking especially about modes of trade, modes of financing and inheritance law. There is a crucial question. Do these institutions support commerce and the evolution of the banking system or crippled it? Also some research of connections of Islamic society and religion is necessary to understand the importance of the Quran in shaping of the finance and banking system. The religion nowadays plays much more important role in the Islamic world than in western one. But it is a current trend, earlier we can find an evidence of the similar approach to religion in both cultures. It is a fact, that one the most important difference between the conventional and Islamic banking – approach to interest, is treated in the same way by the Bible[41] and the Quran.[42] Christianity considered usury morally unacceptable and we can find notions in Old Testament supporting its demise.

[40] Hassan, Lewis (2007)

[41] In fact, the divergences between the two religions on their stance about usury (excessive interest) go a long way to explaining why Christianity relaxed and eventually retreated from the ban on usury, while Islam has not. One factor was the lack in the Christian creed of an overriding injunction on the subject like that in the Holy Qur'an. That deficiency, along with ambiguities on related issues such as the acceptability of trade, opened up Catholicism to the inroads of Protestant revisionist interpretations on usury. Another difference came from the severity of the temporal penalties applied to usurers by the Christian ecclesiastical courts. These inhibited much legitimate trade and at the same time raised the incentive to evade the prohibition in the form of taking advantage of various legal loopholes, which brought the institution itself into disrepute because of the transparency of some of the devices.

Recently, there have been many researches passing off related to financial crises. As the current one is slowly passing by, questions regarding its origin, process and how to prevent its recurrence are often asked. Major western banking players were involved in every financial crisis. Therefore, western society paid greater attention to efforts in clarifying the causes of every single crisis we saw.[43] It means that we can find plenty of empirical and statistical data regarding these events. Sadly from the Islamic scientist's point of view, there is not so much evidence and thorough research in statistical reviews of Islamic financial institutions is needed to assess their performance correctly. In order to compare both banking systems, key statistical indexes regarding banking industry will be used (ROA, ROE, profit, return, capital adequacy, etc.)

3. Evaluation of the sources

In the dissertation, the author will use mainly sources regarding Islamic banking and finance only. It is also necessary to study Islamic economy as a whole, but for the purpose of this work only simple research will suffice. As stated above, fragmentation of each topic makes use of proper resources difficult. Given the fact that many Islamic scholars were given western education, most of the sources are written in English language. Therefore grounds of the work will be based on several major monographs on the topic – Money and Banking in Islam[44], Handbook of Islamic Banking[45], Islamic finance: law, economics and practice[46], Islamic finance in the global economy[47], Methodology of economics: secular vs. Islamic[48], Risk analysis for Islamic banks[49] etc. These monographs will be supported by research on scientific papers on topics closer to the issue. There are several scientific journals providing space to publish these papers – International Journal of Islamic and Middle Eastern Finance and Management[50], The Journal of Economic History[51], Islamic Economic Studies[52], Banking and Finance[53], Arab Law Quarterly[54] etc. Important sources

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[42] Addas (2008)
[43] To name just most recent ones: the Mexico's Tequila crises of 1994, the Asian /Russian crises in 1997-1998, September 11th attack in the United States in 2001, Iraq war in 2004, financial crisis in November 2005 and the global financial crisis of 2007-2009.
[44] Iqbal, Khan, Ahmed (1986)
[45] Hassan, Lewis (2007)
[46] El-El-Gammal (2006)
[47] Warde (2000)
[48] Addas (2008)
[49] Greuning, Iqbal (2008)
[50] (http://www.emeraldinsight.com/products/journals/journals.htm?id=IMEFM)
[51] (http://journals.cambridge.org/action/displayJournal?jid=jeh)
[52] Scientific journal of IRTI organization (www.irti.org)

are official publications of international financial organizations, mainly IMF research papers[55], IDB statistical reviews and yearly Global finance Islamic report. Also internet websites of organizations regarding Islamic finance are valuable research sources. Every work in the historical field should be completed with the work in the archives. The author decided not to use this particular method because given the short history of modern Islamic banking; there are sufficient resources available elsewhere, mainly online.

4. History of the Islamic banking

History of the Islamic finance industry can be roughly divided into three periods. There is something we called pre-colonial era. It covers "the golden age" of Islamic culture, from its very beginning till approximately 16-17th century. Then there is shorter but very important era of colonialism, when majority of countries with an Islamic population was under the rule of colonial powers. Finally we will cover the period since the sixties and up till now, which was particularly important for Islamic finance, till now. Dissolution of colonial empires together with the increasing significance of Arabian countries played important role in establishing of Islamic finance. We will go through each period we mentioned in next chapters. Our goal is to identify important events connected to evolution of Islamic finance and to examine critical institutions, which evolved over time and are somewhat connected to issues of Islamic banking.

4.1 Pre-colonial era

History of Islamic banking cannot be treated separately. Even though globalization was an unknown term in ancient times; there were significant trade and cultural link between different parts of the world – in this case, Europe and Middle East.[56] If we would like to understand the very basics of Islamic finance, we must not focus only on last three decades, but we must dig deeper, to the very beginning of banking operations in the Middle East area. There is evidence that first operations, which can be considered as a primitive banking, took place in the cultures encircling Mediterranean Sea. There were several religions prior to 7th century covering vast areas so it is not surprising, that temples were the

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[53] (http://www.journals.elsevier.com/journal-of-banking-and-finance/)
[54] (http://www.brill.com/arab-law-quarterly)
[55] African department and Middle East and Central Asia Department pay lot of attention to Islamic finance sector.
[56] For more details please see Greif (1989) (http://dx.doi.org/10.1017/S0022050700009475)

first places of banking operations.[57]Partnership and profit-sharing financing structures—concepts that are integral to Islamic finance—continued to flourish in areas of the Mediterranean region as late as the 12th and 13th centuries. And they exist today around the world in the form of cooperatives (such as customer-owned retail or food stores), Mutual Takaful (Islamic insurance) companies, and others.[58]

From the eighth to the fifteenth century, the Islamic civilization was the center of global progress. In contrast, no one can seriously oppose that today's Muslim world is in a state that could only with kindness be called stagnation. It is militarily and economically weak, scientifically comatose, technological living off infusions from the West, and politically plagued by tyrannies. Many in both the West and within the Muslim world have come to ask whether Islam is compatible with modern ideas.[59] Therefore there are important questions to ask. What are the reasons behind such a decline? Are there external, internal or both types of factors to be blamed? Economical power is the cornerstone of today`s society. We divide the world in between the rich North and the poor South. Therefore we will conduct research on economical reasons behind the Islamic civilization´s decline. Banking is an indivisible part of economical progress and it significantly supports the rise of economic power. There is historical evidence that development of banking in Europe was one of the most important factors behind the dominance of western culture for many centuries. We can then form a question considering Islamic world today´s state – Why there were no Islamic banks prior to 1970s? If there is a similar development of European and Islamic culture since the 7th till the 13th century, why we observe the development of the modern banking system in Europe and none of that in the Middle East?

Islam dates back to the 6th century AD. If we would like to date it properly, we can use date of first Hijra (Islamic calendar), 622 AD, as a starting point. Islam and the Holy

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[57] The first stable international currency, the gold bezant, emerged in the fourth Century and was coined by the Byzantine Empire, which bridged the medieval European and Islamic cultures through its capital in Constantinople. The availability of a widely recognized and cross-cultural currency enabled people to undertake more ambitious commercial ventures and wider travel than in the past and provided increased opportunities for private individuals to acquire wealth throughout Europe and the Middle East. Following the emergence of stable coinage, banking activities quickly developed to accommodate international trade. Early merchant banks began to deal in bills of exchange and credit-based transactions. These new financing instruments eliminated the need for merchants to actually deliver the precious metals and coins to pay for transactions in distant ports. In the 11th century, Western Europe, to finance the Crusades, revitalized its credit-based banking system. Thus, the combined forces of Middle Eastern and Western European banking practices were exported around the world as the nations of these regions undertook new global exploration and international trading relationships.

[58] Zahari, Shanmugan, (2009) p.2

[59] Ahmad (2004) p.1

Book of Quran are based on traditions of Arab tribes from the area of the Arabian Peninsula. Also all notes about trade and finance came from the first era of Islamic culture.[60]

Nowadays, there are 21 operational modes to perform banking transactions. We will discuss them in the detail later. However, all of them are based on ancient transactions methods and some of them are basically intact since the 6th century. Most important and the clearest connection throughout history represents mudarabah – single venture partnership.

As Kuran (2003) states, there are two basic law principles regarding Islamic finance in Sharia – Law of Partnership and Islamic inheritance system[61]. The following pages will verify that these two institutions played a significant role in the development of the Islamic finance which dates back to ancient times and up till today. Islamic civilization reached its highlight around 15th century. But frequent trade between Europe, Middle East and Asia was common much earlier. Trade caravans, fleets and other ventures were most common modes of trade. To take part in such a venture, Islamic culture developed a unique tool – Islamic partnership (single venture). Back then, it was a strong and powerful mode of financing business, having its consequences in social and political sphere as well. The Mudarabaha, or single venture partnership, as stated above, was most common kind of business transaction.[62] There were many regulations concerning Islamic partnership in Islamic law. Basically it was the legitimization of prevailing commercial habits between 7th and 10th century.[63] Islamic partnership was poorly suited to produce large, long term trade ventures. As an institution, we can mark the Islamic partnership as "self-reinforcing" – its position in society strengthens with time. Roughly around the same time we can see similar development of trade in the Europe. As Kabir and Lewis (2007) discovered:

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[60] We can find notes about trade and finance in the Quran and subsequent hadiths, for example: *"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, payment made hand by hand. If anyone gives more or asks for more, he has dealt in riba. The receiver and giver are equally guilty".* Above mentioned verse still serve as a base for decisions about riba in modern Islamic banking (gold and silver are considering to be money).

[61] Kuran (2003)

[62] Typical partnership consisted of two people cooperating in a single trade mission. Profit shares were set up before trade mission took place. Whole agreement was for one use only. If one of the partners died, whole agreement had to be negotiated again. More partners meant higher likelihood to premature liquidation, so partnership tended to be as small as possible, bigger ventures were more expensive because of risks. Merchants were not responsible for losses, unless they made initial investment as well. Only capital owners were entitled to losses.

[63] Kuran (2003) p.428

"…finance-based partnerships involving merchants find mention in Islamic sources around 700 CE, but the origins in the West (the *commenda*[64]) go back no further than the tenth century"[65]

If there was a very similar development in trade habits on both sides, what caused stagnation on one side and unprecedented commercial boom on the other?

There were 233 distinct commercial occupations in Islamic culture between 8-11th century. There was roughly the same number at the beginning of the 20th century. On the other way, all other sectors were evolving, so there was inertia[66] only in the commercial sector.[67] To find reasons behind such stagnation, we have to look closely at Islamic inheritance law. It is strictly defined by the Quran and the Quran, as the highest authority, was used as a base for a legal system. We will not examine inheritance rules in details, but we will choose few very important parts. Restricting the individual's testamentary privileges to one-third of his or her estate, the Qur'an reserves the bigger portion for male children, female children, spouses, parents, brothers and sisters, and possibly even distant relatives.[68] On one hand a great degree of attention is paid in regard to the social status of women. In order to ensure woman's future after husbands' possible death, rather bigger part of the fortune is entitled to the wife - compared with the European standards where her position is equal with other persons mentioned in the Testament. On the other hand there were no laws regarding possible business options for women, so fortune inherited in such a way could be only used to maintain social status over a short period of time, not to invest it further. The basic outcome of such strict law was fragmentation of fortune. Combined with the single-use principle of Islamic partnership and need of re-negotiation after the demise of one partner, accumulation of wealth was almost impossible. Increasing of transaction cost of the mudarabah contract in case of death of one partner was almost prohibitive.[69]

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[64] Form of mudarabaha used in North italian cities
[65] Kabir, Lewis (2007) p.75
[66] Kuran (2003) p.425
[67] We can say that society´s commercial capabilities are depended on its legal structure. Society with more commercial-open legal structure has competitive advantage over others and there is feedback between law and economic structure (economic structure is influencing law environment as well).
[68] Kuran (2003) p.428
[69] To see tragedy of such legal organization we can compare it to European one. There were many legal entities – city states, monarchies at the time in Europe and inheritance law were variable. They differ from similarly rigid as Islamic ones on one side, to truly liberal on the other. Such a competition between legal systems led to rapid changes in institution of inheritance. If we would choose from many, most successful were system of primogeniture or ultimo geniture. The option of giving whole family fortune to one legal

There is one more factor we need to consider in case of accumulation of capital. There was no corporation[70] like identity in the Islamic world.[71] In pre-modern Islamic world corporations like business were comprised of family members only.[72] With a combination with the above mentioned factors smaller enterprises were set up. It prohibited economies of scale and inhibited economic modernization. Islamic world saw the creation of ethnically based networks, whereas Europe saw the creation of large financial conglomerates. In Europe businesses started as family ones as well, but they evolved into corporation forms of many kinds. They were not ended by death of one partner so they could enjoy longevity and prosperity of long term relationships, for example Medici family or later joint-stock companies – East India Company, a Levant Company etc.

So, to sum up the conclusions, population growth plus inheritance sharing rules makes fragmentation of fortune very intensive in the Islamic world. Further inhibition of the economy was supported by non-existence of a corporate entity in the Islamic legal framework. Self – reinforcing institution of inheritance, based on the highest legal authority – the Quran, makes social and legal changes in this area almost impossible. In such environment, the costs of restart of Islamic partnership were much higher than the costs of restarting (prolonging) same business in case of primogeniture. Islamic world saw the creation of ethnically based networks, whereas Europe saw the creation of large financial conglomerates. Till 18th century Islamic countries faced mostly competitions in other than European markets – Asia, Africa, which were even less developed, so there were no needs for rapid innovations. By the 19th century at the brink of colonization, Muslim merchants already lost ground to Europeans or minorities.

4.2 History till the 1960s

Traditionally, we divide human history to several bigger periods – Antiquity, Middle Age and Modern history. There was certain development of human cultures all over the world till the end of the Middle Age. We can say, with a certain amount of exaggeration,

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successor led to vast accumulation of capital and rapid boost of commercial activities. The Commenda itself was self-destruction institution – it created opportunities for evolution of more suitable ones. Problems of new forms of partnership fuelled new innovations (accounting methods, stock markets, hierarchical organization. There is no doubt, that from social point of view, European system was less equal, but from economical point of view, it was very healthy for commerce.

[70] Corporation members can make own rules within boundaries of corporation. It has legal status of its own, can have responsibility for debts etc. It makes corporation flexible and very innovative unit on the market.

[71] In Europe corporations were originally for municipal and educational purposes and they later evolved into business entities.

[72] Kuran (2003) p.417

that such a development was more or less equal. If we compare Middle Age realms of Europe, Middle East and Asia, we will not find much of the difference in the sense of economic and political power. We can rather say that the similarities would be found in closer look. As we know there was a massive shift of power, starting at the end of the 15th century in the favor of European nations[73]. The colonization caused massive world-spread of European traditions, values and legal system, violently interrupting any possible evolution of domestic cultures in sense of economical, political or legal institutions. During this period of a massive shift of wealth to a small corner of the world, the Muslims have lost an immense part of their past economic and political status. The political unity represented by the Khalifate[74], which granted Muslims a voice in world affairs, was devastated.[75] Then the First and subsequently the Second World War led to the dissolution of colonial powers and restoration of domestic countries in colonized areas, Muslim world including. After the independence of Muslim nations from their colonial yokes, the later part of the 20th century witnessed the revival of Islamic institutions and polity. On the economic front, this led to, among others, the study of economic issues under the banner of Islamic economy.[76] So from, the beginning of the 20th century, we are talking about modernism in Islam. This very era gave birth to the idea of Islamic economy and Islamic banking.

The Muslim world suffered during the 19th century and the first half of the 20th century from several events and strokes that triggered off modern Islamic movements - the military, political and economic colonization of most of the Muslim world in Asia and Africa by the European Powers, first half of the 20th century the world witnessed two world wars and a serious economic crisis (1929-33). It is not a surprise, that first large scale financial operations were run by Europeans – Imperial Ottoman Bank, Anglo-Egyptian bank etc. First Muslim owned bank emerged at the beginning of the 20th century – Bank Misr in Egypt and Is Banko in Turkey. [77]

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[73] Starting with Spain and Portugal, France and Great Britain together with Nederland became major players.
[74] A unified federal Islamic government in the Muslim world ruled by an elected head of state, or caliph. Regional position differed over time as political power shifted around Muslim world. We consider Ottoman Empire as the last example of Khalifate.
[75] Vadillo (2006) p.10
[76] Ahmed (2002) p.22
[77] Kuran (2003) p.425

The earliest modern example of a bank established along the principles of profit and loss sharing was the Mit Ghamr Savings Bank[78] in Egypt in the early 1960s. The 1970s saw the emergence of similar banks in Kuwait, the United Arab Emirates, Jordan, Sudan, and Pakistan. Two such banks were also established in Luxembourg and Switzerland, and with the active encouragement of the Kingdom of Saudi Arabia, an international development bank-The Islamic Development Bank-was set up in Jeddah in 1975.[79] However, setting up a true Islamic bank at the beginning of the 60s, was an outcome of intellectual and political process, which started more than half a century ago. Evidence exists, that interest-free commercial financial transactions existed in various parts of the Muslim world several decades earlier. For instance, the institution of Anjuman Mowodul Ikhwan of Hyderabad in India provided interest-free loans to Muslims as early as the 1890s.[80] Another institution in Hyderabad, the Anjuman Imdad-e-Bahmi Qardh Bila Sud, was established in 1923 by employees of the Department of Land Development and, within 20 years, had assets worth US$2, 240 and was distributing loans of US$100 to US$135 per month. The bank had a membership of 1,000, which included Muslims and non-Muslims.[81] An Indian subcontinent proved to be fertile ground for modern Islamic thinking. Loan cooperatives, influenced by European mutual loan experiments and infused with religious and ethical ideals, were started from the 1940s there. At least one (short-lived) experiment took place in Pakistan in the late 1950s, when rural landlords created an interest - free credit network. In Malaysia, the Muslim Pilgrims Savings Corporation (Tabung Haji)[82] was set up in 1963 to help people save for performing their religious pilgrimage (hajj). [83]

The earliest writings on the subject of Islamic banking and finance date back to the forties of the twentieth century. But it took a number of political and economic

[78]The founder was Ahmed al-Najjar (who would later become Secretary of the IAIB [International Association of Islamic Banks]) and had been educated in West Germany and greatly influenced by the mutual savings schemes he discovered there. It is one of the more examples, how western-educated Muslims influenced the shape of Islamic banking.
[79] Khan (1986) p.7
[80] Bank provided services not only to muslims, but non-muslims as well, providing only interest-free loans.
[81] Shanmugan, Zahari (2009) p.3
[82] It is the only institutions from the original projects which survived till today. It is because clearly defined business orientation and government support. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which represents a full-fledged Islamic commercial bank in Malaysia.
[83] Warde (2000) p.73

developments more specifically the advent of pan-Islamism[84] and the rise in oil prices, before such ideas were put in practice. What can be characterized as the 'theory' of Islamic banking was, till the end of the nineteen-seventies, largely a plea for replacing interest in bank lending by profit-sharing. This would change the nature of financial intermediation, making the fund owners as well as the financial intermediaries share the risks of the enterprise with the fund users. Early literature's main emphasis was about fairness. It was also argued that most, though not all, the other problems of capitalism were rooted in the practice of lending on interest. Among these problems were, unemployment, inflation, poverty amidst plenty, increasing inequality and recurrent business. These problems, according to Muslim scholars, could be solved by abolishing interest and replacing it by profit sharing.[85] Basic postulate which has guided all the theoretical work on Islamic banking was prohibition of the interest by the Quran. As long as there was no prototype of genuine "Islamic banking" through the history, there was necessity to develop new, alternative system. The body of the first works about the matter is aimed at proving that interest – free system could be viable and competitive to interest driven system. There exists no example, ancient or modern, in a country that has done away with interest. Although there have always been groups hostile to interest-especially in economically primitive communities, in no large community have an interest-based financial deals ever become uncommon.[86]

Muslim economists have pointed out that it is a historical accident that interest has become the kingpin of modern banking. The practice of interest has been condemned by foremost thinkers in human history and by all Biblical religions. Aristotle dwelt on the "barren" nature of money and vehemently condemned the institution of interest which he described as "birth of money from money". Under Judaism, the Israelites were forbidden to demand any increase in the principal amount of the sum lent in transactions among themselves, though interest could be charged in dealings between Israelites and Gentiles. In the early history of Islam the injunction relating to the prohibition of interest was strictly observed, but with the decline of the hold of religion and spread of Western influence, financial practices based on interest began to permeate Muslim societies as well. In the

[84] It is a political movement advocating unity of Muslims under one central government (often a Khaliphate we mentioned above). In comparison with pan-Arabism or pan-Slavism it is a religious nationalism, not ethnic one.
[85] Siddiqi (2009)p.4
[86] Kuran (1995) p.157

period of colonial domination of Muslim countries by Western powers, the interest based system became solidly entrenched. It is this flow of historical circumstances, Muslim scholars argue, which has led to the present-day dominance[87] of interest in financial transactions all over the globe.[88]

Beside the emphasis on fairness, there was another reason behind the proposition of Islamic economy. The ideas on the Islamic economy may have been developed as a reaction to colonialism and capitalist and communist economic systems. There was and still is strong discordance with western values in the Islamic world. There is a deep-rooted idea among large parts of the Muslim intelligentsia, in particular in the Middle East that the forces of the globalizing world, in their view characterized by materialism and sex, are incompatible with the values cherished by Muslims.[89] There are foremost Muslim thinkers, such as professor Siddiqi, who "… takes his brethren (and sisters, but they are less vociferous) to task for what he sees as a 'hostile-West syndrome' that puts all the Muslim countries' woes down to the pernicious influence of the West. He sees this as a step forward in the development of more equitable economic and financial arrangements which the whole world needs and in which Muslim individuals and countries should participate."[90] We can see that development of ideas on Islamic economy and Islamic banking is strongly connected to negative demarcation against the western world. It is not surprising then; these thoughts were originated in Pakistani area. After partition of India, Pakistan was founded expressly to be the homeland for Muslims.

Therefore, Islamic economy has not only emerged from a drive to correct economic imbalances, injustices, or inequalities. The Indian Muslims who launched it in the 1940s were motivated by a desire to defend Islamic civilization against foreign cultural influences. For Sayyid Abul A'la Maududi (1903-1979), the Pakistani ideologist whose voluminous writings popularized the term "Islamic economy" and set the tone for later contributions to the literature, this new approach to economics was to be a vehicle for establishing, or reestablishing, the Islamic authority in a domain where Muslims were falling increasingly under the influence of Western ideas. By replacing Western economic approaches with an

[87] We can see relaxation of strict anti-interest policies in Christian world with the start of Protestant movement in 15th century, when usury was re-defined as an excessive interest in comparison with total prohibition of interest before. One of the example of legal re-definition is 1571 maximum interest law from Britain stating that interest rate over 10 percent is considered usurious and illegal then.
[88] Ziauddin (1994) p.2
[89] Visser (2009) p.1
[90] Visser (2009) p.7

Islamic one, he hoped to restore the Islamic community's self-respect and improve its cohesion.[91] Maududi was the most outspoken advocate of Islamic economy. Sometimes, evolutionary movement in Islamic economy is likening with Protestantism.[92] It is just Maududi´s work and ideas who support this point of view. Muslims, in his eyes, should not only stay away from such things as wine and gambling, but also from ‘music and dances and other means of self-indulgence’ and are furthermore forbidden to wear silken dresses, to use golden ornaments and jewels (except in the case of women, parentheses Maududi’s), or to decorate their house with pictures and jewels. This rejection of culture sounds not too different from the views of some of the more puritan currents within Protestantism.[93] Maududi is considered to be “founding father” of Islamic economy. Basic principles of Islamic banking are outlined in his work and majority of Islamic thinkers are referring to his work as well. As we can see from short notion on his ideas, fervent denial of western values is one of the cornerstones of Islamic banking with prohibition of interest in a front.

Comparing modern Islamic thought movement with the Protestantism is not accidental. The two phenomena share the same mold and the same accomplishment with regard to capitalism. At the center of this issue was a redefinition of the meaning of usury that would allow banks to be accepted as part of the religion. There was the adaptation of the traditional prohibition of usury through a careful redefinition of the term. This ‘conversion’ to capitalism was completed in Christianity during the complex process of Reform or Protestantism. The principal results of the conversion were the ‘Christianization of banking’ and the reduction of Canon Law to personal puritan morality.[94] We can see the shift of term riba, from pure Quoranic view to a more flexible position. There was significant intellectual movement in the Egypt at the second half of the 19th century, which resulted to Fatwa[95] on banking (1903), proposed by Grand Mufti of Egypt[96] – Muhamad Abduh (1849-1905), where he “denounces riba, but allowed banking”.[97] This legally-

[91] Kuran (1995) p.156
[92] We can find similarities with Protestant movement in two ways. First it is redefinition of interest as and totally illegal principle to something less restrictive in sense of trade second is an effort of Muslim thinkers of “return to the roots” of Muslim culture, proposing austerity and self-denial as we can find in writings of Protestant thinkers as well. (Calvin, Luther)
[93] Visser (2009) p.3
[94] Vadillo (2006) p.20
[95] Learned opinion concerning Islamic law issued by an Islamic scholar.
[96] Grand Mufti was political position granted by British government, therefore we can assume that such a person had to show at least compliance with colonial culture and western principles, interest banking included, as well.
[97] Vadillo, p.24

religious statement opened a way to Islamization of the most capitalist institution – the bank. Since the beginning of the 20th century, project of Islamization of the banking took an incredible dimension. In a relatively short period of time, a large literature has come out on the subject. While a few countries are trying to Islamize their economies, the growth of Islamic financial institutions worldwide has been phenomenal.[98]

4.3 History after the 1960s

The modern variant of Islamic economy is a development that began in the 1970s with an alternative system understanding of the existing capitalist modes of production. In this new discourse, the Islamic economy held that the capitalist economic order was responsible for the failure of economic development and environmental issues in developing countries. Therefore, it claimed to be an alternative economic system that, also, owed its development to the emergence of identity politics in the 1970s.[99] The seventies were a period of a considerable turmoil in international markets. There were significant events influencing biggest economies of the world, shape of the global markets and political reality of the Cold war as well. In 1971, dissolution of the Bretton Wood system took place, followed by political events in the Middle East (Yom Kippur War) which led to the First Oil crisis in 1973. A consequent increase in oil prices led to a huge influx of free capital to OPEC countries. It continues further with the 1979 revolution in Iran and another increase in oil prices. These events had a huge impact on the political and economical power of the Arab world and subsequently the development of Islamic banking. Although the 1970s were particularly difficult for the U.S. economy, which suffered from the war in Vietnam and the unprecedented phenomenon of stagflation, inchoate Muslim economies greatly benefited. Countries such as Iraq, Saudi Arabia, United Arab Emirates, Bahrain, Qatar and Kuwait experienced an influx of U.S. dollar denominated assets.[100]

There were several attempts to start a truly Islamic bank at the beginning of the seventies, yet none of them was very successful. The Egypt was a pioneer in Islamic banking. Above mentioned experiment of Mit Ghamr in between 1963 - 67 is officially considered to be “first modern Islamic bank”, 1971 Egypt Nasser Social Bank was established. The official goals were to ‘broaden the base of social solidarity among citizens’

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[98] Ahmed (2002) p.22
[99] Asutay (2007) p.3
[100] Karim (2010) p.53

and 'provide aid to needy citizens'.[101] In a broader context, Arabic countries of that period suffered a shortage of capital needed for banking projects. Only a decade of freedom plus ongoing Cold War left these countries with quite armament, but with no spare funds to invest into the social and economic sphere. Therefore inflow of capital was needed to started evolution of Islamic banking as we know it today. This inflow came in the increase of oil prices.

A new impetus was given with the rise in oil wealth in a number of Muslim countries after the 1973–74 oil crises and the success of Malaysia as a fast grower, both of which may have contributed to a formerly unknown level of self-confidence that made it possible for Muslim governments and firms to develop new financial instruments.[102] Further increasing of political and economic importance of the OPEC cartel led to an unprecedented position of the Gulf Countries. Arabian countries positioned around the Persian Gulf found themselves with plenty of spare funds. An intellectual movement which started at forties and produced academic ideas could finally express in real ways. Oil-related wealth provided the capital resources behind the establishment of many Islamic banks, and the Islamic Development Bank (IDB)[103] based in Jeddah, and created in 1974, was the first institution to benefit from the inflow of oil money. Its formation with the support of the Saudi Arabian government and the Organization of Islamic Countries (OIC) as a multilateral organization nevertheless gave momentum to the Islamic banking movement generally.[104] The institutional backbone of the Islamic bank's establishment was the Organization of the Islamic Conference.[105] On the Third Islamic Conference (1972), held in Jeddah, plans to establish IDB were ratified by the members. In the subsequent OIC summit in Lahore (1974), the intergovernmental character of the IDB was ratified. IDB project was ready then[106] and there were desires that it will become "the cornerstone of Islamic banking system".

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[101] Warde (2000) p. 74
[102] Visser (2009) p.1
[103] Establishment of IDB is considered to be starting point for an expansion of Islamic banking. IDB was the first international organization shielding new industry and providing necessary standardization and support for further international cooperation between countries supporting Islamic banking concept.
[104] Hassan, Lewis (2010) p.12
[105] Nowadays Organization of Islamic Cooperation, established 1969, consist of 57 members.
[106] Organization was then largely dominated by Saudi Arabia, as well as the OPEC, so the shape of nascent institution was much according their ideas. Forty-four countries were founding members of the bank, the largest shareholders being Saudi Arabia (25%), Libya (16%), the United Arab Emirates (14%) and Kuwait (13%).Saudi Arabia, as the richest from OPEC countries, promoted itself as leader of the Arabic World. For more details about rising influence of Arabian countries please see: MACLAURY (1978). OPEC surpluses and

There were many who believed that, the quadrupling of oil prices in 1973–4 marked a watershed, the new era in North–South relations. Under those circumstances, an Islamic banking system held the promise of more control over the Islamic world's political and economic destiny.[107] Establishment of IDB started slow, but steady development of Islamic banking sector, which was gaining a speed over time. Early in the seventies came the Dubai Islamic Bank taking deposits in current as well as investment accounts and engaging in profit-making activities directly as well as through working partners. The IDB was designed to serve Muslim countries and communities by arranging finance for trade and development on non-interest basis. By the late nineteen-seventies there were about half a dozen more banks in the private sector in Egypt, Jordan, Kuwait, and the Gulf.[108] The Dubai Islamic Bank is considered to be the first modern, non-governmental, Islamic bank.

Before the decade was over, similar banks sprouted throughout the Islamic world: the Kuwait Finance House (1977), the Faisal Islamic Bank of Egypt (1977), the Islamic Bank of Sudan (1977), the Jordan Islamic Bank for Finance and Investment (1978), the Bahrain Islamic Bank (1978), and the International Islamic Bank for Investment and Development in Egypt (1980). In addition, a handful of international investment banks were created, such as the Islamic Investment Company in Nassau (1977), the Islamic Investment Company of the Gulf in Sharjah (1978), the Shariah Investment Services in Geneva (1980) and the Bahrain Islamic Investment Bank in Manama (1980). There was also a handful of pioneers, chief among them Prince Mohammed al-Faisal al- Saud (a son of King Faisal) and Sheikh Saleh Kamel, a self-made Saudi businessman and founder of the Dallah Al-Baraka group.[109] The oil fortune and the novelty of the concept allowed quite an amount of experiments. Funds were plentiful for a few Islamic institutions and they had a monopoly on small, but growing group of clients looking for Shariah compliant financial operations.

Governmental support of newly created Islamic banking sector was expressed through the creation of the international body – IDB. There were also countries that take a step more and decided to re-orient its financial services according to modern Islamic thoughts on banking – in other words, they forbid interest by law. It is not a surprise, if we consider the regional distribution of intellectual advance on Islamic Banking, that the first

world financial stability. JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS. November 1978, Proceedings Issue, s. 737-743 (http://www.jstor.org/stable/2330478)

[107] Warde (2010) p.74
[108] Siddiqi (2009) p.3
[109] Warde (2010) p.75

country to start to implement full non-interest financial sector was Pakistan. The seventies also saw Pakistan officially committing to the interest-free Islamic banking, followed by Iran and Sudan in the eighties. Meanwhile Malaysia developed a new approach of introducing Islamic banking and finance under official patronage, while the main system continued along conventional lines Indonesia followed in the early nineties. This pattern later became the model for certain countries in the Gulf, like Bahrain, Qatar and the UAE.[110]

If we consider the fact, that in the human history there was never national formation working without interest based transaction, Pakistani project is quite remarkable. It started in 1977, when President Muhammad Zia al-Haq had seized power.[111] On February 1979 decided that interest-based transactions were to be phased out. Banks were ordered to offer interest-free alternatives to conventional savings accounts and to completely switch to interest-free banking within five years.[112] The process of economy wide Islamization of the banking system in Pakistan was initiated soon after the declaration in February 1979.[113] As from 1st July 1985, no banking company is allowed to accept any interest bearing deposits except foreign currency deposits which continue to earn interest.[114] Pakistan is one of the few countries declaring that they are operating strictly within non-interest financial market. It is true that transition, in case of Pakistan, was eased by almost a dictatorship – type of government. Therefore needs and dispositions of the market were neglected to some extent and only political will was applied. Even under such conditions, a complete transition was not achieved. Till today there are government transactions based on the interest rate basis and Karachi Stock Exchange is creating its KIBOR[115] through the benchmark with other

[110] Siddiqi (2009) p.5
[111] Pakistan is well known for its long traditions of military coup d'états. It is semi-dictator type of government in Pakistan which allowed transition of banking sector to non-interest one quite smoothly in sense of political power. We can see similar development in Iran after 1979 revolution or in Sudan under the president Bashir.
[112] Visser (2009) p.5
[113] Government planned to remove interest from the economy and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Within a few months of this announcement, these specialized financial institutions took the necessary steps to re-orientate their activities on a non-interest basis. The conversion of the operations of commercial banks to non-interest basis was a much more complex task and took a longer time span. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on profit/loss sharing basis in all the domestic branches of the five nationalized commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest bearing deposits or PLS deposits, continued to operate till the end of June 1985
[114] Ziauddin (1994) p.20
[115] It is Karachi Inter Bank Offer Rate, given by on State bank of Pakistan daily, weekly, monthly and on 1, 2 and 3 yearly basis to all the commercial banks of Pakistan so that they charge feesto their customers on that

interbank offer rates all over the world, which are naturally based on interest rates. This dichotomy of Islamic banking would be discussed later.

The idea of an Islamic economy not only proved attractive to Pakistanis, but also to Non-Pakistanis in search of an Islamic answer or alternative to capitalism and communism. It was embraced by the Muslim Brotherhood in Egypt; Members of the Muslim Brotherhood also played a prominent role in the establishment in 1977 of the first Islamic bank in Sudan.[116] After Iran revolution, there was increasing unrest among OPEC members, leading to the breaking of cartel agreements and unilateral increase of oil production by the new Islamic Republic of Iran. The price of oil peaked in 1981 and after a steady decrease, collapsed in 1986. Surprisingly these developments did not hinder the growth of Islamic financial institutions. In fact, countries that experienced financial difficulties welcomed the major Islamic groups.[117] Islamic financial houses exploited full scale marketing based on the promotion of "alternative system" of banking. Many countries blamed interest rate based banking for economic decline and welcomed alternative solution. Together with the religious aspect, Islamic banking further increased its market share. Religion was a strong selling point. Vigorous marketing campaigns warned against the ills of 'usurious interest', and associated their success with their religious orientation. The early eighties also saw further "full Islamization" of banking systems (the Sudan and Iran in 1983). Another interesting development was the decision by Danish authorities to authorize the creation of the Islamic Bank International[118], which would operate according to the Islamic Shariah without any special concessions or exceptions granted.[119]

Decision of Danish government has been just a part of the broader acknowledgment of Islamic banking by the Western world. Major banking groups (Citicorp, Merill Lynch) had longstanding ties with government of Persian Gulf states, but in 80s, as Islamic middle class started to gain its part of oil fortune, they started to aim at them as well. Citicorp's establishment of an Islamic subsidiary in Bahrain in 1996 has been closely watched within the international financial community. Kleinwort Benson, ANZ Grindlays, Goldman Sachs

basis. This rate is inflation adjusted rate and then banks by adding 2 or 3% in KIBOR rate charge their customers for their profit.

[116] Visser (2009) p.6

[117] Warde (2010) p.79

[118] The company was founded in 1982 as a subsidiary of Islamic Finance House (UAE).

[119] Warde (2010) p.78

and ABN Amro are among those Western firms active in Islamic finance.[120] Since the 1980s, such institutions have been created in Europe, the United States and Australia. Today, Islamic banks exist in virtually all parts of the world. In 1997, Russia announced the creation of its first Islamic bank - the Badr Bank [121](with 51 per cent of the shares belonging to Russian citizens but with most of the $20 million start-up capital coming from Iran, Saudi Arabia, Kuwait, Qatar, the Sudan and Egypt).[122] Lately European banks such as HSBC, Citigroup and Deutsche Bank have been in the forefront of developing Islamic financial instruments. Moreover, the International Monetary Fund has built up cordial relationships with the Islamic financial world and the Institute of Islamic Banking and Insurance, set up in London in 1991, calls it a good omen that major international financial organizations are involved in Islamic finance and that there is an active interaction between those organizations and Islamic bodies.[123]

5. Present state of art

In the last two decades Islamic banking underwent relatively fast evolution. After three decades of establishing basic principles, institutions and guidelines, more recent history became a story of a successful and modern financial industry. Especially after World financial crisis (2007-2009), during which Islamic banking sector showed surprising resilience, the demand for Islamic financial services is rising rapidly. We will examine the current status of the Islamic financial sector in the following pages. There will not be dedicating much of an attention regarding the financial crisis itself, because it will be covered in detail and in another context later. It is but necessary to say, that basic underline

[120] Warde (2010) p.86

[121] Data varies, but there are approximately 20 millions of Muslims in Russia Federation. It suggests strong market for Islamic banking products. However, reality looks different. In 1997, “Forte-Bank” started utilizing Islamic financing tools in its operations. “Badr-Bank”, an Islamic unit established by “Forte-Bank” shortly International Commercial Bank “Badr-Forte” used to be the only bank in Russia guided by Islamic business rules. The history of the bank began in 1997, when “Forte Bank”, a Russian bank that had operated in Russia since 1991, established a new bank – “Badr-Bank”. It was proposed that the new bank would provide Islamic banking services. It should be noted that the bank’s popularity among Muslims was limited by the fact that it had no branches in Islamic Russian regions. It faced serious financial problems in 2005, but it was supported by Russian central bank. In the end of 2006, the story of Islamic banking in Russia came to an end. The Central Bank of Russia was not so tolerant towards “Badr-Forte” any more and after and inspection, the banking license was taken from bank. For more details please see: Bekkin (2009) Islamic finance in former Soviet Union (http://www.ide.go.jp/Japanese/Publish/Download/Report/pdf/2008_04_07_shiryou.pdf)

[122] Warde (2010) p.86

[123] Visser (2009) p.7

is that Islamic banking industry withstand crisis pretty well, which supported its development even more.

When the subject matter first began to be written about, it was usual to use the terms 'Islamic banks' and 'Islamic banking'. Nowadays, it has become more commonplace to talk of Islamic finance and Islamic financial institutions, reflecting in part the shift – evident in Western markets as well as Islamic ones – away from what used to be banking activities to financing activities more generally.[124] Therefore Islamic finance industry consists not only of banks, but also several other sectors, very similar to the conventional banking. These had evolved over last two decades and are another proves of converging Islamic finance to something we should call full-fledged financial system.

Today, there are more than 600 Islamic financial institutions that operate in more than 75 countries. Islamic finance assets worldwide has expanded from USD150 billion in the mid-1990s to USD1.3 trillion in 2011.[125] The Banker's[126] latest 2011 Top 500 Islamic Financial Institutions report presents an optimistic scenario of the global Islamic finance industry continuing to experience double digit growth of 21%, with the Shariah compliant assets crossing the US$ One trillion mark. The industry seems to have benefitted from a search for an alternative financial paradigm in the aftermath of the global financial crisis, as conventional solutions are increasingly found to be inappropriate and inadequate to deal with the economic realities.[127]Islamic finance has evolved to become an integral component of the global financial system transcending geographical boundaries from Brunei, Indonesia, GCC states[128] and Malaysia, into new and untapped jurisdictions of Africa (Mauritania, Nigeria, Senegal), Asia (Australia, Kazakhstan, Thailand), Europe (Ireland, France), North America (USA, Canada) and greater MENA[129] (Sudan). What was a local phenomenon in the sixties became recently a world-wide issue. Such huge system could not sustain growth without proper institutional support, so there were several international bodies established lately, to further promote Islamic finance growth, especially within the meaning of standardization and harmonization with the existing global market.

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[124] Hassan, Lewis (2007) p.1

[125] GIFF (2012) p.1

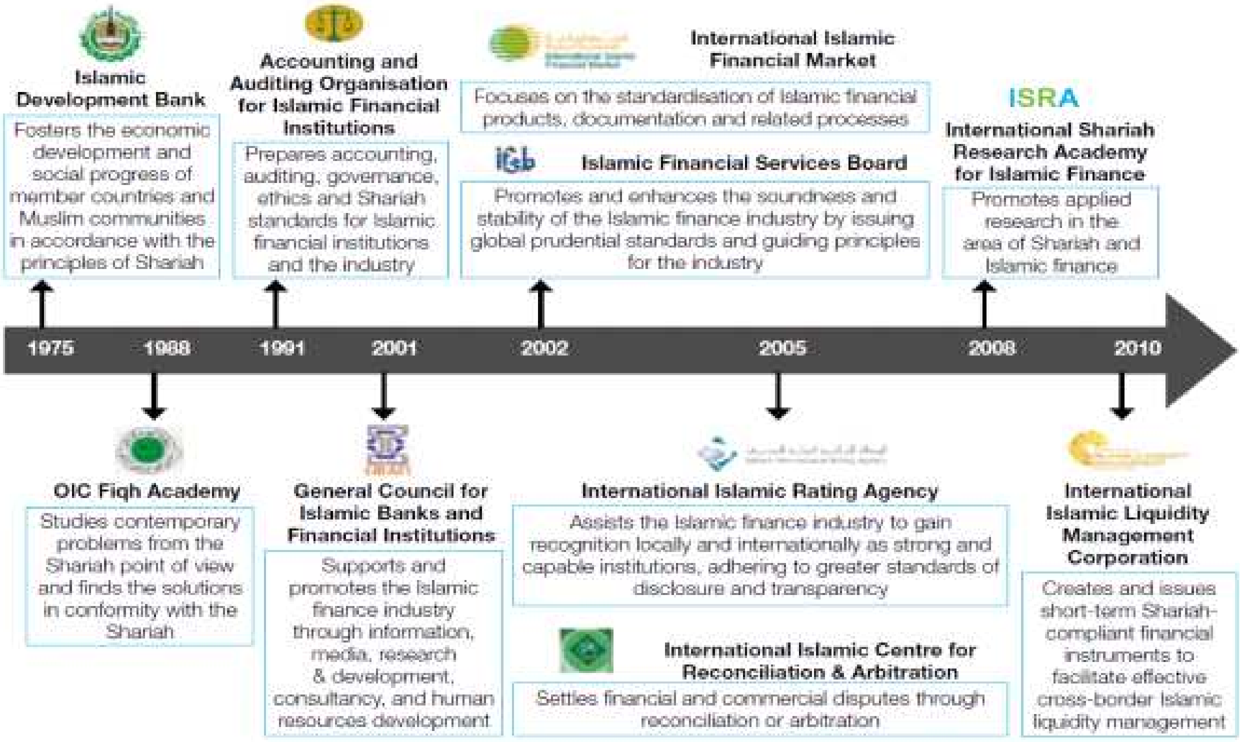
[126] The Banker is the Financial Times subsidy, providing consistent research on world banking industry since 1926. It is also one of the few institutions providing full-scale every-year research on top 500 Islamic banks, creating a valuable source of genuine statistical data. (www.thebanker.com)

[127] IRTI Annual report (2011) p.12

[128] Gulf Cooperation Council countries - Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE. For more details see: http://www.gcc-sg.org/eng/

[129] Middle East plus North Africa

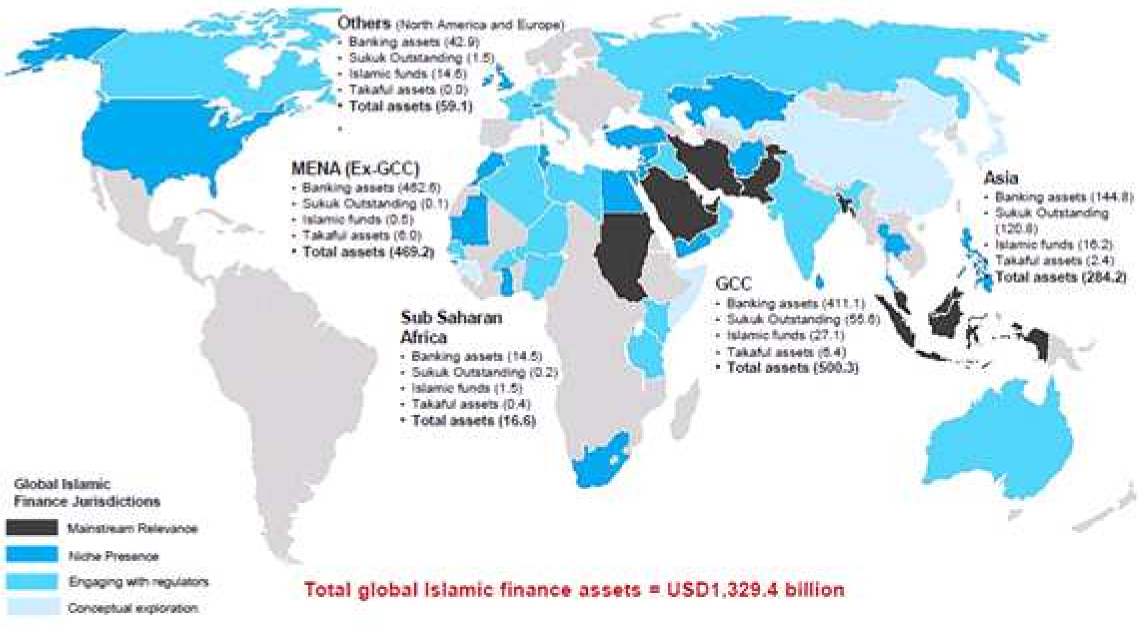
Picture 1: Global Islamic Finance: Industry Architecture



Source: GIFF, 2012

In the early stages of development, Islamic finance was concentrated in countries with large Muslim populations, such as Egypt, Malaysia and the Gulf countries (particularly Saudi Arabia, Kuwait and the United Arab Emirates). Over the past decade, the Islamic finance industry has evolved to become an increasingly important component of the international financial system, what make him much more attractive for non-Muslim investors as well. Increasing recognition of its value propositions has made Islamic finance widely accepted in many western countries, starting with the ones with the biggest Muslim minorities.

Picture 2:Global Islamic Finance Assets, 2011 (USD Billion)



Source 1: Bridging the economies lecture, GIFF 2012

Within the Muslim World, Islamic financial institutions have become major economic players. Five countries are dominated by the Islamic banking: Iran with US$345 billion in Islamic assets; followed by Saudi Arabia (US$258 billion); Malaysia (US$142 billion); Kuwait (US$128 billion); and the United Arab Emirates (US$112 billion). A few non-Muslim countries, among them the United Kingdom[130] and Singapore, have announced

[130] United Kingdom stands for the foremost Islamic finance market in the Western world. For more details see: FSA (2006) Islamic Banking in the UK (http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml)

their intention to become hubs of Islamic finance, and others, such as Australia[131], France and South Korea, have altered their legislations to become more hospitable to Islamic finance.[132] Further involvement of Islamic finance in global markets sparked initiatives regarding acceptance of Islamic finance in countries all over the world. Emerging economies of third world are looking towards alternatives of pure capitalistic conventional banking (which in their eyes failed in order to bring them prosperity), on the other side, sophisticated rich countries of the West are looking for investment alternatives to diversified risk. At the end-2011, there are 363 full-fledged Islamic financial institutions and a further 108 conventional financial institutions operating an Islamic window.[133]

5.1 Global division of Islamic finance activities[134]

5.1.1. Asia

At present, Islamic banking business is available in Malaysia, Indonesia, Brunei, Sri Lanka, Thailand, Singapore, Bangladesh, China, Philippines, Russia, Pakistan, Kazakhstan, Azerbaijan and Afghanistan. In terms of Islamic banking assets in the region, Malaysia constitutes 72.1% of the total followed by Indonesia (10.8%), Bangladesh (5.4%), Pakistan (4.9%) and Brunei (3.4%) while other countries constitute the remaining 3.4%. The newest entrant in the list of markets for Islamic finance is Indonesia, with its vast population of Muslim consumers and therefore potential for rapid growth. Since 2011, Kazakhstan has become the first country in the Commonwealth of Independent States to introduce fundamental legislative amendments for purpose of Islamic finance.[135]

5.1.2. Europe

The Islamic Bank of Britain[136] was the first full-fledged Shariah –compliant retail bank in the UK which marked the launch of the first Islamic bank in the western world. There are five full-fledged Islamic banks and 17 windows offering Islamic banking products

[131] Australia represents typical ready-market for Islamic finance. There is strong, fast growing Muslim minority and there are already several Islamic finance institutions providing services (namely the Muslim Community Cooperative Australia (MCCA), Iskan Finance and Islamic Co-operative Finance Australia Limited (ICFAL). As the demand rises, the Australian government, both at state and federal levels, is working on the possibility of removing regulatory obstacles and tax disincentives for Islamic financial institutions.
[132] IRTI Annual report (2011) p.17
[133] GIFF (2012) p.15
[134] All statistical data in this part are cited with respect to Global Islamic Finance Forum (GIFF) report, 2012
[135] For more details see: http://www.ashurst.com/publication-item.aspx?id_Content=7559
[136] IBB was established in September 2004 and was first standalone retail bank providing Islamic finance products in western world (first Islamic finance institutions was established sooner in Luxembourg). For more details see: http://www.islamic-bank.com/about-us/

and services in the UK today. Meanwhile, Germany[137] is home to the Islamic banking unit of Kuveyt Participation Bank of Turkey[138], located in the Southern city of Mannheim[139] while the French subsidiary of a conventional Moroccan bank recently began offering products through their Islamic window.

5.1.3. MENA

The majorities of Islamic banks in the MENA region are part of the private sector, existing along with the conventional financial institutions, with the exception of Iran which classifies all as Islamic while the majority of them are state owned. Among the MENA countries, most developed Islamic banking sectors are found in Bahrain, Kuwait, Qatar, Saudi Arabia and United Arab Emirates which are home to some of the industry's largest Islamic banks. Oman is the latest GCC member that has embarked on introducing Islamic banking through the issuing of two full-fledged Islamic banking licenses. Morocco is another merging country, with 99.0% of its population comprising Muslims, and represents a potentially right market for Islamic finance. Bank Al-Maghrib, the central bank of Morocco, has recently examined possible options to regulate and develop Islamic banking in its jurisdiction. Back in March 2007 Bank Al- Maghrib approved the offering of Islamic financing products.

5.1.4. North America

The development of Islamic finance in the United States of America (US) started in 1999 when Dow Jones launched its first Islamic market indices[140], which act as benchmarks for Shariah-compliant equity managers. At present there are no less than 15 financial institutions that operate in the US offering a wide range of Shariah-compliant products and

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[137] With a population of 4 million Muslims in Germany, holding an estimated wealth of 25 billion €, Germany potentially is a big market for Islamic Finance. Not only are net incomes of Muslim households estimated to rise further in the future, Muslims also having a remarkable savings rate (18 %). There is also significant trend of decreasing foreign money transfers as original season workers from Turkey are more and more established in Germany.

[138] For more details see: http://www.reuters.com/article/2012/11/28/kuveytturk-germany-idUSL5E8MS8Q920121128

[139] In 2013, there is expected an expansion of Kuvert bank into Berlin and Frankfurt. For more details see: Sandkuhler (2012)

[140] The Dow Jones Islamic Market Index (DJIM), launched in 1999 in Bahrain, was the first index created for investors seeking investments in compliance with Muslim Sharia law. The DJIM has an independent Shariah (Islamic Law) Supervisory Board. The DJIM screens have been adopted by the Auditing & Accounting Organization of Islamic Financial Institutions ("AAOIFI"). The DJIM measure the performance of a global universe of investable equities that have been screened for Shariah compliance consistent with Dow Jones Indexes' methodology, which makes it fully comparable with other Dow Jones Indexes. For more details see: http://www.djindexes.com/islamicmarket/

services ranging from home financing, personal financing, mutual funds, business financing and investment services. Elsewhere in Canada, The Toronto Financial Services Alliance (TFSA) has made submissions to the federal and provincial governments, calling for changes to Canadian laws and regulations to facilitate Islamic banking and finance in Canada.[141]

5.1.5. Africa (except MENA countries)

The banking industry in Africa can be divided into four main regional markets, namely, Kenya, Nigeria, Sudan and South Africa. Currently there are 38 Islamic financial institutions operating in Africa. Among the four regional markets, Sudan is taking the lead in the Shariah-compliant banking services with 81.5%.[142] Measures have been undertaken by some of the African governments to review and reform their respective banking laws to allow Islamic financial institutions to be set up and to prosper. The Central Bank of Nigeria has recently issued guidelines for non-interest banking and has approved a banking license to launch the country’s first Islamic bank.[143]

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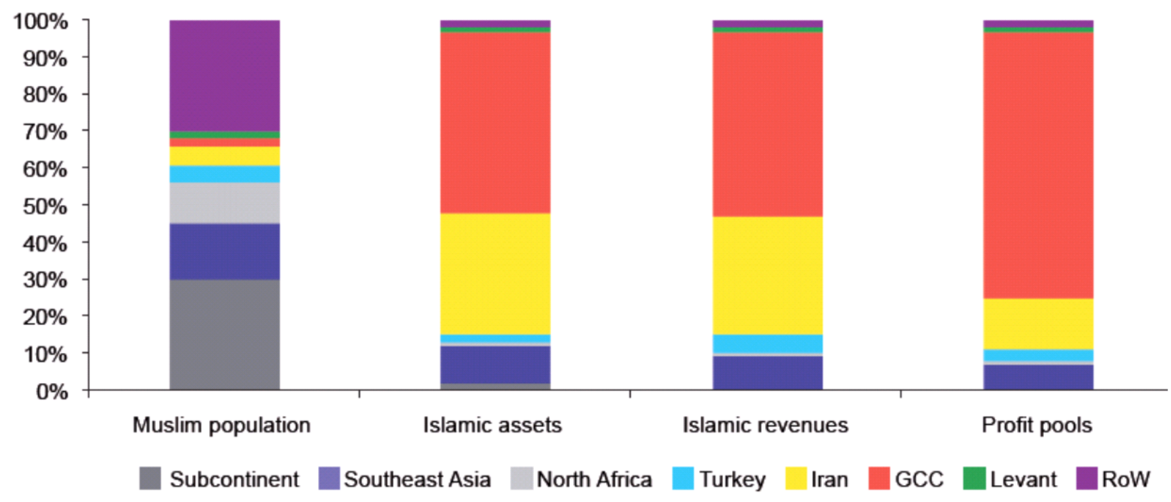
[141] For more details see: http://www.blg.com/en/NewsAndPublications/Documents/publication_2067.pdf

[142] The process of the economy wide Islamization of the banking system in Sudan has not been smooth and steady. The first attempt to Islamize the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest based dealings with immediate effect and to negotiate the conversion of their then existing interest bearing deposits and advances into Islamically acceptable forms. Foreign transactions were allowed to be continued on the basis of interest for the time being. It is reported that this sudden change forced the banks to adopt the nearest Islamic alternative available that is murabahah, which soon constituted 90 percent of their financial operations. It is also reported that conventional banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the central bank of the country. Policy makers in the central bank were also discontented with the procedure of transforming the banking system. They considered it as a mere political decision imposed by the government without being preceded by adequate detailed studies. This experiment with economy wide Islamization of banking system came to an end in 1985 with the change in government .The government which is presently in power has decided on the economy wide Islamization of the banking system once again, and that the effort is much more earnest and much better organized this time.

[143] For details about guidelines see: http://www.cenbank.org/Out/2011/pressrelease/gvd/Non-Interest%20Banking%20Guidelines%20June%2020%202011.pdf

If we compare starting a regional division of the Islamic finance industry with the current state, we can clearly see that there is strong globalization going on. Yet we can, with respect to the current regional division of Islamic asset say that this trend is just at the beginning.

Graph 1 – Muslim population, Islamic assets, revenues and profit pool breakdown by region, 2007



Regional breakdown as follows:
Levant : Israel, Jordan, Lebanon, Palestine, Syria
GCC: Qatar, Bahrain, Kuwait, UAE, Saudi Arabia, Oman
North Africa: Algeria, Egypt, Libya, Mauritania, Morocco Tunisia, Sudan
Southeast Asia: Cambodia, Laos, Thailand, Vietnam, Philippines, Brunei, East Timor, Indonesia, Malaysia, Singapore
Subcontinent: India, Pakistan, Bangladesh, Bhutan, Nepal

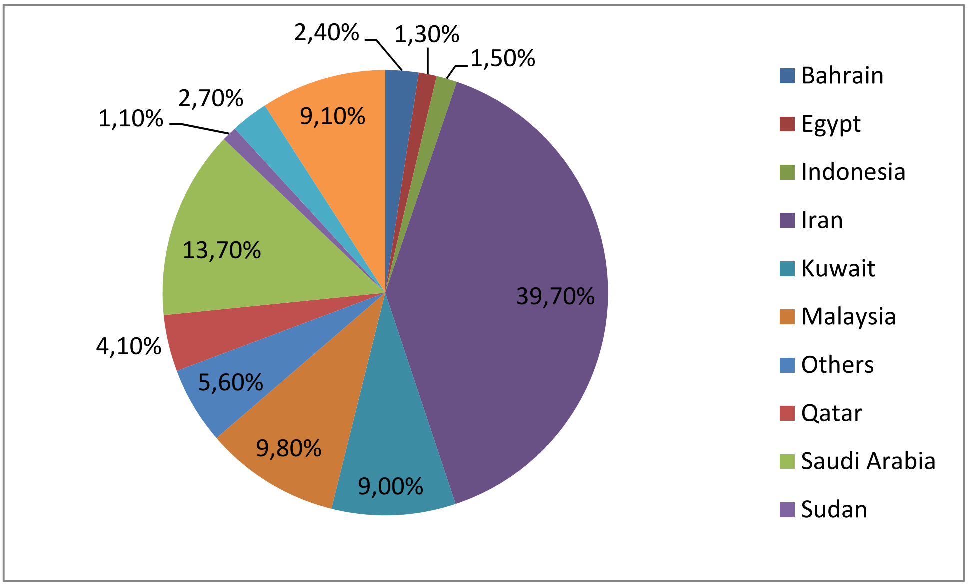
Source 2: Islamic finance and global financial stability, 2010

As the popularity of Islamic finance services rises, we can expect further redistribution of from the Muslim population towards bigger institutional investors all over the world. The global growth of Islamic finance continued its healthy trajectory in 2011 despite the uncertainty elsewhere in the world's financial markets. According to Standard & Poor's[144] research, worldwide, Shariah-compliant assets--about $1.4 trillion at year-end 2011--are likely to continue double-digit growth in the coming two to three years. As the industry matures, Shariah-compliant instruments are becoming specific asset classes in their own right. The coming to the market of new entrants, as well as the growing sophistication of existing players, is likely to further support growth. On the other, the Islamic finance industry is to continue suffering from a classic imbalance between supply and demand. It

[144] Standard & Poor's has been leading credit research and analysis in Islamic finance for half a decade. It provides ratings to all significant institutions providing Shariah-compliant products all over the world. It also publishes yearbooks on Islamic finance regarding specific sectors of Islamic finance industry – takaful, sukuk, banking, year competitiveness report etc. For more details see: http://www.standardandpoors.com/about-sp/gcc/en/eu

remains indeed a demand-driven segment, with limited supply, hampered by a lack of a widely recognized consensus about how to finance the Shariah-compliant way. The two current heavyweights of the industry—Asia (most notably Malaysia) and the Gulf Cooperation Council (comprising Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) are set to spearhead the overcoming of these obstacles. They are building on the momentum created by companies in those regions to resort increasingly to Shariah-compliant means to finance their huge infrastructure-related projects.[145]

Graph 2: Share of global Islamic assets, 2011



Source 3: According to GIFF, 2012

The overall growth of Islamic finance uses synergy effects for creating new products. On the one side, there is growing demand for new products as industry flourish, on the other side; new products are helping industry to flourish. The system became more diversified and comprehensive with a wider spectrum of financial products and services, such as the Islamic Inter-bank Benchmark Rate, Shariah compliant hedging products etc. The Islamic financial services sector also witnessed the development of new types of intermediaries in the form of specialized banking institutions, Takaful, capital market intermediaries and microfinance institutions. Financial markets, including the Islamic money and Sukuk[146] markets witnessed

[145] Standard&Poor, Islamic finance outlook (2012) p.2
[146] Sukuk (legal instrument, deed, check) is the Arabic name for financial certificates, but commonly refers to the Islamic equivalent of bonds. Since fixed income, interest bearing bonds are not permissible in Islam, Sukuk securities are structured to comply with the Islamic law and its investment principles, which prohibits the charging, or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets. Sukuk can be structured

the expansion and played a significant role in ensuring the flow of funds in the Islamic financial system.[147]

Picture 3: Islamic Finance Industry: Developement of Products and Services

Source 4: GIFF, 2012

Further demand for financial products is driven by several aspects:[148]

- Ready market of growing Muslim population
- Growing demand for ethical investment
- Abundant liquidity
- Growth of the halal industry
- Increasing awareness of investors
- Governments introducing tax and legal incentives to encourage Islamic finance business
- Above mentioned product innovation
- Searching for alternatives to conventional banking
- Sukuk market

6. Division of Islamic finance industry

As we noted above, the Islamic finance industry now reaches further than simple banking services. What was started in the sixties as a regional banking project now covers a full scale of investment, leasing, insurance and funding options. Islamic finance assets

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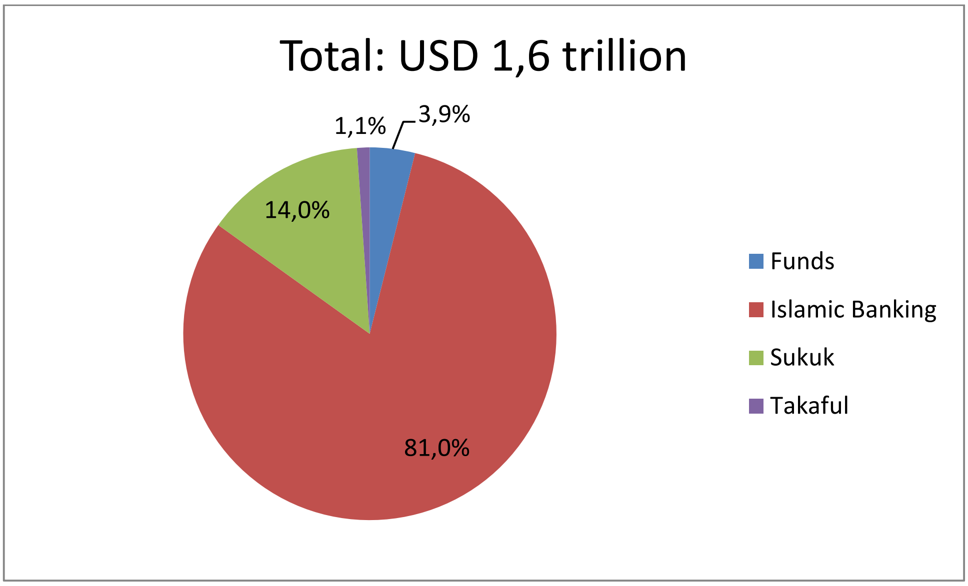
alongside different techniques. While a conventional bond is a promise to repay a loan, Sukuk constitute partial ownership in a debt, asset, project, business, or investment. Most commonly used Sukuk structures replicate the cash flows of conventional bonds. Such structures are listed on exchanges, commonly Luxembourg Stock Exchange and London Stock Exchange in Europe, and made tradable through conventional organizations like Euroclear or Clearstream.

[147] IRTI Annual report (2011) p.12

[148] GIFF (2012) p.11

worldwide has expanded from USD150 billion in the mid-1990s to USD1.3 trillion as at end-2011[149], yet this growth was not equally divided in between provided products. In the further we will examine every single sector of Islamic finance with regards to its importance. There are four most important services provided by Islamic finance industry today. First there is Islamic banking, original and still the biggest part of the industry. Secondly there is Sukuk sector, rapidly increasing its share of the market since the global financial crisis. Islamic investment funds are currently on the third place in the overall summary. On the last, the fourth spot, there is small but very significant sector – Islamic insurance, called Takaful. As long as this work aims to the Islamic banking, we will examine it in much more detail than others. However, at least short notice about all sectors is necessary to deeper understating of Islamic finance industry development.

Graph 3: Global Islamic finance assets (2012)



Source 5:According to GIFF, 2012

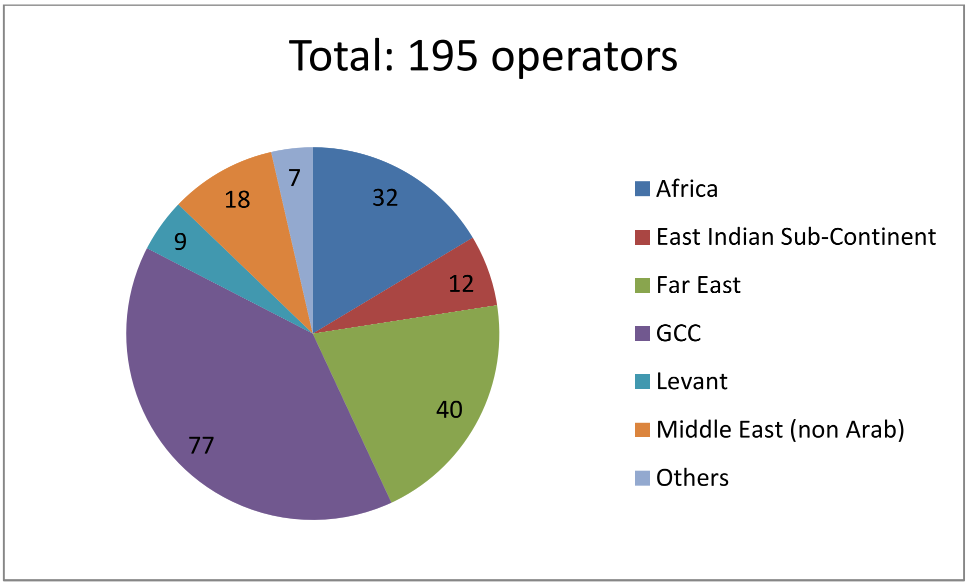
6.1 Islamic insurance – Takaful

Takaful represents the smallest part of the Islamic finance. It was started a bit later than first Islamic banks, in 1979 in Sudan, yet the biggest boom come in last five years. In 2008, they were 133 Takaful companies (TCs) registered. In 2010 we are talking about 195 TCs. Between 2007 and 2011, global Takaful contributions expanded at a CAGR of 19.1% to reach an USD15.2 billion in 2011.[150] Today Takaful market spreads across more than 30

[149] GIFF (2012) p.4
[150] GIFF (2012) p.1

countries; however it is highly concentrated in the Middle East, especially in GCC countries, with an exception of traditional proponent of Islamic finance – Malaysia.

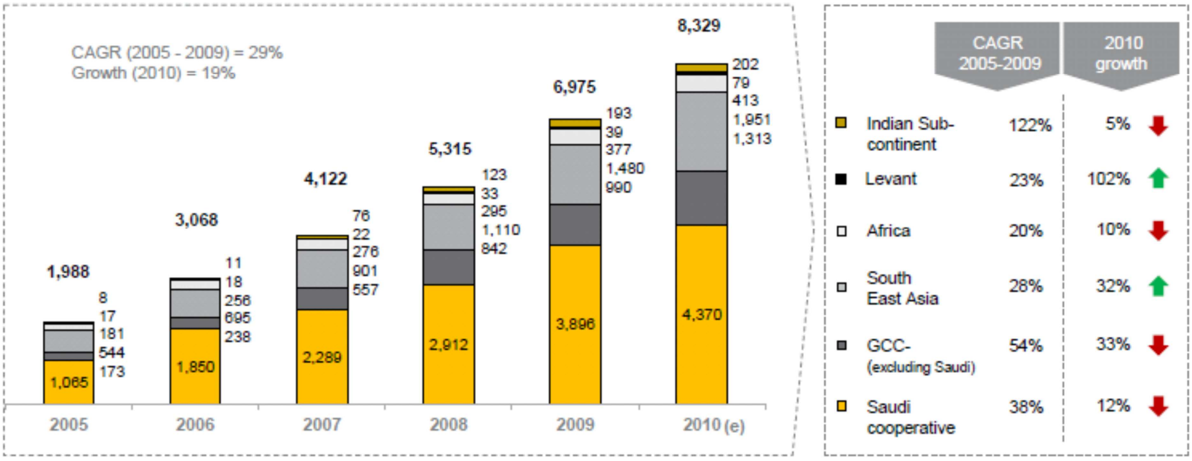
Graph 4: Regional division of Takaful companies



Source 6: According to World Islamic Insurance Directory, 2012

We can find several aspects behind the present rapid growth of Takaful industry. There are several common with Islamic finance industry as a whole – growing demand for Shariah-compliant products, increasing awareness of customers worldwide, abundant liquidity and government support. There also some industry-specific factors behind the growth, especially synergy effects from Sukuk markets and real economy. Issuance of high quality Sukuk papers further increasing investment options for Takaful companies. Increasing amount of banking products provides basis for further development in the insurance sector. Furthermore, Growth of real economy, especially huge infrastructure projects need to be the backboned by the insurance and development of the real estate market create further opportunities as well. Also strengthening of cooperation between individual Takaful companies creates more efficient distribution channels and supports spread of Islamic insurance products. All of these factors support outstanding efficiency of Takaful industry, which is expressed in double digit growth in post crisis years.

Graph 5: Global Takaful contribution 2005-2010



Source 7: Ernst&Young´s World Takaful report, 2012

It is clear, that Takaful industry operates predominantly in Muslim markets, but even if we consider only Muslim countries as relevant markets, Takaful is far from reaching its potential. Share of Islamic Finance in GCC and Malaysia is 25% and 22% whereas Takaful market share is 15% and 10% respectively. It means that Takaful has at least 10% of the known Shariah inclined market that they have not yet tapped. The GCC Takaful market predominantly comprises of general Takaful business with family Takaful accounting for as little as 5% in certain markets. With a high disposable income average and low market penetration, the GCC presents potential for family Takaful.[151] If we would turn to potential market, we will discover even more space for improving. There are approximately 1,6 billion Muslims all over the globe. From several reasons (religious, educational, monetary etc.), conventional insurance penetration among Muslim population is really low. There are ready-markets for Takaful opening just now – Libya, Egypt, Bangladesh, Indonesia, and Tunisia. Also there is significant Muslim minority spread over the Globe.[152] These people are already aware of Islamic banking products and soon they will turn to other options of Islamic finance, Takaful including. Therefore we can say, that, regardless its minority position among Islamic finance services, Takaful poses a huge potential to further increase its extent.

[151] Ernst&Young´s World Takaful report (2012) p.22

[152] If we consider only the most economically developed countries – USA (3,75 %), UK (2,7 %), Canada (1,48 %), Germany (3,4 %), France (7 %), Japan (1 %), Russia (18%), China (11%) . For more statistical data about Muslim population please see: https://www.cia.gov/library/publications/the-world-factbook/

6.2 Islamic funds

The Islamic fund industry has developed rapidly over the last decade to become one of the key components of the Islamic finance industry. Shariah-compliant funds have a relatively short history. They first appeared in the late 1960s in Malaysia and in the mid-1970s in the Middle East.[153] Since then, the Islamic fund industry has been on a growth momentum in recent years, spanning over 36 countries. It is true, that Islamic fund industry accounted only for approximately 4.5% of the global Islamic finance asset, with total assets under management of the industry stood at USD60.0 billion in 2011. [154] In regards to Islamic asset management, product development and the manufacture of Islamic funds has been commendable. The Islamic fund universe has grown at a strong pace. As an example, in 1996, there were approximately 40 Islamic equity funds whereas in 2010 the total universe has grown to more than 800 across various asset classes. This suggests substantial growth in the number of organizations involved in Islamic asset management in a space of less than 10 years.[155] Positive prospects are expected for the Islamic fund industry to improve moving forward, supported by sustained economic growth especially from oil and commodity-producing economies as well as high-savings and surplus countries, thereby driving the demand for Shariah-compliant investments.[156]

In terms of asset allocation, equities are the main asset class for Shariah-compliant funds worldwide, accounting for almost half of all assets. Malaysia is the largest Islamic equity market for Islamic funds with Saudi Arabia, the US, Ireland and Kuwait being the other major markets.

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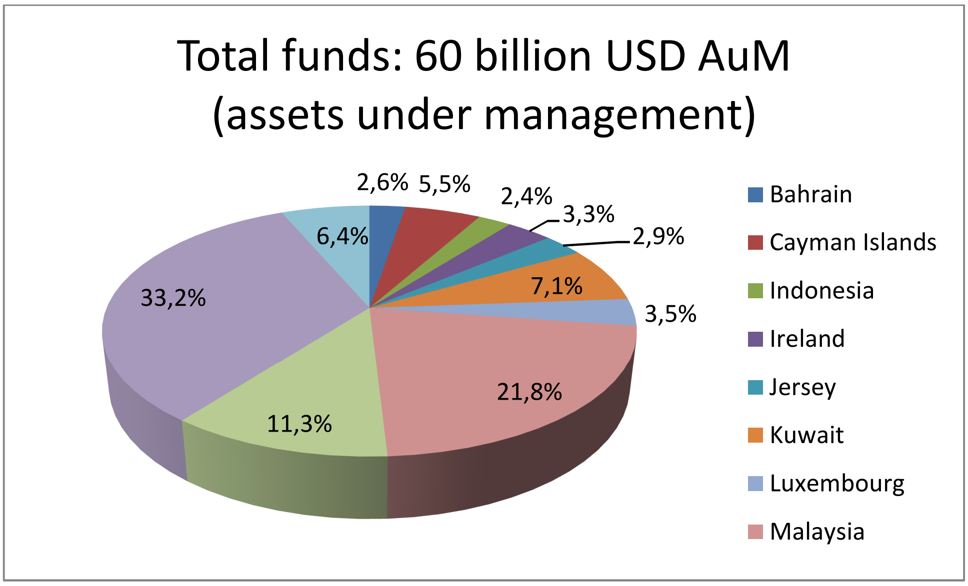
[153] GIFR (2010) p.67
[154] GIFF (2012) p.1
[155] GIFR (2011) p.81
[156] For more details see: Standard & Poor's Islamic Finance Outlook 2012

Graph 6: Islamic funds by domicile, 2011

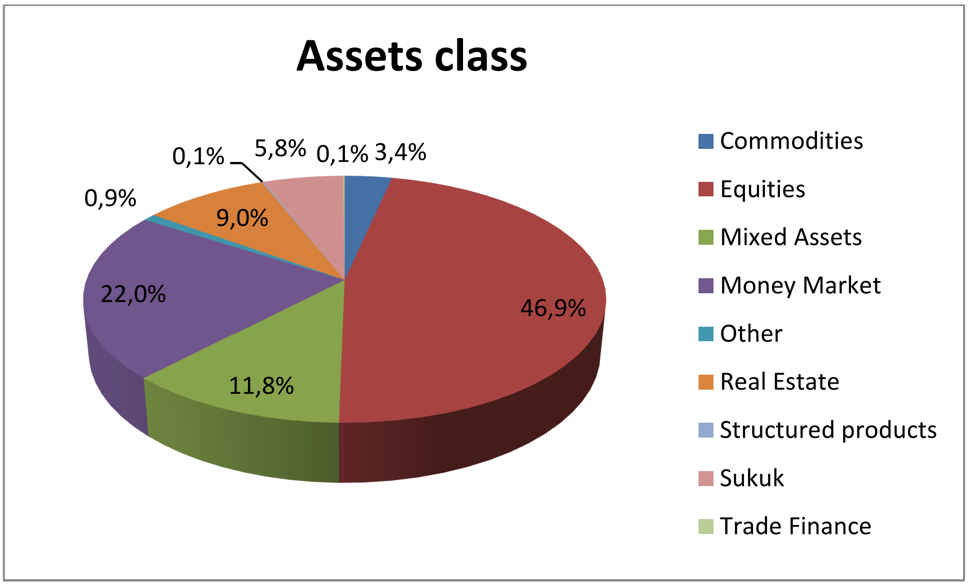


Source: According to GIFF, 2012

The rising wealth in Muslim nations, especially in the emerging economies and oil-rich countries, has helped drive investible assets. Especially sovereign funds of oil-producing countries[157] are well accepted in the global investment community. Despite the global economic struggles and the sovereign debt crisis in Europe, Islamic funds have managed to grow their assets on the back of descent market performance, as well as experiencing a number of new funds raised. With the global equity indices underperforming, investors continue to search for alternative asset classes. In particular, commodity funds have been an attractive safe haven for a wide range of investors during the turbulent times.

[157] A sovereign wealth fund (SWF) is a fund owned by a state (or a political subdivision of a federal state) composed of financial assets such as stocks, bonds, property or other financial instruments. Sovereign wealth funds are entities that manage the national savings for the purposes of investment. We are talking about billions of USD in oil-producing countries which are ready to be situated in various form of investment, Shariah-compliant including. (UAE – 861,6; Saudi Arabia – 538,1; Kuwait 342; Qatar – 115, Brunei – 30).

Graph 7: Islamic Funds by Asset class, 2011



Source 8: According to GIFF, 2012

It is necessary to note, that the Islamic fund universe is indeed very small; with Shariah-compliant funds numbering only 1.3% of their conventional cousins, and only 0.36% in assets under management compared to the global fund universe.[158] However, the reality of global market beneficial for Islamic funds. As the Europe struggles with debt crisis, new safe havens for institutional investors are demanded. Together with newly emerged Sukuk markets, as an alternative to conventional equity market, Islamic funds are attracting a lot of free capital. Also domestic demand has to be mentioned. As we mentioned above, there are 1,3 billion Muslims all over the world. Especially in GCC[159] and Western countries, there is strong potential among wealthy individuals to invest. Also the demographics of Muslim countries are heavily towards the under-40 age group. This would suggest that what underpins the growth expectations of the Islamic asset management industry is a booming younger Muslim generation of potential investors.

6.3 Sukuk market

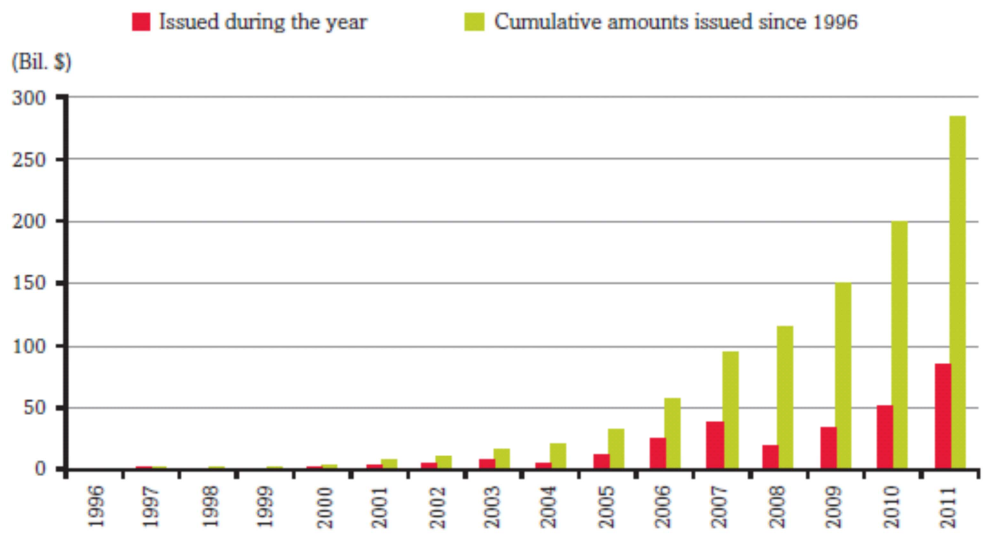
Sukuk is the Arabic name for financial certificates, but it is commonly used as an Islamic equivalent of bonds. It represents an equal and undivided share of ownership of tangible assets, usufruct and services or ownership in investment activity. The first private-

[158] GIFR (2011) p.75

[159] There are 45,9 million inhabitants in GCC, bearing together 1,37 trillion USD GDP, which makes it 29,9 GDP per capita.

sector sukuk issues were launched in Malaysia[160] in the 1990s, but over time, also governments played a key role in sponsoring these developments. The Malaysian government issued the first global sovereign sukuk in 2002 and this encouraged other Muslims countries to follow suit.[161] After its presentation in Malaysia, sukuk market developed rapidly across the globe in the GCC region and in other parts of Asia. As at end-2011, global Sukuk outstanding topped USD178.2 billion, as 2011 witnessed record high new sukuk issuances of USD85.1 billion. Over the years, the sukuk market has grown by a compound annual growth rate (CAGR) of 28.3% between 2006 and in the first half of 2012 to reach USD210.8 billion and contributed 13.4% of the global Islamic finance assets in 2011.[162]

Graph 8: Global sukuk issuance, 1996-2011



Source 9: Standard&Poor´s Islamic finance outlook, 2012

Lastly, since sukuk are the flagship product of Islamic finance and banks are the biggest players in that market, these financial instruments are likely to herald wider international recognition of Islamic banking on the global financial scene, and contribute to its expansion outside Asia and the GCC. Sukuk, which grew from zero issuance before 1996 to a cumulative $350 billion by mid-2012, are representative of the strengths of the Islamic

[160] The Malaysian government introduced somewhat special approach to Islamic finance. As we said before, there is mixed banking system in Malaysia – commercial and Islamic banking exist next to each other. However, commercial banking is subject to market forces, while Islamic finance industry enjoys consistent and long-term support from government. It is one of the reasons while Malaysian Islamic finance sector produce so many innovations in field of Islamic finance, sukuk including.

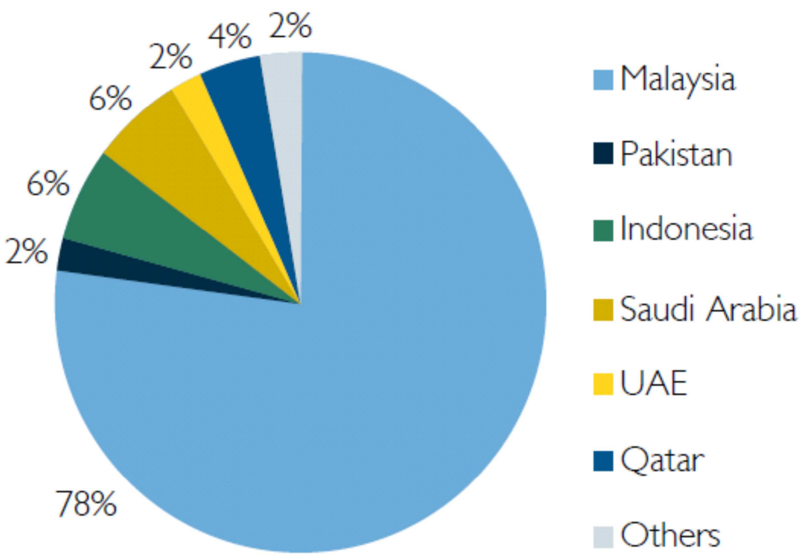
[161] GIFR (2011) p.66

[162] GIFF (2012) pp.19-21

finance industry as a whole.[163] The growth in the sukuk market has fueled the emergence of the Islamic asset management industry, particularly in Saudi Arabia where the regulator decided to separate investment banking activities from asset management (very similar to Glass-Steagall Act, 1933).[164]

The original position of Malaysia as a leader on sukuk markets is still unchallenged; however there is an increase of sukuk issuance all over the Muslim, especially in GCC countries. The GCC's combined economic resilience, strong project pipeline, and regional refinancing needs could cause issuance from the GCC to match that from Malaysia in the medium- to long-term. Sovereign issues are needed to fuel huge infrastructure projects of the Gulf countries (e.g. there was currently more than USD276.2 billion in planned transportation projects in the GCC countries in 2012).[165]

Graph 9: Geographical distribution of primary Sukuk Issuance in 2011



Source 10: GIFR, 2011

Nowadays we can find full scale of Sukuk principles. Starting with Ijarah (lease) and Murabaha (cost-plus contract) Sukuk in the 90s, Sukuk market now covers sectors of all

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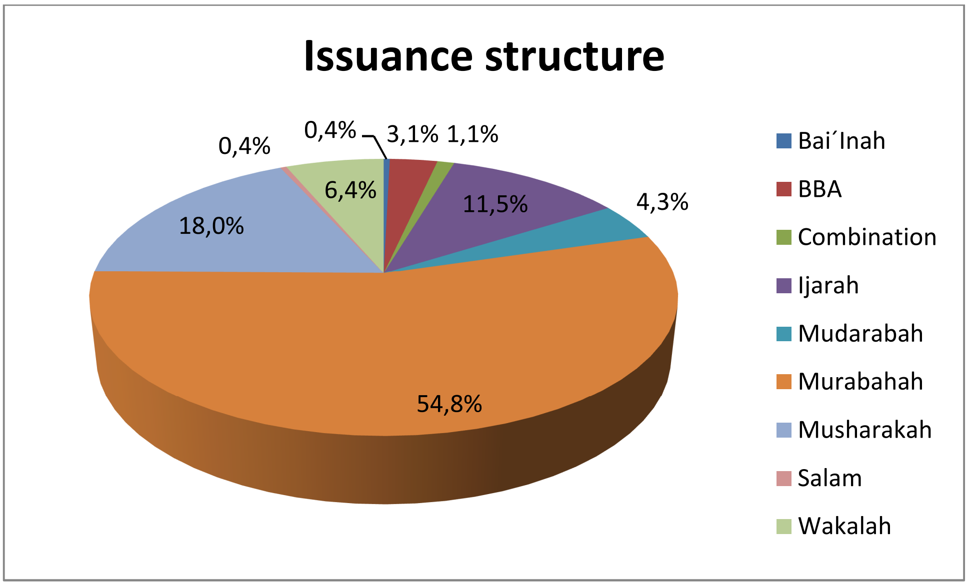
[163] STANDARD&POOR Islamic finance outlook (2012) p.22

[164] The term Glass–Steagall Act is most often used to refer to four provisions of the United States Banking Act of 1933 that limited commercial bank securities activities and affiliations between commercial banks and securities firms. For the full version of the Act see: Federal reserve archive (http://fraser.stlouisfed.org/publication-issue/?id=10671)

[165] GIFF (2012) p.20

Islamic banking products - Musharakah (equity participation), Wakalah (insurance agency), Salam (forward sale), Mudarabah (trustee finance), convertible and exchangeable trusts, etc.

Graph 10: Sukuk Issuance by structure, 2011



Source 11: According to GIFF, 2012

With such a broad scale of an option Sukuk has become a viable alternative to conventional bonds evidenced by the large number of funds raised by both corporate and sovereign issuers. The huge growth of sukuk witnessed in 2011 was driven by the declining yields for both corporate and sovereign issuances on the back of the Middle Eastern political tensions, which in turn led to a record year for Middle Eastern sukuk issuances, and the uncertainty in the global economy due to both the European sovereign debt crisis, and the fears of another recession in the US and other developed markets. It is true that growth has been mainly driven by the South East Asia; however demand from European investors picked up markedly towards the end of 2011 as funds fled to safety. Until the global credit crises in 2008 we saw mainly corporate sukuks issues, now mostly come from government subjects. Sovereign issuers maintain the bulk share of primary market issuances over the past few years as governments increase their local currency programs, which makes sovereign sukuks safe havens for capital fleeing from unstable western markets.

Graph 11: Sukuk issuance by issuer type

Source 12: Standard&Poor´s Islamic finance outlook, 2012

Sukuk market is definitely very popular these days. There are growth drivers similar with Islamic finance sector, however, we can find sector specific as well. Governments have strong incentives and initiatives to support sukuk issuances. High liquidity levels in GCC[166] and others countries are creating strong demand for short term sukuk investment. This demand means that cost associated with rating funds through sukuk has declined significantly. Also there are existing funding gaps and infrastructure requirements in key Islamic markets, where sukuk already penetrated. It is necessary to note, that there are also aspects slowing the growth of the industry. Further standardization is needed[167] to attract more international capital. Right now, sukuks are issued mainly privately to preselected investors. We can witness listing of sukuk on exchange stocks, yet this phenomenon is just gaining speed and it will take some time.

[166] Total liquidity levels in GCC has more than doubled between 2005 and 2012, boosted by high oil prices and inward FDI (foreign direct investment) flows due to improved economic outlook. The ratio of total GCC money supply (M3) to total GCC population above the age of 15 rose from USD 14,722 in 2005, to 27,908 in 2012. The financial crisis of 2008 pushed GCC investors to hold more liquid assets and the trend continued after the crisis. For more details see: http://www.gic.com.kw/site_media/GIC/GCCMonthly2013.pdf

[167] Standardization of Islamic finance sector is actual ongoing issue. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 1990, is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari'a standards for Islamic financial institutions and the industry. It has 200 members from 45 countries and stands as the foremost institution in field of standardization of Islamic finance sector. For more details see: www.aaoifi.com

The overall sukuk market is a rising star of Islamic finance. Both primary and secondary markets are drawing attention of the global investment public. With still an unresolved European debt crisis and never ending trade quarrel between China and USA, sukuk represents a viable alternative to conventional bonds. It is still very exotic, attracting more risk oriented players of the investment market, however, with further standardization, and sukuk market bears huge potential.

7. Islamic Banking

Banks account for the lion's share of total assets in the global Islamic finance market. That's natural, given that Islamic finance started at banks, before spreading its wings to insurance and wealth and fund management. And there is a lot of room for continued growth since this market is relatively small[168] compared to the global financial industry.[169] The expansion of Islamic banking in the past few years accelerated. The industry matured in traditional territories and started to spread out to other potential markets. Especially countries with significant Muslim minorities, like the United Kingdom and Africa (more than 400 millions of Muslim population spread over the continent) bear huge potential for expansion of Islamic banking. In order to assess the current state of Islamic industry it is necessary to note one fact. It is difficult to assess the size of Islamic banking accurately. Although most of the world's leading financial institutions have windows for Islamic banking, they rarely disclose the importance of Islamic banking in their business. Moreover, small rural cooperatives run on Islamic principles are not accounted for. Also, the definition of Islamic banking varies across countries, with an Islamic bank in Iran conducting its business differently from an Islamic bank in, say, Malaysia. Thus current databases almost certainly underestimate the importance of Islamic banking.[170]

There are well over 200 Islamic banks operating in over 70 countries comprising most of the Muslim world and many Western countries.[171] The industry is growing at a rate of 10-15 percent per annum compared to 7 percent recorded by global finance Industry.[172]Islamic banking has been the major driving force of the global Islamic finance industry, with an estimated asset size of USD1.1 trillion as at end-2011 contributed to 80.9%

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[168] The Islamic banking industry currently constitutes only 1.6% of the total assets of the top 50 largest banks in the world (totaling USD66.2 trillion at the end-2011).
[169] STANDARD&POOR Islamic finance outlook (2012) p.21
[170] Imam, Kpodar (2010) p.8
[171] Hassan, Lewis (2007) p.1
[172] Anwar (2003) p.64

of Islamic finance assets worldwide.[173] Although there is significant evidence of sustainable growth in Islamic banking, industry itself still poses no real competition to conventional banking in sense of assets managed. The whole Islamic finance industry represents only approximately 1% of global assets [174] and we should have in mind that banking represents not the whole industry. Therefore we can say that even if Islamic banking will grow at a steady pace of two digit growth, it will take a considerable amount of time to catch up with conventional banking. In this sense I would like to stress regional importance of Islamic banking. Islamic banking plays significant role in several Muslim countries, especially GCC and we must have it in mind during further research.

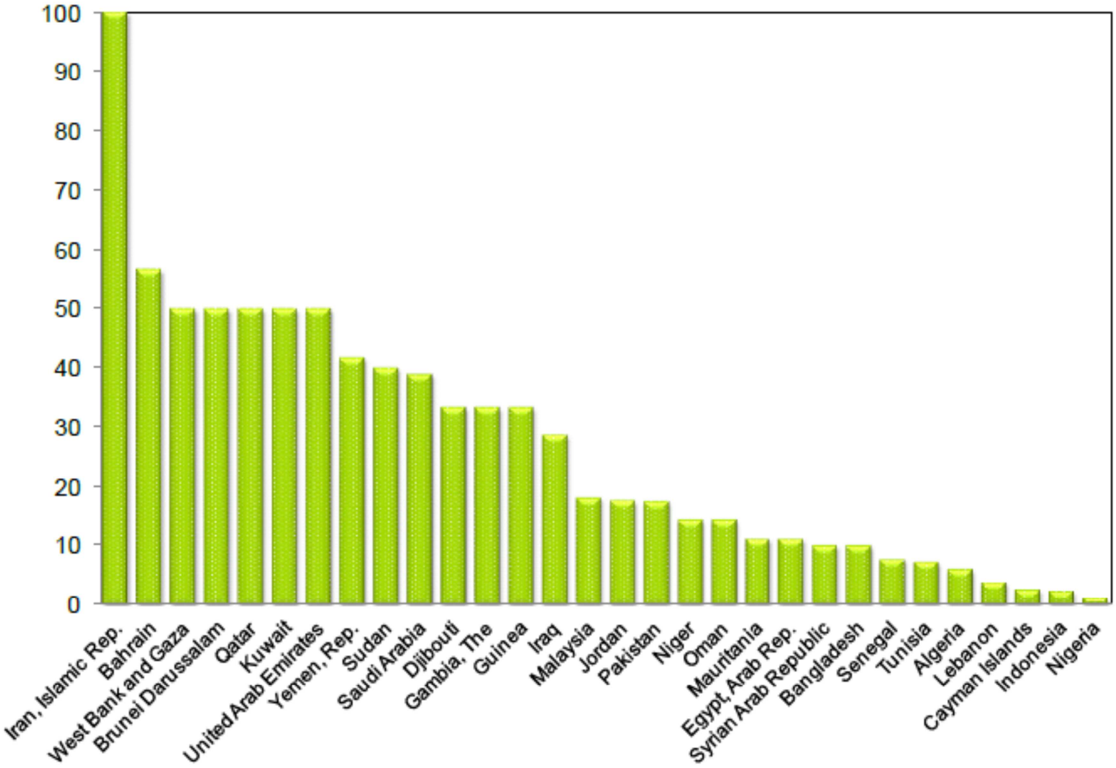
Even in countries, who are proponents of Islamic banking and stand in front of its progress, Islamic banks have to face competition of the conventional banking system. There is not a single country in the world without some providers of conventional banking services (with exception of Islamic republic of Iran as we mentioned above).[175] However, Islamic banking proves as a viable alternative.

[173] GIFF (2012) p.15

[174] Islamic finance and Global financial stability, 2010, p. 28

[175] We also mentioned Pakistan and Sudan together with Iran. However in these two countries, transition to full Islamic banking system is not finished. It was either halted or slowed down from various political and economical obstacles.

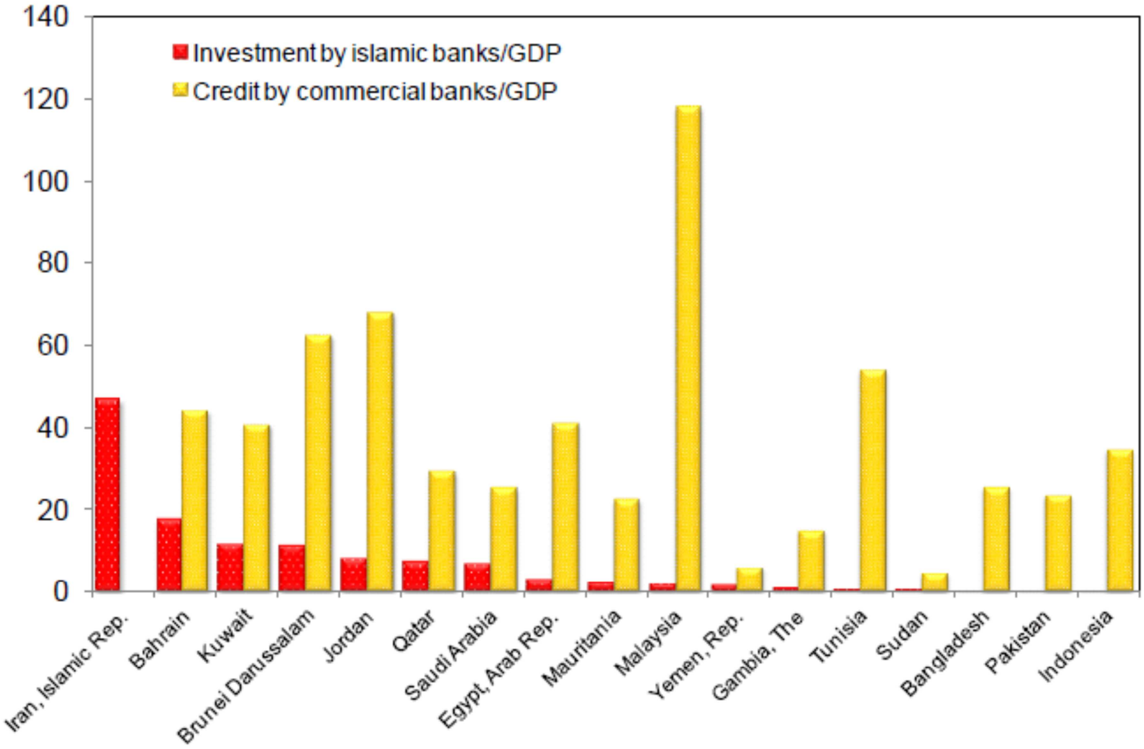
Graph 12: Share of Islamic Banks in Total Banking System in Selected Countries, 2006 (in percents)



Source 13:Imam, Kpodar, 2010

As we can see from the graph no. 12, the share hold of Islamic banking on the banking industry of several countries is relatively high. This suggests that with certain institutional background and some degree of governmental support, Islamic banking could surpass its conventional older brother. However, the number of banking institutions does not prove effectiveness or attractiveness of the products or services. We need to turn to more predictive factors and subject them to further research.

Graph 13: Comparing Investment by Islamic Banks with Credit by Conventional Banks in Selected Countries (average 1992-2006, percent of GDP)



Source 14: Imam, Kpodar, 2010

If we compare credit by Islamic banks to conventional banks, even in countries like Malaysia where Islamic banking is well-developed, it is dwarfed by conventional banks. We can see that in almost all countries, except Iran, the ratio of credit of conventional banks to GDP is substantially higher than the investment to GDP ratio of Islamic banks, which accounts for less than 20 percent of GDP in most countries. Therefore, the importance of Islamic banking varies, being relatively high in the Gulf and East Asia in absolute numbers though relatively small in comparison with how much investment they finance as a share of GDP compared to conventional banks. In other regions, the importance of Islamic banking is even lower.

The relative importance of the Islamic banking has nothing to do with the fact that it exhibits an unprecedented growth rate. Therefore it suggests that we will see increase of importance of Islamic banking industry in the future – starting in well-covered regions like Bahrain or Kuwait, expanding further into potential markets we mentioned above. There are several aspects supporting growth of Islamic banking industry:[176]

- Proven performance over the financial crisis period. The Islamic banking industry remained resilient despite the recent financial crisis with a CAGR of 28.2% between 2007 and 2009
- Growth in supply of banking products and services. New jurisdictions are introducing Islamic banking operations with a wide range of competitive products and services offered as a viable alternative to the conventional product range
- Increased trade between Muslin countries creates demand for Shariah-compliant trade financing solutions. Nowadays especially connections between Asia and Middle East trade centers are strengthened.
- Growth in micro financing products for lower society classes.[177] The offering of Islamic micro financing products opens up opportunities for rural, under-banked and low income groups to surplus funds for financing various economic activities.
- Significant Muslim communities in the UK, US, Germany and France provides opportunities for the Islamic banks in offering Shariah-compliant products and services.
- Huge funding gap in GCC from the retreat of European banks, due to the recent European debt crisis.

Given that the Islamic banking industry is only half a century old and represents a young market segment in the global financial system, it has a huge market potential to grow further. Thus, it is important for Islamic banks lead the market in product innovation in order to distinguish themselves from their conventional peers as a viable alternative solution.

[176] GIFF (2012) p.16

[177] Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance. It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law. As a result, Islamic microfinance is becoming an ever more important instrument to fight rural poverty in Muslim countries, and effectively diversify strategies improving access to finance in other parts of the world. Islamic microfinance is current phenomena and it is increasing its importance every year. For more details see: http://www.ifad.org/operations/projects/regions/pn/factsheets/nena_islamic.pdf

It is true, that product innovation should stand as the main goal of the industry in order to further increase its glamour for potential customers. However geographical expansion should be emphasized as well. Major Islamic bank houses already started to push forward into potential markets. There is a significant amount of new countries accepting Islamic finance, either as a viable alternative to conventional system or its complement.

Recently Oman has taken steps to establish a full-fledged banking company. Nigeria is going to launch its first Islamic financial house (Jaiz bank) soon. Also Islamic Bank of Maldives opened its doors for business along with the Amana Bank in Sri Lanka.[178] The Islamic banking industry is expected to witness encouraging developments in emerging economies such as Turkey, Indonesia, India and China promote the alternative form of financial intermediation, underpinned by the increasing demand for alternative banking products and services. Other jurisdictions in Central Asia such as Kazakhstan, Turkmenistan and Tajikistan are also identified as high potentials in the Islamic banking radar given the demographics and support from government agencies.[179] We can also find promising political movement towards Islamic banking in western countries. France is another new entrant to the IFCCR (The Islamic Finance Centers Competitive Review) list this year and is included as one of the emerging markets for Islamic finance. The initiatives pursued by the French government have turned its fledgling Islamic finance market into a promising and attractive proposition for investors. In Australia, the government is working hard to be part of the Islamic finance industry and to position itself to attract a greater number of Shariah-compliant funds.[180]

Opposite to the historical development of Islamic banking, when private companies were pioneers of the industry, currently strong governmental support[181] usually starts penetration of the potential markets. Changes of demographic structures of western countries are creating political pressure as more and more citizens demands Shariah-

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[178] Islamic development bank Annual report, 2011, p.58

[179] GIFF (2012) p.17

[180] GIFF (2012) p.42

[181] We can see strong governmental support in new markets, however there are some countries with fully developed Islamic banks, where government support either does not exist or is limited at the best. For example, there is lack of government support for Islamic finance in Oman, while officials in Bahrain and Kuwait have been very supportive. Ironically, on a comparative level, Saudi Arabia's government has been very reluctant to promote Islamic banking in the Kingdom. Whereas the central banks in Bahrain and Kuwait have been active in integrating Islamic banks to the broader domestic financial system, the SAMA (Saudi Arabia's central bank) has yet to formally recognize the presence of Islamic finance in the Kingdom. (http://gulfnews.com/business/banking/islamic-finance-lacks-government-support-in-some-gcc-countries-1.499863)

compliant modes of financing (this is true especially in European countries like UK, France, Luxembourg, Germany and others). There are also purely market pressures coming from increased demand for Islamic banking products (USA, Hong Kong, Australia).

There are no doubts, that Islamic banking industry bears significant potential. With its growth rate and current penetration of potential markets, we can say that there is a future for this specific segment of global finance. Whether this future will be long or short lasting depends primarily on the ability of Islamic banking to further attract not only Muslim clients but also global players in financial markets. We will examine the characteristics of Islamic banking in detail further, especially with respect of its viability as a separate and alternative banking system to conventional baking.

8. Introduction of Islamic Banking

We discussed and examined historical and institutional development of Islamic banking above. However, if we want to properly compare conventional and Islamic banking system, there is a second part to be examined. Historical development and current state of art show us what was achieved in the field of Islamic finance, but we must examine the operational framework and processes behind this development. Only so we can fully understand why Islamic banking is so successful /unsuccessful in comparison to its conventional version. Therefore we will go through the principles of Islamic moral economy. These creates theoretical basis for the operational framework in Islamic finance. We will identify the basic principles and guidelines of Islamic banking today, highlighting prohibition of riba and profit-loss sharing. These principles and guidelines set framework in which particular modes of financing and banking products are operating. Then we will go shortly through products offered by Islamic banks in order to identify possible stabilizing factors for the banking system in comparison to conventional banking. Attention will be paid also to schism in between the ideal model of Islamic banking presented in Islamic Moral economy and reality on international markets.

8.1 Islamic moral economy

Islamic Moral economy (IME), in its modern form came into use in the 1970s. It comes out of the critique of capitalist and communist systems which failed to provide newly created post-colonial states desired wealth and prosperity. In the eyes of Muslim scholars more emphasis should be given to societal well-being rather than market performance.

In the opinion of the founding fathers[182], the failure of economic development in the 1960s and 1970s was attributed to capitalist economic development strategies, which ignored the importance of the human being and its well-being. Their objective was, to develop an economic system understanding, which could develop a human-centric development strategy. The Islamic Moral economy paradigm aimed at the creation of the Islamic system of economics with its distinct values, norm, rules and institutions in accordance with historical Islamic values derived from the Quran and hadiths.[183] Then, the Islamic Moral Economy, is an approach to, and process of, interpreting and solving the economic problems of human beings based on the values, norms, laws and institutions found in, and derived from the sources of Islam. There are several basic principles creating a framework for IME[184] and these principles are creating the basis of Islamic economy (we mentioned these principles in the first chapter so we will not go into details in here)

- Tawhid (God´s unity and sovereignty[185])
- Al-'adl wa'l-ihsan (socioeconomic justice and equilibrium)
- Ikhtiyar (free will)
- Fard (responsibility)
- Rububiyyah (Divine arrangements to perfection
- Tazkiyah.
- Khilafah

There is one more axiom supporting above mentioned - Maqasid al-Shariah (objective of Shariah). We also discussed it in methodology part so there is no need to go through in detail. Together with respecting Shariah law all these axioms create the framework of the Islamic moral economy, which, in consequence stands as a foundation for Islamic finance. The universal ethical system, based on these axioms, is believed to produce policies aimed at enhancing motivation to seek knowledge and work, enhance productivity, and enhance transparency in government. They should also importantly enhance intra-and intergenerational equity.[186]

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[182] According to Visser(2010), founding fathers of Islamic economy are: A. Maududi (1903-1979), M. Iqbal (1950 -), N. Siddiqi (1931 -) and M. al-Sadr (1935-1980)
[183] Asutay (2010) p.1
[184] Asutay (2008)p.1, for comparison see Karim (2010)
[185] The Islamic worldview is based on tawhid (the Oneness of God), risalah (God's prophets as the source of Divine Guidance) and akhirah (life-after death, that is the continuity of life beyond death and a system of accountability based on Divine Law)
[186] Naqvi (1994)

As you can see, what Muslims proudly call Islamic values and Westerners boast of as Western values are in reality universal values. Let's begin with the big three: life, liberty, and property.[187] It is true that axioms presented above are somehow summarizing basic liberties as we know them even from our culture. However, there is strong evidence from reality that these liberties and rights are not given in full extent to the whole population, western or Islamic world including. Therefore there is one important fact to recognize. IME is a utopian concept and as such, it should guide reality towards itself. It is definitely not a description of reality of Muslim countries.

The Islamic Moral economy espouses economic values and practices that embrace utopian ideals of absolute financial and social equality. It is a utopian riba-free universe where all unfairness and injustice are removed from reality; it promotes a reality that incorporates elements of the free market economy vis-à-vis the price function of supply and demand, as well as socialist elements of mutual ownership and care.[188] The role of buyer and seller, and thus supply and demand, is imbued with certain moral and ethical expectations rooted in Islamic ideas equity, responsibility and free will. Therefore, market participants are not allowed to engage in activities prohibited by Shariah. In the Muslim paradigm all relationships are contractual. The divine law is the outer limit within which human beings create their own relationships and interactions. In that space there is vast room for a variety of arrangements. It is for this reason that one observes such differences in Muslims societies from those of the Berbers of Africa, the Arabs of the Gulf, to the villagers of Indonesia. Morally, theft, fraud, and injustice have been prohibited by the Shariah. Islam does not merely respect the right of contract in the abstract, but holds contracts to be of such importance that some specifics of Islamic contract law are found in the Quran[189] itself.[190]

These restrictions have consequences on Islamic finance. The Islamic Moral economy is free from riba, maysir and gharar, which are generally defined as "financial interest" or "usury," "gambling," and "excessive risk" respectively. The elimination of riba, maysir and gharar form the foundational basis for modern attempts at establishing an Islamic Moral Economy. In modern Islamic economy, riba, maysir and gharar are superficially and

[187] Ahmad, Shabbir (2008)p.5
[188] Karim (2010) p.125
[189] The holy Quran provides provisions for making contracts when a loan is given or when any business agreement is made. Allah exhorts the people to write down the terms of business or loan given free of interest so that they do not forget the terms of the business or loan agreement later. For more details see: http://www.ijbssnet.com/journals/Vol._1_No._2_November_2010/14.pdf
[190] Ahmad, Shabbir (2008) p.6

legally omitted from contracts, or are holistically replaced by true profit-and-loss sharing models that embrace risk and reward reciprocity.[191]

It naturally follows that the constraints placed on economic activity by Islam appear to be Utopian in nature. It is not practically possible to ensure that all market participants are honest, generous and considerate. Neither is it practical to assume that all market participants have equal knowledge about prices in the marketplace. Indeed, theIslamic moral economy, like Marx's communism, has a great deal of appeal: elimination of hunger, poverty, mutual care, and so forth. However, the problem is that the Islamic Moral economy and Islamic economic doctrines in general assume that each market participant will exercise the basic principles and values expected of Muslims. However, what is expected (i.e., the ideal) and what actually occurs (i.e., reality) are often very different.[192]

I would like to use simile in this case. If you study economics anywhere in the Western world, since the first year you are confronted with idea of perfectly competitive markets. Something unreachable but still close enough to keep trying. The idea of perfect competitive markets has a long tradition in western economic thinking and it is never being fully discarded, or reached. It is very similar in theory of Islamic moral economics. As a paradigm started in the 70s, it serves as a perfect image of what should be Islamic economy and subsequently finance in its perfect state. And we should accept it as that – benchmark to reality which should lead contemporary scientist on the right way. It is then target of this work to assess how far present Islamic finance diverts from this Utopia and how this departure affects its market performance, but first we have to identify basic principles of Islamic finance as it stands today.

9. Basic principles of Islamic banking

Islamic culture is characterized by strict guidelines in most aspects of life, including financial sphere. Therefore there are several strict rules which have to be followed in order to ensure islamicity of banking transactions. Each banking product is examined through correspondent institutions to assess if it complies with these basic principles. Six basic principles are taken into consideration while executing any Islamic banking transaction:[193]

[191] Karim (2010) p.5
[192] Ibidem p.129
[193] Ahmad, Shabbir (2008) p.14

1. Sanctity of contract
2. Risk sharing
3. Prohibition of Riba/interest
4. Economic purpose/activity
5. Fairness
6. No invalid subject matter

We will go through every single principle to define base for Islamic banking transaction and asses their impact on the real market.

9.1 Sanctity of contract

Before executing any Islamic banking transaction, the counter parties have to satisfy whether the transaction is halal[194] (valid) in the eyes of Islamic Shariah. This means that Islamic bank's transaction must not be invalid or voidable. An invalid contract is a contract, which by virtue of its nature is invalid according to Shariah rulings. Whereas a contract is voidable contract, which by nature is valid, but some invalid components are inserted in the valid contract. Unless these invalid components are eliminated from the valid contract, the contract will remain voidable.[195] Islamic finance 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.[196]

Each contract is judged according to Shariah rulings. There is not positive definition but rather negative one. In reverse to halal (valid) transactions, there are haram[197] (invalid) transactions. There is strict definition provided by law, what is haram. Rest of actions (financial transactions included) are halal then. Haram actions are applied to actions, such as murder, getting tattooed etc, policies, such as prohibition of riba or food and drinks prohibited to Muslims. There are several haram activities connected to the financial sector. We will go through riba prohibition, because we will examine that in detail later. The most important restrictions considering Islamic finance are in field of investment. As we

194 Halal (permissible, valid) is a term designating any object or an action which is permissible to use or engage in, according to Islamic law. The term was originally used to designate food seen as permissible according to Islamic law. Nowadays the term not only covers food and drink, but also all matters of daily life.
195 Ahmad, Shabbir (2008) p.15
196 Islamic finance and Global financial stability, 2010, p.16
197 Literaly translated as „sinful", haram is used to refer to any act prohibited by God. Acts that are haraam are typically prohibited in the religious texts of the Quran and the Sunnah. The category of haram is the highest status of prohibition. Actions that are haram result in punishment, and is therefore considered a sin if carried out by a Muslim.

mentioned above, financial contracts are invalid if haram object is a matter of contract (in other word, it breaks Shariah rulings). In reality it means, that there are no investments going on to follow industries – pork producing and processing industry, alcohol beverages producing and consuming sector, there are restrictions in the entertainment industry – Porn is highly illegal according to Shariah. Furthermore all forms of gambling are prohibited as well so we can rule out casinos or betting shops. It is also necessary to mention that these Shariah ruling are not generally accepted. Things or actions defined as haram/halal can differ under different jurisdiction. For examples it is forbidden for Islamic banks to invest in the tobacco industry in Malaysia yet it is allowed in Bahrain.[198]

As you can see there are severe investment limits for Islamic finance houses, however, there is another aspect as well. These limits definitely restrict the potential of Islamic banking, but, they also restrict its presence in somehow specific industries. We can witness every day struggle over tobacco industry in the western countries, there are significant funds issued in order to “fight” gambling, alcohol and porn industry. Also, as certain social groups are fighting these industries, corruption is often an issue in these industries in order to retain its position. Therefore limits or absolute restrictions of these investments could possibly contribute to the stability of the banking system in the sense of redirecting funds to more productive (or socially acceptable) use.

9.2 Risk sharing

Islamic banking is based on sharing the profit between borrower and lender on predefined rules.[199] Islamic jurists have drawn two principles from the saying of the prophet

Muhammad (SAW).[200]vThese are “Alkhiraj Biddamaan”[201] and “Alghunun Bilghurum”[202] Both the principles have similar meanings that no profit can be earned from an asset or a capital unless ownership risks have been taken by the earner of that profit. Thus in every Islamic banking transaction, the Islamic financial institution and/or its deposit holder take(s)

[198] Krasicka, Nowak (2012) p.8
[199] Khan (1986) p.6
[200] SAW - *ṣall Allāhu ´alay-hi wa-sallam* - Peace be upon him. It is custom to say or write this phrase after naming the Prophet Muhammad
[201] Gain accompanies liability for loss. Expression of the principle – no risk, no gain.
[202] Earning profit is legitimized only by risk-sharing and engaging in economic activity

the risk of ownership of the tangible asset, real services or capital before earning any profit there from. [203]

In the pre-Islamic period, all financial resources were mobilized on the basis of either interest or some sort of profit/loss sharing arrangements. Islam prohibited all dealings based on interest but allowed the continuance of the system of profit/loss sharing.[204] Profit-and-loss (PLS) sharing and risk sharing is officially preferred ever since as it is believed it alongside creates more value addition to the economy. PLS principle is also one of the few unanimously accepted in the Islamic legal and economic literatures as the cornerstone of financial transactions. According to the PLS principle, the bank may earn a return on invested funds provided that the bank shares in the risk of the investment and bears a loss if the project fails.[205]Muslim economists expect PLS based banking to exercise a favorable effect on the level of investment. It has been pointed out that both the demand for investment funds and the supply of investment funds are likely to show an increase consequent on replacement of interest-based banking by PLS based banking. The demand for investment funds is likely to increase as a fixed cost of capital is no longer required to be met as a part of the firm's profit calculations.[206]

Charging a fixed interest rate on the loans extended would raise several questions, as the results of the operations of a certain production enterprise, in which such loans are to be invested, are by no means certain. Therefore, guaranteeing, in advance, a fixed return on a loan without taking into consideration the actual results of the operations of the borrowing enterprise would put all business risk on the entrepreneur. However the arrangement would be fair if the financier were to participate in the actual profit or loss of the enterprise, as the case may be.[207] This is, in short, PLS theory applied in the Islamic banking. No profit should be made without bearing a risk. Riskless profits are against the spirits and the principles of Islamic Moral economy and therefore are forbidden in Islamic banking as well and replaced by PLS principles.

There has been extensive discussion about the effects of the PLS system of the real economy. It has been argued that a switch over from interest based banking to PLS

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[203] Ahmad, Shabbir (2008) p.15
[204] Ziauddin (1994) .p.4
[205] Aggarwal, Yousef (2000) p.96
[206] Ziauddin (1994) p.14
[207] Iqbal (2001) p.36

base banking would impart greater stability to the banking system. The argument proceeds on the following lines. In the interest based system, the nominal value of deposit liabilities is fixed. However, there is no assurance on the assets side that all the loans and advances will be recovered. Shocks on the assets side, therefore, lead to divergence between assets and liabilities, and the banking system can suffer a loss of confidence in the process, leading to banking crises. In the PLS based system, the nominal value of investment deposits is not guaranteed, and shocks to the asset positions are promptly absorbed in the values of investment deposits. This minimizes the risk of bank failures and enhances the stability of the banking system.[208] Therefore introducing PLS modes of financing into the banking system has almost the same effect as direct investment which brings a return to economic development.

There are also other arguments supporting not only bigger stability of the PLS banking system but also synergy effects in economy. Islamic banking could complement conventional banks and thereby help diversify systemic risk. In conventional banks, when a bank gives out a loan, the borrower bears all risks, except in the case of bankruptcy. In Islamic banking, both bank and entrepreneurs share the rewards and failure. In many developing countries risk sharing might allow entrepreneurs with little savings to undertake projects they could not contemplate in an environment where all the risk lies on them. In conventional banking, the creditworthiness of the borrower is the main determinant of the lending decision, and banks are interested in the interest and principal on the loan. In Islamic banking, because profits and losses are shared, banks will receive a return only if a project is successful. Therefore, Islamic banks are more prone to finance sound projects, even if the entrepreneur has no credit history.[209]

PLS is one of the most important principles of Islamic banking, so for further analysis, I would like to sum up the biggest advantages of it:[210]

- The allocation of financial resources on the basis of profit-and-loss sharing gives maximum weight to the profitability of the investment, whereas an interest-based allocation gives it to credit worthiness. We can expect the allocation made on the basis of profitability to be more efficient than that made on the basis of interest.

[208] Ziauddin (1994) p.16
[209] Imam, Kpodar (2010) p.6
[210] Iqbal (2001) p.36-37

- A system based on profit sharing would be more stable compared to one based on a fixed interest rate on capital. In the first, the bank is obliged to pay a fixed return on its obligations regardless of their performance, should the economic conditions deteriorate. In the latter, the return paid on the bank's obligations depends directly on the returns of its portfolio of assets. Consequently, the cost of capital would adjust itself automatically to adapt to changes in production and in other business conditions.
- Any shock, which might befall the obligations' side of the balance sheet, would be automatically absorbed. This flexibility not only prevents the failure of the enterprises seeking funding, but also ensures the existence of a necessary harmony between the firm's cash flow and its repayment obligations, that element which enables the financial system to work smoothly.
- Since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in contrast with the financial factors) become the prime movers of the rates of return to the financial sector.
- The transformation of an interest-based system into one based on profit-sharing helps achieve economic growth as this results in increasing the supply of venture or risk capital and, consequently, encourages new project owners to enter the realm of production as a result of more participation in the risk-taking.

9.3 No Riba/interest

Islamic banks cannot involve in riba/interest related transactions. Prohibition of Riba comes from many references in the Quran and it is unquestionable to a Muslim population. There are several references defining what it is Riba and how to deal with those who practice business including riba elements.

Those who take interest will not stand but as stands whom the demon has driven crazy by his touch. That is because they have said: 'Trading is but like riba'. And Allah has permitted trading and prohibited riba. So, whoever receives an advice from his Lord and stops, he is allowed what has passed, and his matter is up to Allah. And the ones who revert back, those are the people of the Fire. There they remain forever. Allah destroys riba and nourishes charities. And Allah does not like any sinful disbeliever. Surely those who believe and do good deeds, establish Salah and pay Zakah, have their reward with their Lord, and there is no fear for them, nor shall they grieve. O those who believe, fear Allah and give up what still remains of the riba if you are believers. But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your *principal. Neither you wrong, nor are wronged. And if there is one in misery, then deferment till ease. And that you leave it as alms is far better for you, if you really know. And be fearful of a day when you shall be returned to Allah, then everybody shall be paid, in full, what he has earned. And they shall not be wronged." [Surah Al-Baqarah 2:275-281]*[211]

Those who practice riba will not rise from the grave except as someone driven mad by Shaytan's touch. That is because they say, "Trade is the same as riba." But Allah has permitted trade and He has forbidden riba. Anyone who receives a warning from his Lord and then desists can keep what he received in the past and his affair is up to Allah. But any who return to it will be the Companions of the Fire, remaining in it timelessly, forever.[Surah Al-Baqarah 2:274][212]

There are also many Hadiths referring to the prohibition of riba and are quoting Prophet Muhammad´s (SAW) followers: [213]

Riba is equal to seventy different kinds of sins, the least grave being equivalent to a man marrying (i.e. having sexual intercourse) with his own mother.

A Dirham of Riba, which a man receives knowingly, is worse than committing adultery thirty-six times.

This night I dreamt that two men came and took me to a holy land whence we proceeded on till we reached a river of blood, where a man was standing, and on its bank was standing another man with stones in this hand. The man in the middle of the river tried to come out, but the other threw a stone at his mouth and forced him to go back to his original place. Whenever he tried to come out the other threw a stone at his mouth and forced him to go back. I asked: "Who is this?" I was told: "The person in the river was one who consumed Riba.

As you can see, the Islamic restriction against interest is quite explicit and has to be taken as axiomatic. Transactions based on riba are strictly prohibited in the Quran.[214] The hostility to interest is based on the belief that the Quran bans all interest, regardless of its rate or form.[215] Nevertheless, for the past half-century, opposition to interest has been treated as the sine qua non of being an "Islamic" economist.[216] On an individual level, there is no real room for differences in interpretation about whether interest can or cannot be paid in an Islamic economy. It is the general view that it is considerations of equity and

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[211] Saheeh International (2010) p.62
[212] Ibidem p.61
[213] Vadillo (2006) p.4
[214] Khan (1986) p.5
[215] In fact, what the Quran bans is ribdi, the pre-Islamic Arabian practice of doubling the debt of a borrower unable to make restitution on schedule, including both the principal and the accumulated interest. Riba tended to push defaulters into enslavement, so it was an acute source of social friction. From the earliest days of Islam to the present, various interpreters of the Quran have held, accordingly, that the purpose of the ban on ribdi was simply to block socially harmful financial practices.
[216] Kuran (1995) p.157

protection of the poor that lie behind the strong condemnation of interest-based transaction.[217]

There is an extensive discussion among Islamic scholars whether definition of riba really equals with definition of interest. Riba in its literal sense means excess and in the technical sense (in the Shariah), riba is the stipulated excess without any counter-value in bay (sale).[218] It is not target of this work to discuss possible deviations in between riba and interest. It is the author´s opinion, in compliance with today common practice in Islamic banking, that riba means interest in all its forms. For detailed discussion about the matter please see Farook (2007), Siddiqi (2006), Vadillo (2006) or Karim (2010).

9.4 Economic purpose/activity

Every Islamic banking transaction has certain economic purpose/activity. Each financial transaction must refer to a tangible, identifiable underlying asset or real service. This restriction is closely connected with definition of riba in the Quran. It refers to possessions (*´ayn*) and non-possession (*dayn*) of the object of exchange. ´Ayn is tangible merchandise. Dayn is a promise of payment or a debt, or anything whose delivery or payment is delayed. To exchange dayn for ´ayn of the same genus is Riba. To exchange dayn for dayn is also forbidden. In an exchange it is only allowed to exchange ‘ayn for ‘ayn.[219] Definitions of possession and non-possession bring serious consequence about the fiat money as we know them. In Islamic finance, money is not allowed to be used as “potential” capital. Money itself bears no productivity so there has to be no refund for holding them without further use. Money is not a commodity, but a medium of exchange, a stored value and a unit of measurement. Money represents purchasing power and cannot be utilized to increase the purchasing power without any productive activity. Islamic finance advocates the creation of wealth through trade and commerce not through lending or borrowing.[220]

Prohibition of debt-financing and debt-trading further restricts Islamic bank´s investment and hedging options. However it also makes them less vulnerable to the effects of abundant trading with debt-obligations. It also protects them from the effect of over-complicated financial engineering involving debt transfers. Prohibition of debt instruments

[217] Khan (1986) p.5
[218] Farooq (2007) p.8
[219] Vadillo (2006) p.14
[220] Islamic finance global stability report, 2010, p.16

like CDO, mortgage backed securities and other ABS proved to be the right decision in light of subprime mortgage crisis and recent European debt crisis. We will discuss real impacts of such a prohibition on Islamic banks later.

9.5 Fairness

Islamic banking inculcates fairness through its operations. Transactions based on dubious terms and conditions cannot become part of Islamic banking. All the terms and conditions embedded in the transactions are properly disclosed in the contract/agreement.[221] Fairness is closely connected to prohibition of riba, because all transactions including aspects of riba are deemed as unfair by the Quran. For example, when a borrower knows what would be the total amount to repay the borrowing, he can assess the contract and make the decision voluntarily whether to enter into such a contract. In the absence of a stipulation of predetermined excess (rate or lump-sum), the borrower doesn't know what kind of excess would have to be faced, if the debt is not settled at the end of the contract period. It means if I don’t know how much interest I will pay, it is unfair. Knowing and accepting the terms of a contract are not sufficient to ensure fairness, but they are necessary conditions. [222] Fair contracts should include full disclosure of all the pertinent terms.

There are two other aspects of fairness in the Islamic finance – extreme uncertainty (*gharar)* and game of chance (gambling) (*maysir).* Islamic finance prohibits transactions featuring these two aspects. Uncertainty and gambling in contractual terms and conditions are forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.[223]

Gharar and Maysir concept are overlapping. Making contract extremely uncertain is in fact making it a gamble. Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling.[224] There are the ancient roots of such a restriction, where original cause was to prevent fraud and deception and decrease informational asymmetry. The Prophet itself (SAW) has forbidden the purchase of the unborn animal in its mother’s womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their

[221] Ahmad, Shabbir (2008) p.15
[222] Farooq (2007) p.10
[223] Standard&Poor´s Islamic finance outlook (2012) p.96
[224] El-Gammal (2000)p.7

distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.[225]

From today's viewpoint, gharar and maysir concepts are in fact prohibitive in sense of speculation on the financial markets. There are different views on the speculation among Western scholars, yet there are many claiming that speculation in fact increases the amplitude of recessions and crisis through market volatility. There is also a factual prohibition of option instruments in Islamic banking, which make prices in some markets, for example commodity market, more connected to reality and therefore stable. Gharar and maysir concepts are ancient tools and as such, there is discussion about their interpretation similar to the one we mentioned in case of riba. For further details I would suggest Al-Suwailem (2010) or Karim (2010).

9.6 No invalid subject matter

The last principle of the Islamic banking is basically just a framework for above stated. While executing an Islamic banking transaction, it is ensured that no invalid subject matter or activity is financed by the Islamic financial transaction. Some subject matter or activities may be allowed by the law of the respective country but if the same are not allowed by Shariah, these cannot be provided as products by an Islamic bank. As you can see, there are several levels of control before the product is declared as approved for business. There are overlapping jurisdictions checking every single product and service from Islamic point of view. The Sharia law creates framework under which every institution deemed as Islamic operates. Below the Sharia, there are international institutions covering Islamic banking like IDB or AAIFI.[226] Then there are national jurisdictions creating their own law framework. At last there are Shariah boards[227] in every Islamic financial institution. The set of these institutions ensures that every product labeled as Islamic is truly in compliance with today´s Islamic principles.

[225] Siddiqi (2009) p.21
[226] Accounting and Auditing organization for Islamic Financial Institutions
[227] A Sharia Board certifies the Islamic financial products as being Sharia-compliant. It thereby reviews the related contracts and provides an opinion about whether those agreements would be permissible under Islamic law.

10. Basic products

Islamic banks all over the world are providing financial services according above stated principles. There is a significant part of the Muslim population demanding Shariah compliant products from various reasons. It could be personal, religious or simply public relations incentive to use purely Islamic finance means. It is not target of this work to assess the incentives behind this demand in detail. However, since most Muslims lack sufficient knowledge regarding the various conditions for a sale to be valid, contemporary jurists and financial practitioners have limited Islamic banking and finance to a few "named" contracts. These are contracts that have been studied extensively by jurists over the centuries, and whose validity is well established through the Prophet's (SAW) own actions (Sunnah), or consensus of the early Muslim communities and jurists. To further add credibility to the industry, the Arabic names for those contracts are often used instead of their English counterparts (e.g. the term Ijarah is often used instead of its English counterpart "lease"). In what follows, we shall review the most commonly used contracts in Islamic finance, utilizing both their Arabic and English names.[228]

We can divide Islamic financial products (or contracts) into three subcategories:[229]

1. Profit and loss sharing modes – mudarabah, musharakah
2. Debt creating modes (financing the purchase of commodities on credit with a mark-up) – murabahah, Salam, istisina, ijarah
3. Non-profit products – qardhul-hasan, awqah, Zakat

There are 21 operational modes to perform banking transactions used today: mudarabah, musharakah, mutnaqisah, ijarah, ijarah wa iktina, murabahah, bail Salam, mau mu´ajjal, bai Istisna, bai eenah, muzara´a, musaqah, qardhul-hasan, wakala, finacing through aquaf and etc.[230] These operational modes differ in sense of importance and amounts of financing utilize. Therefore we will go just through the most important for them to describe the actual practice of Islamic banks. We will not discuss here most lately phenomena of Islamic finance – various sukuk issues, tawaruq practices[231] and Islamic funds. As they appeared or

[228] El-Gammal (2000)p.10
[229] Ahmad, Shabbir (2008) p.41
[230] Anwar (2003) p.63
[231] Tawaruq is a transaction where one party buys some goods on credit at a marked-up price and sells the same at a lesser value for the purpose of getting cash (i.e. the spot value of the goods). The purpose of this transaction is not the possession of the goods, but the obtainment of liquidity. However this practice is considered debt-like financing and it is denied by majority of Islamic banks, while it is legally permissible.

are broadly in use just lately, there is no connection between examining stability during former crisis and these recent products.

As we said above Islamic banks provide financing using two basic methods. The first depends on profit-and-loss sharing and includes mudarabah and mushārakah. In this case the return is not fixed in advance and depends on the ultimate outcome of the business. The second involves the sale of goods and services on credit and leads to the indebtedness of the party purchasing those goods and services. It incorporates a number of modes including murābahah, ijārah, Salam and istisnā. The return to the financier in these modes is a part of the price. These modes of finance are unique for two main reasons. First, the debt associated with financing by way of markup results from the sale/purchase of real goods and services rather than the lending and borrowing of money Secondly, the introduction into a banking of modes that depend on profit and loss sharing bring important advantages. It brings the financial system closer to reality and provides return based on actual performance of the economy.[232]

10.1 Mudarabah (passive partnership)

The earliest Islamic financial product to appear on the scene was investment deposit with an Islamic bank or investment certificate issued by an Islamic investment company. Both were based on profit-sharing partnership – Mudarabah, between the depositor/certificate holder (rabb-al-mal) and the bank/investment company (mudarib).[233]

Mudarabah represent contract between two parties: a capital owner (rabb-al-mail) and an investment manager (mudarib). The capital owners are responsible for supplying the mudarabah partnership with capital and maintain the legal right to the profits of the enterprise in proportion to capital invested; losses are borne by the rabb-al-mail and are limited to the capital invested. The mudarib or entrepreneur is not liable for the losses of the

Whatever the legal opinion, the economic role of the transaction can hardly be different from that of lending and borrowing money. As the credit price on which the client buys the asset is invariably higher than the cash price on which the asset is sold, tawaruq is functionally identical to interest based. For further details see Siddiqi (2009)

[232]Iqbal, Al-Jarhi (2001) p.21

[233] Siddiqi (2009)p.8

enterprise unless such losses are due to negligence or fraud.[234] There are two sub forms of mudarabah contract.[235]

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as rabb-al-mal and the bank as the mudarib. Mudarabah deposits can be either general, which enter into a common pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the rabb-al-mal and the businessman as the mudarib (manager). However; the manager is often allowed to mix the mudarabah capital with his own funds. In this case profit may be distributed in accordance with the ratios agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.[236]The hard core of almost all Islamic banking models developed so far is a two-tier mudarabah contract, the first among the depositors and the bank, and the second between the bank and the parties to whom finance is provided.237

The mudarabah type of partnership represents the basic model of capital acquisition for banks. Two-tier variant of partnership serves as a mean to collect the savings of the common populous in compliance with Islamic principles. Therefore mudarabah is a cornerstone of today´s Islamic banking in the sense of acquiring funds.

10.2 Musharakah (active partnership, equity partnership)

The musharakah contract is seen as the most innovative and religiously viable financial contract within today's Islamic banking product repertoire.[238] The contract involves two or more equity partners engaged in the purchase or operation of a good, service or business enterprise respectively. A musharakah contract is similar to that of the mudarabah, with the difference that in the case of musharakah all partners can participate in the management and provision of capital and also share in the profit and loss. Profits are distributed between partners in accordance with pre-agreed ratios, but the loss must be

[234] Karim (2010) p.86

[235] Al-Mudarabah Al-Muqayyada: Rabb-al-mal who, in case of Islamic bank, is depositor specifies a particular business or a particular place for the mudarib (bank), in which case he shall invest the money. This is called Al-Mudarabah Al- Muqayyadah (restricted Mudarabah).
Al-Mudarabah Al-Mutlaqah: In case where rabb-al-mal (depositor) gives full freedom to the mudarib (bank) to undertake whatever business he deems fit, this is called Al-Mudarabah Al-Mutlaqah (unrestricted Mudarabah).

[236] Iqbal, Al-Jarhi (2001) p.22

[237] Ziauddin (1994) p.5

[238] Karim (2010) p.68

distributed in proportion to the share of each in the total capital.[239] It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.[240] The typical musharakah contract can be seen in three different kinds – permanent, temporary and diminishing. Diminishing musharakah is broadly used in housing markets so we will pay bigger attention to it.

Diminishing musharakah is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.[241] Necessary part of the diminishing partnership is a lease agreement on the product (rental agreement in case of a house), where one party agrees to lease product to the second one till the time that gradual selling is done.[242]

10.3 Murabahah (Sales contract at a profit mark – up)

Contracts based on sales were next to appear in Islamic finance. Murabahah is a sale with a mark-up on purchase price, payment being deferred.[243] Under this contract, the client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called markup in favor of the

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239 Iqbal, Al-Jarhi (2001) p.23
240 Ahmad, Shabbir (2008) p.20
241 El-Gammal (2000) p.23
242 To illustrate the musharakah partnership more clearly, the following is a hypothetical scenario: Assume that A has $20,000 and wishes to purchase a home for $100,000, instead of borrowing the remaining $80,000 from a bank and paying interest, A approaches B for the purposes of forming a diminishing musharakah partnership. After B conducts its due diligence, B concludes that the home purchase may be a profitable investment. A and B enter into a musharakah partnership agreement where A contributes $20,000 and B contributes $80,000; the ownership ratio of the home and all the income and expenses it may generate shall be distributed in the 20:80 ratio for A and B respectively. Additionally, A enters into a separate and independent agreement to rent the newly acquired home from the musharakah partnership in the form of an ijarah lease agreement at a hypothetical market rent of $ 1,000. Because A owns 20 percent of the partnership and B owns the remaining 80 percent, $200 of the gross rent belongs to A and $800 belongs to B. With the $200 rental income, A then purchases $200 of additional equity interest in the musharakah partnership in the form of units or shares from B thereby increasing A's ownership interest to $20,200 and decreasing B's ownership interest to $79,800. Therefore any increase or decrease in ownership by A or B respectively is similar to the declining loan balance of a conventional interest-based mortgage.
243 Siddiqi (2009) p.9

bank. Thus, the transaction consists of an order accompanied by a promise to purchase and two sales contracts. The first contract is concluded between the Islamic bank and the supply of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a markup. The deferred price may be paid as a lump sum or in installments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent to receive the goods purchased by the ban.[244]

Today murabahah contracts represent the majority of all contracts concluded in Islamic banks. The murabahah contract has been used to finance myriad goods and services including smaller consumer transactions that would normally be purchased through credit cards, to larger transactions involving more capital intensive assets (e.g., automobiles, aircraft, real estate, equipment, etc.) The murabahah contract may also be used for commercial revolving credit facilities that typically finance working capital requirements of for-profit and non-profit enterprises.[245]

Murabahah practice creates a controversial phenomenon in today's Islamic finance. Even that it is legally in order and it is approved by Shariah experts; controversial aspects of this practice are still discussed. A question may be raised that selling goods for profit (under murabahah) and charging interest on the loan (as per the practice of conventional banks) appears to be one of the same things and also produces the same results. In addition to the problem of marginal ownership risk for lenders in a murabahah contract, most Islamic banks also utilize an interest-rate benchmark (e.g., LIBOR, FFR or the Wall Street Journal Prime Rate) for pricing the gross "profit-margin" on murabahah transactions. Thus, the murabahah not only eliminates the fundamental principle of profit-and-loss sharing vis-à-vis ownership risk for the "lending" institution, but the pricing mechanism is also explicitly tied to the time-value function of a usurious financial metric.[246] On the other hand, murabahah is a sale contract whereas the conventional finance overdraft facility is an interest based lending agreement and transaction. In case of murabahah, the bank sells an asset and charges profit which is a trade activity declared halal (valid) in the Islamic Shariah. Whereas giving loan and charging interest thereupon is pure interest-based transaction declared haram (prohibited) by Islamic Shariah.

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[244] Iqbal, Al-Jarhi (2001) p.23
[245] Karim (2010) p. 59
[246] Ibidem p.60

Therefore for the purposes of this work we will accept murabahah as a valid Islamic finance mode. I would suggest Karim (2010), Ahmad, Shabbir (2008) or Al-Jarhi, Iqbal (2001) for further details about the validity of the mark – up sales practices.

10.4 Ijarah (leasing)

The subject matter in a leasing contract is the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains, etc. This usufruct is sold to the lessee at a predetermined price. The lessor retains the ownership of the asset with all the rights as well as the responsibilities that go with ownership. As a form of financing used by Islamic banks, the contract takes the form of an order by a client to the bank, requesting the bank to purchase a piece of equipment, promising, at the same time, to lease it from the bank after it has been purchased. Thus, this mode of financing includes a purchase order, a promise to lease, and a leasing contract.[247] An ijarah lease, with compliance with the general principles of Islamic banking, must be asset-based, and more specifically, an asset that is considered durable; additionally, both parties must be exposed to reciprocal risk.

Legally, the lease contract is not a sale of the object, but rather a sale of the usufruct (the right to use the object) for a specified period of time. The sale of usufruct is permissible in Islam, as evidenced by the verses in the Quran:

And if they suckle your offspring, give them their recompense. [Surah al-Talaq, 65:6][248]

The most important financial difference between islamically permitted leasing and conventional financial leasing is that the leasing agency must own the leased object for the duration of the lease. Recently, Muslim jurists have also provided an Islamic alternative to conventional lease-purchase agreements. In this contract, a lease is written as discussed above, with an additional promise by the lessor that he will agree to sell the leased object at the end of the lease at a pre-determined residual value. This promise is binding on the lessor only, and the lessee has the option of purchasing the item at the end of the lease, or returning it to the owner-lessor.[249]

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[247] Iqbal, Al-Jarhi (2001) p.21
[248] Saheeh International (2010) p.832
[249] El-Gammal (2000)p.14

However there is also discussion about the appropriateness of Ijarah agreements as well. From an Islamic Moral economy perspective, the capital lease contract is considered an unfair and unjust financial arrangement because the lessor maintains legal ownership of the asset. Yet, the lessee is responsible for the ownership risk of the leased asset. Any contingent costs arising from the ownership risk of the leased asset are borne by the lessee and not the lessor. Moreover, a capital lease may not be cancelled before the lease contract maturity; this provision implicitly eliminates any possibility of reciprocal risk for the lessor and thus violates a requirement for a valid contract.[250]

10.5 Al- Istisna (Contract of manufacturer)

Al-Istisna is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. According to a decision of the OIC Fiqh Academy, this type of contract is of a binding nature, and the payment of a price could be deferred. [251] This form of financing is very rarely used so we will mention it just briefly.

It is a specific kind of a Bai (sale) where the sale of the commodity is transacted before the commodity comes into existence. The legality of Istisna is accepted by the Shariah scholars because it does not contain any prohibition. As far as the financing mode, it has been legalized on the basis of the principles of Istihsan (public interest).[252] Istisna is an agreement culminating in a sale at an agreed price whereby the purchaser places an order to manufacture, assemble or construct (or cause so to do) anything to be delivered at a future date. It becomes an obligation of the manufacturer or the builder (as the case may be) to deliver the asset of agreed specifications at the agreed period of time. As the sale was executed at the time of entering into the Istisna contract, the contracting parties need not renew an exchange of offer and acceptance after the subject matter is prepared. Istisna can be used for providing the facility of financing the manufacture or construction of houses, plants, projects and building of bridges, roads and highways etc.[253]

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[250] Karim (2010) p.84

[251] Iqbal, Al-Jarhi (2001) p.23

[252] Istihsan (In its literal sense it means "to consider something good) serves as a base principle for legal exceptions from basic principles of the Islamic banking. It is one of the principles of legal thought underlying personal interpretation of law (Ijtihad). For more details see: Interpretation in Islamic Law: The Theory of Ijtihād, Bernard Weiss, The American Journal of Comparative Law Vol. 26, No. 2, (Spring, 1978), pp. 199-212 Published by: American Society of Comparative Law Article Stable URL: http://www.jstor.org/stable/839668.

[253] Ahmad, Shabbir (2008) p.31

In general, the sale of non-existent objects is forbidden due to Gharar. However, to facilitate certain types of business, exceptions were given through this contract. As a conclusion, there are many conditions which must be met for an Istisna contract to be valid. It makes it expensive, bureaucratic and therefore not so used mode of finance.[254]

10.6 Salam

Salam contract has many similar aspects like Istisna. Its legitimacy in Shariah law is based on public interest as well; therefore we can say it is an exception. It is also used to finance non-existent objects at the time of the deal, which is generally considered as gharar. Therefore it is not broadly used in comparison to other modes of finance like Ijarah or murabahah, but it has its place among the financing options on Islamic markets.

Salam is a sales contract in which the price was paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a Salam contract. It is usually applied only to fungible commodities. For example, the bank could buy a commodity by making an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on a Salam or an installment sale basis.[255]

It looks like that Salam and Istisna are two very similar contracts but there are several important distinctions:[256]

- In case of Istisna, the subject on which transaction is based is always a thing which needs manufacturing/assembling/processing etc., whereas in case of Salam, the subject matter can be a thing that does not necessarily need manufacturing etc.
- The price in Istisna does not necessarily need to be paid in full in advance. It is not even necessary to pay the full price at delivery. It can be deferred to any time according to the agreement of the parties. The payment may also be made in installments. In case of Salam, the price has to be paid in full in advance.
- The time of delivery does not have to be necessarily fixed in Istisna whereas in case of Salam the time of delivery is an essential part of the sale.

[254] El-Gammal (2000) p.17
[255] Iqbal, Al-Jahri (2001) p. 25
[256] Ahmad, Shabbir (2008) p. 33

- Istisna contract can be cancelled before the manufacturer starts the work. Salam contract cannot be cancelled unilaterally.

10.7 Non profit products

Non-profit products of Islamic banking could be identified as a charity. It is basically a form of social help, some kind of social insurance. In theory, each financial institution should cherish these instruments to help to achieve targets of the Islamic Moral economy – social equality, abolishment of the poverty, etc. Some of these instruments, for example Zakat, have a long tradition in Islamic culture, so it is not possible for Islamic banks don't follow rules including these charitable tools. There is evidence, that these instruments are either not used properly or at such a scale they should be. We will discuss this problem briefly in the next section. As long as these instruments do not play any major role in Islamic banking, we will mention them only briefly just to demonstrate its existence and to describe its ideal use.

While the non-profit domain in Islamic finance has been in operation for many centuries, it is not so publicly known. This domain comprises institutions such as Zakat, Sadaqah, Awqaf and similar philanthropic and social responsibilities[257], which, in theory, are considered just as essential as the for profit domain within Islamic finance. They also perform beneficial economic support in serving the 'safety net' arrangement:[258]

- Zakat may be compared to a type of 'wealth tax', being an obligation related to defined types of assets from which a part is to be paid by the owner of the assets when the assets reach a certain amount. For example, Zakat on savings requires, inter alia, a holder of idle funds to contribute at a rate of 2.5% per annum to the eligible beneficiaries. It becomes payable if the holder's monetary funds have been idle for one year. This negates the incentive for hoarding, which the Holy Qur'an takes a strong position against.
- Awqaf represents the creation of an endowment whereby an asset or pool of assets is dedicated in perpetuity, primarily for charitable purposes. Historically, Awqaf has proven to be a useful institution in mobilizing idle assets for addressing poverty, as

[257] There is a discussion about social responsibility in Islamic banking. In theory, social injustice is mitigated through finance practices which are in compliance with Islamic principles, however, there is not such evidence nowadays. For more details see: Asutay (2008) or Aggarval, Yousef (2000).
[258] GIFR (2010) p.23

the beneficiaries of Awqaf can enjoy the benefits of education, health care, basic infrastructure and entrepreneurial assistance.

- The economic empowerment of the less fortunate, if carried out in a systematic and structured manner, may elevate them from the "non-bankable" to the "bankable" segment, thereby benefiting the individuals themselves, the financial system, and the community at large, as well as increasing financial inclusion.
- Qard al-hasanah is social or benevolent loan. These loans are made at no charge, with no interest due, and with no mark-up. It is similar to charitable or gift, rather than a loan because according to the rules, the principal amount should be forgiven to those who are not able to repay.

11. Ideal vs. reality of the Islamic banking.

We described the Islamic banking thoroughly in the chapters above. We also described the theoretical concept called Islamic Moral economy, which served as a framework for the creation of Islamic banking. It is now, after three decades of existence, when we have enough empirical evidence to assess if the Islamic banking really fulfills its targets, as was proposed and plan decades ago.

There are more and more voices[259] calling for revision of Islamic banking stating that it turn away from its original concept and should be rebuilt that way. I would like to briefly summarize Islamic banking and provide evidence of this diversion by comparison of ideal versus real status of the industry.

Probably the most highlighted aspects of Islamic banking are its stability and responsibility to lower social classes through profit-loss sharing contracts. There are many reasons for the possible instability of the traditional banking system. The basic flaw in the traditional system is that, as a crisis developed and earnings fell, banks would seek to contract loans to increase reserves. Each bank could do so, however, only at the expense of other banks, and in the process some banks would become insolvent and be forced to close. Alternatively banks tend to switch from the techniques of asset management to those of liability management in the face of a crisis, and that this practice has increased in the U.S. banking system. In other words, if banks raise interest rates to attract or retain de-posits in problem situations, and if the total stock of deposits is fixed in the short run, the process

[259] T. Kuran, M.Iqbal, M. Al-Jahri, etc.

would clearly be unstable and would eventually lead to bankruptcies. In such circumstances any system that guaranteed the transaction-balances component of deposits and eliminated the need or incentives for liability management would likely stabilize the process.[260]

In standard banking systems the individual is assured of the nominal value of his deposit on the other hand, in Islamic banking, value of the deposit is strictly connected to profit, positive profit is increasing nominal value, negative decreasing. It means that during the crisis bank would not bankrupt, because it would not have to pay predetermined levels of deposit but an actual one, given its financial health. In most countries there exists some form of official insurance scheme that backs the guarantee provided by banks; even if there is not, it is normally assumed that the government would step in should the need arise,[261] how we have seen during huge bail outs lately. This is amplifying negative impacts on people, even if bank would repay them, during crisis, the full amount of deposits, they will lose money on future tax increase to cover budget deficits created by deposit insurance.

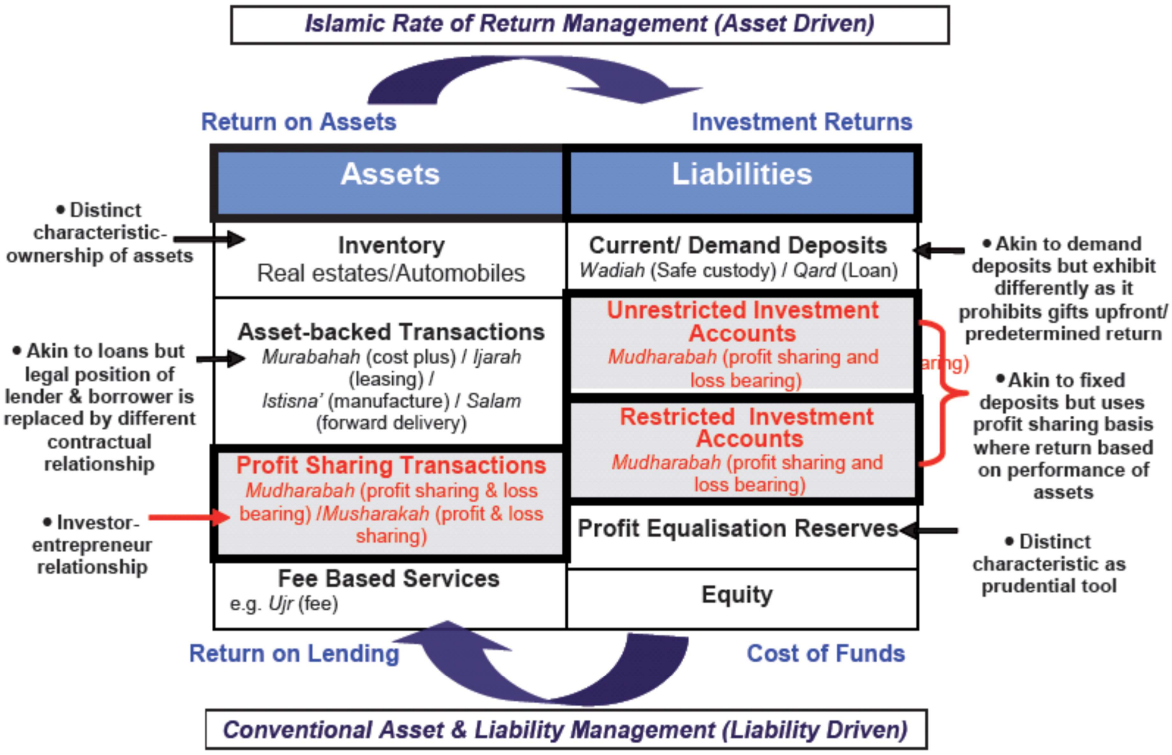
The result of such an operation would be what we see in the Islamic banking model. The fall in real profits of the banks will be matched with a real decline of wealth of common citizens, with the government intervening in the process. However, in conventional banking the whole process is much longer and much more hurtful. It suggests that there is rigidity in traditional banking system which can be overcome by implementing basic principles of Islamic banking, profit-loss sharing contracts primarily.

If, in theory, PLS contracts bring such endurance to the shocks of the economy, they should be promoted in Islamic banking in reality as well. However, we will see that this is not the case.

[260] Khan (1986) p.9

[261] We are referring to "too big too fail" concept. The **"too big to fail"** theory asserts that certain financial institutions are so large and so interconnected that their failure would be disastrous to the economy, and they therefore must be supported by government when they face difficulty. The colloquial term "too big to fail" was popularized in a 1984 Congressional hearing, discussing the Federal Deposit Insurance Corporation's intervention with Continental Illinois. The term had previously been used occasionally in the press and it is used ever since.

Picture 4: General balance sheet of an Islamic bank



Source 15: Islamic finance global stability report, 2010

What we see on the picture no. 4 is a balance sheet of an average Islamic bank. On the liability side, mobilizing funds on a profit sharing basis means that in principle the value of liabilities adjust accordingly in response to any change in the price of assets. Even if the price of the financed assets remains unchanged, the expected returns for the partners may fall (for example, because of weak demand), which will subsequently reduce the profit to be shared. On the asset side, Islamic banks enter into different financing modes we described above.[262]

While, on the liabilities side, Islamic banks have made significant progress in using profit sharing, this is not the case on the assets side. The share of profit-sharing modes in the total financing provided by Islamic banks is very small. Most of the financing is provided on a murabahah basis. This is evident from the statistics given in the table-score below. The weighted average of the use of murabahah mode is 66 percent.[263]

[262] Islamic finance and Global financial stability, 2010, p.18
[263] Iqbal, Al-Jahri, 2001, p.29

Distribution of Financing Provided by Islamic Banks (1994-1996) in percentage						
	Total Financing (Million US$)	**Mur*a*ba*h*ah**	**Mush*a*rakah**	**Mu*d*a*rabah***	**Leasing**	**Other Modes**
Institution						
Al Baraka Islamic Bank for Investment	119	82	7	6	2	3
Bahrain Islamic Bank	320	93	5	2	0	1
Faisal Islamic Bank, Bahrain	945	69	9	6	11	5
Bangladesh Islamic Bank Ltd.	309	52	4	17	14	14
Dubai Islamic Bank	1,3	88	1	6	0	6
Faisal Islamic Bank, Egypt	1,364	73	13	11	3	0
Jordan Islamic Bank	574	62	4	0	5	30
Kuwait Finance House	2,454	45	20	11	1	23
Islam Malaysia Bank Berhad	580	66	1	1	7	24
Qatar Islamic Bank	598	73	1	13	5	8
Simple Average	8,563	70	7	7	5	11
Weighted Average		66	10	8	4	12

Source: According to Iqbal, Al-Jahri, 2001.

The popularity of murabahah mode of financing is not coincidental or short-termed. Since the beginning of the Islamic banking industry, there were projects, which cannot be financed through profit-sharing from various reasons. In these cases, ‘returns’ to the finance would accrue over many decades in the future while costs had to be met in the present. Recourse to trade based modes of finance became necessary. This happened to privately established Islamic banks in the Gulf area as well as with the Islamic Development Bank. By the early nineteen-eighties, murabahah had become the dominant mode of Islamic finance everywhere.[264] An early theory had failed to pay due attention to trade based modes of finance and to the issue of capital protection. Murabahah seemed to fill the gap.[265] Islamic banks operating in different countries are using a combination of the different financing techniques permissible in Shariah. As we saw, most of them lean heavily on murabahah in

[264] Regarding preference towards equity-based PLS and risk-sharing financing over debt financing, data analysis, for instance, in the Malaysian IBF case depicts that the percentage share of musharakah declined from 1.4 per cent in 2000 to 0.2 per cent 2006, while major modes of Islamic financing remain to be sale of goods on a deferred payment basis with 55.9 per cent and 25.2 per cent respectively in 2006. In addition, from 1984 to 2006, murabahah constituted 88.1 per cent of the mode of financing for Bank Islam Malaysia Berhad, and 67.3 per cent for Dubai Islamic Bank, while mudarabah and musharakah was about 1.7 per cent and 9.3 per cent respectively. For more details see Asutay(2008).

[265] Siddiqi (2009) p.6

their operations. This is for two main reasons. Their orientation mainly is towards short term financing of trade transactions for which murabahah appear to be more convenient device compared to the system of profit/loss sharing. Secondly they are in competition with conventional banks and they want to earn at least the same. Mark-up methods make it easier as long as you can benchmark mark-up with actual interest rates.[266]

There has been a critical voice arguing that murabahah serves only as another tool to cover what is actually interest – based practice. Murabahah is formally equivalent to the resale contracting used in various parts of the world, even in places where interest avoidance is not an issue, to take advantage of differences in tax rates. Let us say a cash-poor industrialist needs a new computer. His Islamic bank buys the computer, marks up its price, and then transfers to him the computer's ownership; in return, our industrialist agrees to pay the bank the marked-up price in a year's time. If the predetermined markup rate were identical to the prevailing interest rate, this murabahah contract would be essentially equivalent to an interest-based contract. But there would still be one difference, which Islamic economy considers critical: during the period when the computer was owned by the bank, the bank would carry all the risks of ownership, including those of theft, fire, and breakage. In practice, however, the bank's ownership generally lasts just a few seconds, so its exposure risk is negligible. Ordinarily, therefore, murabahah serves as a covered form of interest.[267]

Critics of murabahah practice generalized the problem of disguising of the interest to whole Islamic banking industry saying that: … *Islamic bankers have devised various legalistic means of avoiding terminology that refers to interest or any time-value of borrowed capital through the concept of Salam or trade; the murabahah cost-plus contract is one example of how Islamic banking superficially avoids interest*… and that … *The financial instruments in use today by Islamic banks and insurers are not fundamentally different from their conventional non- Islamic counterparts. Instead, the contract language is changed superficially to incorporate various Arabic terms that purport to adhere to some sort of Islamic authenticity.*[268]

It is necessary to realize, that nowadays financial institutions generally operate in global markets. There is no way how to avoid interaction with interest-based tools from the

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266 Ziauddin (1994) p.19
267 Kuran (1995) p.162
268 Karim (2010) pp.30, 126

side of Islamic banking. Besides that, generations of Islamic bankers are western-educated. All together with tough competition from the side of conventional banking, there was significant pressure to provide competitive products. While theory aspired to prove Islamic finance was different from the conventional one, practitioners were busy searching for ways to make it similar to it. Convergence rather than divergence was the order of the day. Starting sometime during the nineteen eighties, Shariah advisors focused mainly on designing 'Shariah-compliant' substitutes for financial products with which the market was familiar.[269]

There is one more aspect supporting convergence theory. While Islamic banks respond to the needs of Muslim customers, they are not acting as religious institutions. Like other banks they are profit-maximizing entities. They act as intermediaries between savers and investors and offer custodial and other services found in traditional banking systems.[270] It had also has to do with the reality that many of the leading financial patrons of the Islamic financial institutions are interested in Shariah compliance only in a legalistic sense - without really any concern for injustice or exploitation. In most respects, the investment behavior of the estimated 200,000 high net worth individuals from Saudi Arabia and the Gulf is little different from that of their counterparts elsewhere. Their aim is to generate income and wealth of their assets which benefits their families and themselves, where the funds are invested being a less important considered. How funds are invested is for many more crucial than where, as most Saudi Arabian and Gulf citizens like Muslims elsewhere, are concerned about deriving income from interest, even though for the majority this concern does not translate into positive action. Some cleanse or purify interest income by donating it to charitable causes; others invest part of their funds in a Shariah –compliant manner to ease their conscience, while investing the remainder conventionally. In this respect, Islamic investors are little different to Western ethical investors, who tend to adopt a partial approach rather than deploying all their funds ethically.[271]

Therefore we can say that reality of international markets, which prioritize economic incentives rather than religious behavioral norms, has forced the Islamic banking industry to become part of the global financial market by adopting a system very similar to conventional one. There is evidence that Arabic language used in Islamic banking represents

[269] Siddiqi (2009) p. 7
[270] Imam, Kpodar (2010) p.3
[271] Farooq (2007) p.15

the only legal side of the industry. The original meaning of the Islamic banking, as proposed in Islamic morale Economy was definitely not achieved yet and probably would not in this course. Islamic banks are fulfilling the legal terms of being “Islamic” yet in reality they converge to conventional banking system.

12. Comparative part

Nowadays, most of the global financial world is based on what we called conventional banking. Interest rates driven transaction which is based on lender – borrower relationship are a cornerstone of this system. It is a well known system, practiced for centuries now. However, in light of current events in global markets, there are voices calling for either reform or alternative options how to govern financial flows properly, without possible “troubles” which we are currently experiencing.

Conventional financial system has played an active role in the development of the world economy; the system is now affected by severe crisis and now according to estimation during the last four decades this financial system is affected by more over 100 financial crunches.[272] Not a single geographical area or major country has been spared the effect of these crises. Even some of the countries that have generally followed sound fiscal and monetary policies have become engulfed in these crises. The subprime mortgage financial crisis, which started in the summer of 2007, was more severe than any in the past and shows no sign of abating despite a coordinated bail out of three to four trillion dollars by the US, the UK, Europe and a number of other countries.[273] Today we are experiencing and aftermath of something called “European credit crunch” (even so aftermath is probably not the proper word to use, as we can see in the case of Cyprus, some crisis connected issues are very actual). This credit crunch is but another from the series of financial crisis. In the twentieth century occurred a number of financial crises, just to note the few; the electricity crisis (1900-1903), Copper crisis (1907), 1929 crises (Great Depression), (oil price crisis) of 1973, (the Wall Street crisis) of 1987, the (Asian financial crisis) of 1997 which affected many Asian countries and the most recently current crisis in the world since 2008.[274] As the world markets become more global, these crises are having more severe impacts on the level of Production, GDP, Level of Employment, Per Capita Incomes, Inflation, Net of Trading,

[272] Shafiq, Faheem, Abdullah (2008) p.125
[273] Chapra (2008) p.1
[274] Al-Smadi, Almsafir (2012) p.425

Exchange Rate, Public Debt, etc.[275] Those impacts urged many researchers to find out the main causes of those crises. This has created an uneasy feeling that there is something basically wrong with the system. There is, hence, a call for a new architecture.

As we are experiencing further turmoil in financial markets, there are more and more researchers trying to find a common denominator for these events. The severity of the current crisis has led to the evaluation of the foundations of the capitalist financial system and the search for ideas and solutions. Clearly, serious mistakes have been made and lessons need to be learned. But to whom should governments, regulators and financial bosses turn for inspiration? One area of the banking sector that has consistently outperformed most other banks since the onset of the crisis is Islamic banking. Though still a very small part of the global financial system, Islamic banking has consistently enjoyed double-digit annual growth, even during the worst years of the global downturn.[276]

The current global financial crisis has accentuated the urgent need to embark on one of the most radical reshape of the international financial system. The attitudes and the approaches articulated by the advocates and the opponents of both government intervention versus free market economies schools of thought thus far have failed to deliver a viable long-term solution to the crisis or to prescribe a practical mechanism on how to deal with its consequences and implications.[277] So, has the time come to seek out alternatives?

Because the traditional financing led to the creation of financial bubbles in the many of capitalist economies, this has led to the attempt to find solutions to get out of these financial bubbles. Therefore, some researchers indicated that, Islamic economy has a vision and a different attitude in terms of the causes of economic shocks. Data indicates that, the Islamic banks have been affected less than the conventional banks in the last global financial crisis in the terms of performance.[278]As the World has not yet recovered from the global recession, Islamic banking is gaining popularity in emerging economies as it bolstered financial institutions avoid the worst of the economic meltdown. With irresponsible banking

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[275]For example, the International Monetary Fund (IMF) estimates that, from 2006 to projected year-end 2012, total debt in the Eurozone will increase by EUR2.8 trillion (USD3.5 trillion) from EUR5.9 trillion (USD7.3 trillion) to EUR8.7 trillion (USD10.8 trillion). By comparison, GDP is expected to grow by EUR1.1 trillion (USD1.4 trillion) from EUR8.6 trillion (USD10.6 trillion) in 2006 to an estimated EUR9.7 trillion (USD12.0 trillion) in 2012. With such projections, the absolute debt level in the EU is expected to grow 2.5 times faster than its GDP. (www.imf.org)

[276] Alberto, Weit, Wackerberg (2011) p.53

[277] Hassan, Kayed (2011) p.12

[278] Al-Smadi, Almsafir (2012) p.421

practices taking the blame for bringing about the global economic crisis, there has been a surge of interest in Islamic finance.[279]

Therefore we will examine these questions in following part:

- Have Islamic banks fared differently than conventional banks during the financial crisis?
- If so, why?
- What can conventional system learned from Islamic one?

12.1 Theoretical resilience to crisis

As we noted above, there has been numerous financial crises during the 20th century. If we would like to assess performance of Islamic banking in periods of turmoil we need to be cautious about which period we will choose. We discussed the historical development of Islamic banking in the chapters above. It originated in the 70s and there are only several decades of development. In order to capture the performance of Islamic banking properly, we would like to choose subprime mortgage crisis in 2007 as a model. There are several reasons for such a choice. First, if we can talk about any maturity in sense of Islamic banking system at all, the most recent date means most mature state of the industry. Second, we can say that this crisis is definitely over. Whether it caused most recent credit issues in the European banking system is not an issue here. Third, there has been extensive theoretical and empirical research on subprime mortgage crisis, which allows us to identify basic problems and assess them in comparison with the same issues within Islamic banking. Therefore the period of subprime mortgage crisis (2007-2009) will be examined in detail. First, theoretical analyses, second empirical as well, (although empirical analyses proved to be quite puzzled in this case).

What began as a limited subprime mortgage impasse in the US real estate market grew to be the world's biggest financial crisis since the 1930s. The impact of the crisis was felt worldwide. Individuals, regardless of their whereabouts, have been directly or indirectly affected by the crisis as it has hit almost every sector of the world's economy.[280] Therefore we will identify basic sources of the crisis and we will examine them from the viewpoint of Islamic finance.

[279] Alzalabanin, Nair (2013) p.16
[280] Hassan, Kayed (2011) p.11

The financial crisis started in the summer of 2007, triggered initially by the implosion of the USA's housing bubble. It gained momentum and then sharply intensified in September 2008. The crisis was triggered by the collapse of the subprime mortgage market. In 2006, lenders made $640 billion in subprime loans which amounted to about 20 percent of all mortgage lending and about 17 percent of home purchases in the same year. Many believe that the prolonged period of low interest rates combined with lax regulation and supervision encouraged rapid and substantial growth of credit and, as a result, pushed house prices up. The Federal Reserve lowered the interest rate in 2001 from 6.5 percent to 1.75 percent and then to 1 percent in 2003, a 45-year low.[281] Generally crises which happened in the last 20th centuries were caused by imprudent lending transaction. Financial bubbles are generally linked to easy credit, excessive debt, speculation, greed, fraud, and corruption. Easy credit leads to lack of adequate market discipline, which in turn instigates excessive and imprudent lending.[282]

The subprime financial crisis was also caused by imprudent lending transaction which was then worsen by the excessive derivative and speculative transaction on the capital market. When default could not be further avoided, the crash of capital market led to the banking crisis,[283] which later brought to crisis on the financial sector and harm the real economy sector. There are undoubtedly a number of causes. Widely recognized, the most important cause is, however, excessive and imprudent lending by banks. One cannot blame the banks for this because, like everyone else, they also wish to maximize their profits in a materialist cultural environment where maximization of income and wealth is the highest measure of human achievement. The more credit they extend, the higher will be their profit. It is high leverage which enables excessive lending.[284]

Securitization or the originate-to-distribute model[285] of financing has played a crucial role in this crisis. Mortgage originators collateralized the debt by mixing prime and

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[281] Smolo, Mirakhor (2010) p.73
[282] Hassan, Kayed (2009) p.36
[283] A banking crisis is a financial crisis that affects banking activity. Banking crises include bank runs, which affect single banks; banking panics, which affect many banks; and systemic banking crises, in which a country experiences a large number of defaults and financial institutions and corporations face great difficulties repaying contracts. For details see: Laeven, Luc A. and Valencia, Fabian V. (2008), Systemic Banking Crises: A New Database. IMF Working Papers, Vol. , pp. 1-78, . Available at SSRN: http://ssrn.com/abstract=1278435
[284] Chapra (2008) p.2
[285] An originate-to-distribute (OTD) model of lending, when lenders make loans with the intention of selling them to other institutions and/or investors, as opposed to holding the loans through maturity was a popular method of mortgage lending before the onset of the subprime mortgage crisis. For details see: Purnanandam,

subprime debt. By selling the collateralized debt obligations (CDOs) where they passed the entire risk of default to the ultimate purchaser, therefore, having less incentive to undertake careful underwriting. Consequently, a number of banks have either failed or have had to be bailed out or nationalized by governments in the USA, the UK, Europe, and a number of other countries.[286]

This raises the question of why the market discipline has not been able to exercise a restraint on excessive lending. Is it possible that market discipline is not adequate in the financial system? If this is the case, then why is it so? The market can impose a discipline primarily through incentives and deterrents. If incentives and deterrents do not exist or become weak, market discipline will also become weak. The incentives and deterrents come through the prospect of making a profit or loss. The major source of profit in the conventional system is the interest that the banks earn through their lending operations. The loss comes through the inability to recover these loans with interest. One would, therefore, expect that banks would carefully analyze their lending operations so as not to undertake those that would lead to a loss. There would be a check over excessive lending if the banks were afraid of suffering losses that would reduce their net profit. This happens in a system where the repayment of loans with interest is not generally guaranteed.

There are two factors that enable banks to assume that they will not suffer losses. The first of these is the collateral, which is indispensable and unavoidable in any financial system for managing the risk of default. The collateral can, of course, do this only if it is of good quality. Collateral is, however, exposed to a valuation risk. Its value can be impaired by the same factors that diminish the borrower's ability to repay. The collateral, cannot, therefore, be a substitute for a more careful evaluation of the project financed. The second is too big to fail concept.[287]

Overall research discovered main reasons behind subprime mortgage crises. As we noted imprudent lending is the key to the financial crisis. There are three factors that make this possible. One of these is an inadequate market discipline in the financial system resulting from the absence of PLS. The second is the mind-boggling expansion in the size of derivatives, particularly credit default swaps (CDSs), and the third is the "too big to fail"

Amiyatosh K.,(2010) Originate-to-Distribute Model and the Subprime Mortgage Crisis. AFA 2010 Atlanta Meetings Paper. Available at SSRN: http://ssrn.com/abstract=1167786

[286] Ahmed (2010) p. 307

[287] Chapra (2008) p.3

concept, which tends to give an assurance to big banks that the central bank will definitely come to their rescue and not allow them to fail.[288]

If we want to examine Islamic finance performance during the financial crisis, subprime mortgage in this case, we need to take reasons behind and look at them in the framework of Islamic finance. We will therefore try to prove that follow reasons;

1) Inadequate market discipline in the financial system resulting from the absence of profit and loss sharing (PLS)

2) Expansion in the size of derivatives

3) The "too big to fail" concept.

are incompatible with Islamic finance framework not only in theoretical level, but also in reality and therefore this incompatibility shielded the Islamic finance sector from the severity of subprime mortgage crisis.

12.2 Resilience of Islamic finance

As one of the fastest growing segments in global financial services, Islamic finance has become systemically important in many markets and too big to ignore in others. While conventional intermediation is largely debt-based and allows for risk transfer, Islamic intermediation, in contrast, is asset-based, and centers on risk sharing. In addition to providing Islamic banks with additional buffers, these features make their activities more closely related to the real economy and tend to reduce their contribution to excesses and bubbles. The views supporting Islamic finance state that Islamic financial institutions are more resilient to external shocks. Profit and loss sharing feature of the transactions in Islamic finance provides a protection to these institutions, apart from the capital. This feature of the Islamic financial institutions could transfer a negative shock on the asset side to the liability side.[289]

During the recent financial crisis, Islamic financial institutions have demonstrated significant resilience. They have been less affected compared to the conventional financial institutions thanks to prohibitions on the excessive leverage. The transfer of risks related

[288] Ahmed (2010) p.315
[289] Yilmaz (2009) p.2

with the debt is prohibited in the Islamic finance. Therefore speculative transactions such as derivative, options and futures, everything what we saw behind the crises in the USA is forbidden in the Islamic finance framework.[290] Transferring the risk related to the debt and speculative financial activities could cause unnecessary booming of the financial transaction volume well above the size of the real economy. Theoretically, it would be impossible for a crisis resulting from subprime mortgages, inadequate assessment of risk, complex financial instruments to shift risk, speculation and short selling, excessive leverage, lax regulatory framework and excessive lending among others, to take place in the Islamic capital markets sector.[291]

We can find support for such a claim in the chapters above. We went through basic principles of Islamic banking which are the key to performance of the industry. So what are the principles related to stability of the financial industry?

First, it is prohibited by Shariah law, to sell debt against debt. Second Islamic finance is based on the concept of assets backing. Definition of gharar situations ensures that these assets have higher quality plus they have to be of tangible character. Third, Islam has a particular interest in fostering close relationship between the parties involved in contracts. Full contract specification and transparency are one of the basic cornerstones of Islamic contracts. Fourth, it is not allowed to trade with debt or shift default risk. [292]In other words, financing provided by means of Islamic institutions can be used only with the real economic activity, and thereby, help restricts excessive credit boom. Credit is mainly extended for the purchasing of the real goods and services. In Islamic finance, Islamic financial institutions should own and possess the real goods and services and the buyers of the real goods and services should want to take delivery. Therefore, stakeholders share profits in good times and losses in bad times.[293]

Therefore we suggest that all three reasons which were leading to the subprime mortgage crisis would not occur in the Islamic finance framework, (or not at least in such a scale). Those three above problems actually can be anticipated by ways of implementing the

[290] Hackensberger (2009) p.1
[291] Hassan, Kayed (2011) p.18
[292] The principle “no pain no gain” is embedded in Islamic financial structure and entails that no one has the right to profit without risk of incurring loss. Moreover, linking credit supply to growth rate of the economic activity, Islamic finance acts as a natural hedging scheme.
[293] Yilmaz (2009) p.3

Islamic finance principles, which, besides providing financial intermediation, aimed to realize greater justice in human society as well.

By implementing PLS-based transactions, the risk of the transaction is not entirely shifted from financier to financed party. This principle, basically, acts as a control toward higher market discipline. This is because the financiers are really encouraged to be more careful in assessing the risk of the financed parties before giving any funding to them. Furthermore, to ensure the financiers that they will get appropriate profit sharing, they are needed to monitor the use of funds by the financed parties. These mechanisms will later establish higher market discipline and even more stable economy. Moreover, for any transaction that cannot be accomplished by mean of PLS, Islam also suggests the way. However, rather than using direct borrowing-lending mechanism, Islam commands that the transaction shall be based on the sale or lease of real, not imaginary, assets by means of Islamic schemes such as *murabahah, ijarah, Salam,* and *Istisna.* For applying the schemes, the real assets involved in the transaction must be fully owned and possessed by the seller/lessor, which makes these transactions more certain sense of risk.[294]

Second problem we mentioned was extensive use of derivative tools and re-selling of the debt. Islam does not allow securitization of unreal asset, as well as debt, as done by its conventional counterpart. This ruling can inhibit the debt from rising far above the size of the real economy. From the Islamic finance perspective, short sales, futures, options and swaps are all cases of speculation resulting from risk shifting. The use of these complex derivatives was partly the genesis of the current crisis. From the Islamic finance perspective, they are gharar-stricken transactions and should be prohibited.[295]

Too big to fail concept was never the issue in Islamic finance. During and after the crisis period we saw no defaults among Islamic banks and definitely no bail out from the government side.[296] We are not trying to say that there is no chance of similar problems in the Islamic banking system as in conventional one. But due to the nature of their liabilities (equity capital, sight deposits and deposits in investment accounts) and the principle of sharing profit and losses, Islamic banks should have better immunity to external shocks than conventional banks. For example, they are immune to the risk of a difference in value between assets and liabilities. If the value of their assets is affected by a shock, they can

[294] Al-Bakri (2009) P.84
[295] Hassan, Kayed (2009) p.41
[296] GIFF (2012)

adjust this difference by lowering the value of investment deposits on the liability side of the balance sheet.[297] Basic principles of profit-loss sharing partnership ensure prompt reaction on both sides of balance sheets. In other words, if conventional banks raise interest rates to attract or retain deposits in problem situations, and if the total stock of deposits is fixed in the short run, the process would clearly be unstable and would eventually lead to bankruptcies. In such circumstances any system that guaranteed the transaction-balances component of deposits and eliminated the need or incentives for liability management would likely stabilize the process.[298]

What we did in the chapter above was one of the cornerstones for confirmation of our thesis, that Islamic banking system is more stable than conventional one. We tried to connect basic principles of Islamic finance with the particular case of subprime mortgage crises. The real world implications of conduction transactions in the Islamic finance framework would most likely either impair the crisis or never let it happen in the first place. We confirm that, at least in theoretical cases. Now we will try to prove our conclusions empirically, which should be more problematic than expected. Empirical analyses of non-mature industries are somewhat troubling, as you will see in the next chapter.

13. Empirical evidence of the Islamic banking performance

Empirical evidence supporting our conclusions is one of the most important parts of this work. However we found it hard to discover some. In this chapter we will discuss problems of empirical research on Islamic finance. Then we will sum up the little evidence we found out in order to assess performance of Islamic banking during financial crisis. Finally we will pay attention to so-called second round effects of the crisis which showed up to be pretty important in our comparison.

Comparing the impact of the crisis on the two different groups of banks is a challenging task, for two main reasons. First, detailed data on the performance of banks in countries where Islamic banks represent a significant portion of the banking system are not readily available. Second, the impact of the crisis depends largely on the pre-crisis industrial and market structures, vulnerabilities in the banking system, and the policy response in each country, which really complicates cross-country comparisons.[299] Third anecdotal evidence

[297] Boumediene, Caby (2009) p.4
[298] Khan (1986) p.9
[299] Hassan, Dridi (2010) p.11

suggests that there are significant differences across countries in terms of how Shariah-compliant products are exactly structured, with some of the banks basically offering conventional products repackaged as Shariah-compliant products. This implies that we need to exercise caution when interpreting Islamic banking in the context of traditional models of financial intermediation. In addition, there are differences across different Muslim countries in what is considered Shariah-compliant and what is not, which makes it difficult to do cross-country comparisons as well. Second, given the different nature of conventional and Shariah-compliant products balance sheet and income statement items might not be completely comparable across bank types even within the same country.[300]

Also maturity of the industry plays its role. In case of Islamic finance we found ourselves in a situation, where there are no long term statistical data, either because they do not exist, or because no one really started to collect them. However, this situation is rapidly changing at the moment. With the unraveling of the global financial crisis, the differences between both commercial and Islamic banks in financial stability have become more important. A number of papers discuss risks in Islamic financial institutions, but do so in theoretical terms instead of through analysis of data, while empirical papers on Islamic banks focus on issues related to efficiency are scarce.[301] There is relatively little empirical analysis of the role of Islamic banks in financial stability than.

There is only a handful of researches regarding Islamic banks financial stability. However, we would like to present their outcomes to support our conclusions. Besides papers and studies there are several private institutions performing data collections about Islamic finance industry.[302] Also credit ranking agencies and audit companies show quite an interest in Islamic finance, S&P, McKinsey and Ernst&Young especially.

According to the Banker research, as an industry, the Shariah-compliant assets of financial institutions rose by 28.6% in 2009, to $822bn from $639bn in 2008. Islamic finance as an industry has a compound annual growth rate of 27.86% (2006 to 2009). As the world's conventional financial systems recast themselves into new regulatory regimes and banks reconsider their positions, Islamic finance continued on a double-digit growth

[300] Beck, Kunt, Merrouche (2010) p.5
[301] Cihak, Hesee (2010) p.1
[302] The Banker, Zawya database, Kuwait finance house.

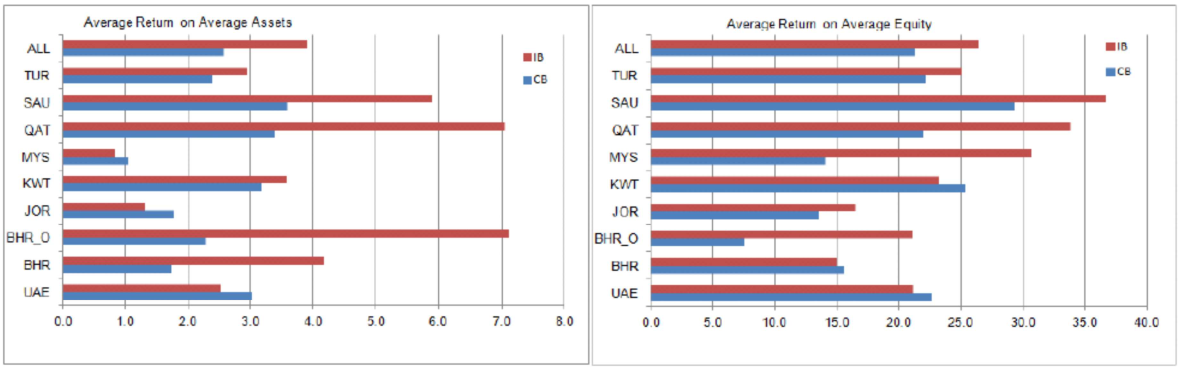
trajectory. The rate of growth in 2009 (28.6%) was slightly more than 2008 (27.7%) and it was slightly less than 2007 (29.6%).[303]

In 2007-2009 we witnessed situations where conventional banking sector found itself in big problems. There were several bankrupts among world-scale players like Bearn Sterns, Freddie Mac, Fannie May, countless closer banking houses were shut down as well. In a contrast, an analysis of the data indicates that Islamic finance fared relatively well when compared with its conventional counterparts. During the year 2009, 28 new banks offering Shariah-compliant finance entered the market. However, the rate of new market entrants has slowed from previous years (51 banks in 2008 and 78 banks in 2007) as the second round crisis effects hit Islamic finance industry.[304] Islamic research and training institute (IRTI) found that, the combined market capitalization of top 10 conventional banks suffered a decline of 42.8% vs. A 8.5 % decline in market capitalization of Islamic banks for the period between December 2006 and May 2010, the Aggregate net profits of conventional banks fell from USD116 billion in 2006 to a net loss of USD42 billion in 2008. In contrast, Islamic banks' net profit increased 9% during the same period from USD4.2 billion to USD4.6 billion.[305] There are other studies supporting our data findings, for more details please see Smolo, Mirakhor (2010), Willson (2011), Islamic Finance and Global Financial Stability report (2010) etc.

To our knowledge, there are only two articles that explicitly (and empirically) deal with the issue of the financial stability of Islamic banks – Cihak, Hesse (2010) and Hassan, Dridi, (2010), so we would like to present their findings which support our theory, that the Islamic finance industry fared better than conventional during period of subprime mortgage crisis.

[303] The Banker (2009) p.8
[304] The Banker (2009) p.3
[305] Al-Smadi, Almsafir (2010) p.423

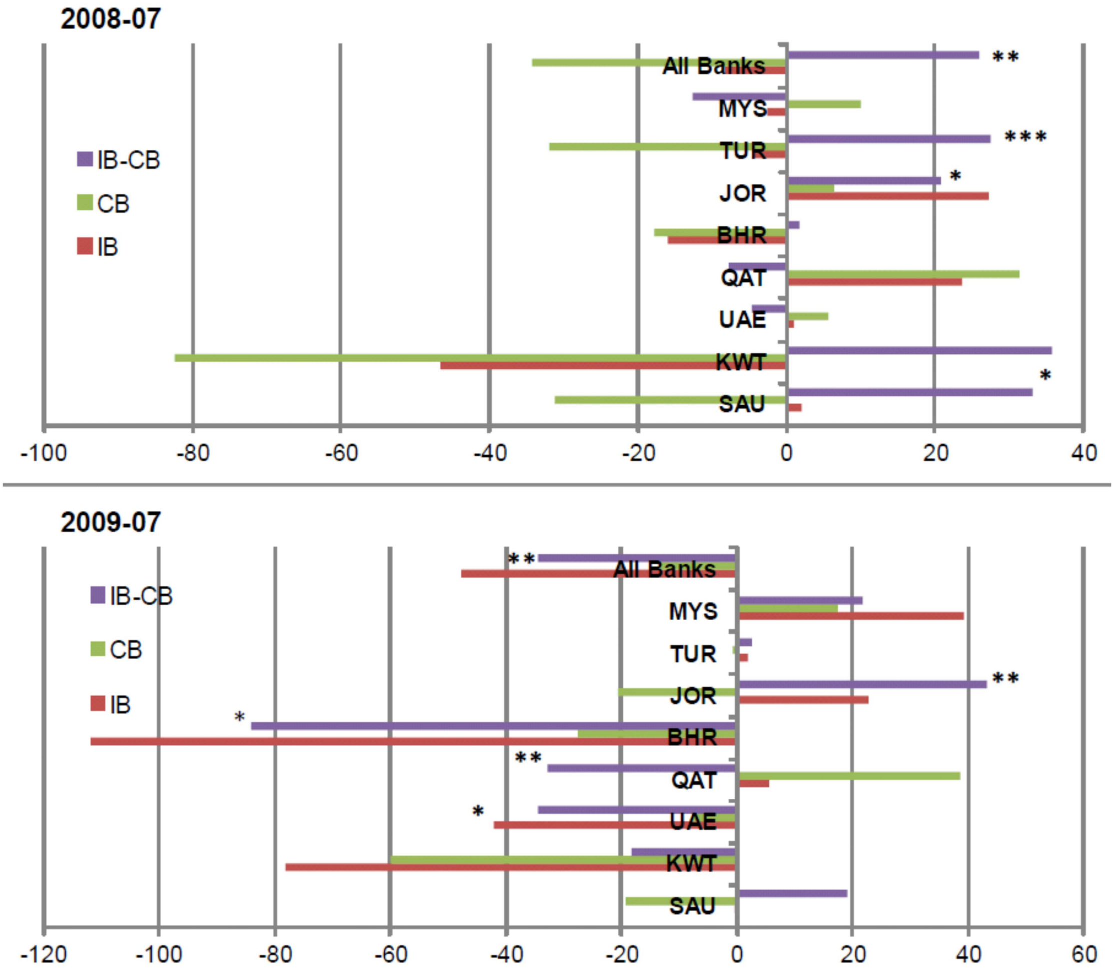
Graph 14: Return on equity and return on assets 2005-2007



Source 16: Hassan, Dridi, 2010

The graph no. 15 shows that the average profitability of Islamic banks measured either by ROA or ROE was clearly higher than in case of conventional banks in pre-crises period. There is more evidence showing that these trends continued onward even during the crises.

Graph 15: Changes in profitability (in percent) in chosen countries



Notes: IB – Islamic banking, CB – conventional banking, MYS – Malaysia, TUR – Turkey, JOR – Jordan, BHR – Bahrain, QAT – Qatar, UAE – United Arabian Emirates, KWR – Kuwait, SAU – Saudi Arabia

Source 17:Hassan, Dridi , 2010

Despite higher profitability during the pre-global crisis period (2005–07), Islamic bank's average profitability for 2008–09 was similar to that of CBs, indicating better cumulative (pre- and post-crisis) profitability and suggesting that higher pre-crisis profitability was not driven by a strategy of greater risk taking. Large Islamic banks have fared better than small ones. Better diversification, economies of scale, and stronger reputation might have contributed to this better performance. This suggests that developing the industry and increasing competition should be achieved through establishing large and well managed Islamic banks that can compete with existing banks. Islamic bank´s credit and asset growth were at least twice higher than that of conventional banks during the crisis, suggesting a growing market share going forward and larger supervisory responsibility. External rating agencies re-assessment of Islamic banks' risk was generally more favorable or similar to that of conventional banks. Higher solvency has facilitated meeting the relatively more robust demand for Islamic banking finance and maintaining stable external ratings. Lending to the less affected consumer sector has helped support strong credit and asset growth.[306] This suggests that Islamic banks have been affected differently during the crisis. The initial impact of the crisis on Islamic bank's profitability in 2008 was limited. However, with the impact of the crisis moving into the real economy, Islamic banks in some countries faced larger losses compared to their conventional peers.

According to Cihak, Hesse (2010), the researchers found that (1) small Islamic banks (with assets under US$ 1 billion) were financially more solid than conventional banks of the same size; (2) large Islamic banks were less solid than conventional banks of the same size; and (3) small Islamic banks are financially more solid than large Islamic banks. The contrast between the high stability in small Islamic banks and the relatively low stability in large Islamic banks is particularly interesting. It suggests that Islamic banks while relatively more stable when operating on a small scale, are less stable when operating on a large scale.[307] It supports an outcome of previously mentioned article as well. If we consider the fact that bigger part of Islamic banking industry consist of smaller financial institution (in comparison to capitalization of conventional banks), we can see that both conclusions strengthen each other. It means that Islamic banks are generally smaller, which according Cihak, Hesse (2010) means more financial stability and it leads to better financial performance as proved by Hassan, Dridi (2010).

Considering the performance of Islamic and conventional banks during the recent crisis, we find differences in liquidity matters. Islamic banks increased their liquidity holdings in the run up to and during the crisis relative to conventional banks. This also explains why Islamic banks’ stocks performed better during the crisis compared to conventional banks’ stocks. Finally the good performance of Islamic banks during the recent crisis appears to be driven by higher precaution in liquidity holdings and capitalization, but no inherent difference in asset quality between the two bank types.[308] Also the results of the Boumediene, Caby (2009) study shows that conventional bank returns were highly volatile during the crisis period, while Islamic banks saw their volatility – initially low – increase during the crisis, though to a much more moderate extent. These

[306] Hassan, Dridi (2010) p.34
[307] Cihak, Hesse (2010) p.16
[308] Beck, Kunt, Merrouche (2010) p.4

results corroborate both the hypothesis that Islamic banks were at least partially immune to the subprime crisis and the underlying hypothesis that Islamic banks are not subject to the same risks as conventional banks – although, due to their links with the real economy, they do eventually suffer the consequences of the subprime crisis.[309]

Proving that Islamic banks performed better during the crises does not mean that they were not hit by the crises as well. On the other side, they are far from it. Global recessions are connected with oil-prices fluctuations which inevitably hit Gulf oil-producing countries where most of the Islamic finance industry is situated.[310]Although Islamic finance has not felt “the full impact” of the global credit crisis, the immediate fallout from the crisis is evidenced by the fall in equity valuations and the plunge in the real estate market across the Gulf States with all that that entails for the Islamic banking sector–bearing in mind the intense engagement of the Islamic banking sector in the real estate industry.[311]

We stressed many times that one of the basic principles of Islamic finance is its connection to the real economy. The crisis has shown that the stronger link to the real economy has not necessarily made Islamic finance more crisis proof in sense of second round effects. As the crisis spilled over from financial markets, Islamic bank's significant exposure to real estate turned out to be highly problematic. The evidence shows that, in terms of profitability, Islamic banks fared better than conventional banks in 2008. However, this was reversed in 2009 as the crisis hit the real economy, especially Gulf countries' real estate markets.[312]

Therefore we can conclude that the Islamic banking sector showed resilience to the first-round effect of the crisis. This conclusion is supported by scarce empirical evidence we found. However, as the spillover effects from western financial sector hit global economy, closer connection of Islamic banking with economy channeled second round effects of the crisis straight to the Islamic finance industry.

Conclusion

The subprime mortgage crisis was one the most severe crisis hitting global financial markets we have ever seen. After it resolved, many questions regarding the stability of the

[309] Boumediene, Caby (2009) p.1
[310] Alzalabani, Nair(2013) p.33
[311] Hassan, Kayed (2009) p.52
[312] Hassan, Dridi (2010) p.6

conventional banking system arise. There was need to either find solutions to apparent flaws (recurrent financial bubbles) or suggest a viable alternative to the current banking system. This development attracted attention to Islamic finance and subsequently banking. Islamic banking developed in the late 60s and it reported significant growth ever since. Nowadays it moved from being on the edge of the interest in global markets to its very center. Its apparent resilience to the crisis opened a possibility of finding alternative to the conventional banking system.

Islamic banking was developed in the second half of the twentieth century. There were several reasons behind the lag of the development of financial services in the Muslim world in comparison to Western one. Medieval institution of Islamic partnership proved itself a suitable mode of trade; however its terms prohibited the creation of bigger ventures. Together with strict heritage laws, anchored in the Holy Quran itself, supporting further fragmentation of fortune after the demise of one of the business partners. Muslim world never saw the creation of large individual fortunes which later evolved into banking houses (like European ones). Together with unfavorable political development represented by colonial era, Islamic banking never been even close to its emergence till second half of the twentieth century.

After dissolution of colonial empires, newly created Islamic countries of Africa and Asia sought tools to control its economies in order to achieve prosperity and development. This search led to theoretical research on third possible approach (beside capitalism and communism) – purely Islamic way of economy and subsequently banking. This theory combined with the influx of petrodollars, coming from increased revenues from oil production, led to creation of first Islamic financial institutions, based on different principles than capitalist banking system. These principles are closely connected with Islam and are based on religious sources of the Holy Quran and Sunnah. I am talking about the sanctity of contracts, profit-loss sharing in business, prohibition of riba (interest), and emphasis of real economic activity behind business actions, fairness and exclusion of haram activities. I discovered that, there are similar principles of conventional banking system, however there are also completely opposite ones. This unique combination of religious principles and banking services led to creation of the Islamic finance industry.

There are several basic products of Islamic banking. Despite its emphasis on profit-loss sharing principles, mark-up products are playing major role in today Islamic banking.

There is also a significant shift towards conventional banking practices, however these are either disguised or modified according to Islamic principles. This convergence of Islamic banking has serious conclusions. I can say that modern Islamic banking is rather closer to the conventional ones, diverting it from its theoretical basis. It is caused by several reasons. First is severe competition in the global financial markets, where Islamic banks bear the higher cost because of its religious limitations. Second is that practitioners of Islamic banking are mostly western-educated, which inevitably lead to a certain degree of influence on their professional actions.

In order to confirm my hypothesis I discussed two aspects of Islamic finance. Primarily I focused at the theoretical resilience to the crisis. There is an extensive research done on the subject. I discussed each principle of Islamic banking with regards to the subprime mortgage crisis. I discovered three most important reasons behind the subprime mortgage crisis – excessive lending, debt trading (CDOs, CDSs) and banks certitude about not being subject to losses (collateral, deposit insurance and too big to fail concept). Excessive lending is mitigated in Islamic banking through profit-loss sharing principle. If there is no option of shifting the whole risk on the creditor, lender (bank) is more careful about providing its funds. Trading with debt is not by any means real economic activity and as such is strictly forbidden in Islamic finance. Pre-crises conventional banks were almost sure that in case of losses, they would shift costs to the third party. The first reason behind is collateral, which showed in the case of mortgages insufficient. As long as Islamic banks operate on a profit-loss sharing they are much more cautious about collateral than their conventional peers. Second is deposit insurance – there is nothing like that in the Islamic finance framework as it operates on the principle of risk sharing, there cannot be riskless deposit. Third is too big to fail concept and it was never an issue in Islamic banking. Too big to fail concept suggests that bankruptcy of financial institution is not an option because of economic side-effects. In case of Islamic banks, negative external shocks are smoothly transferred from liability to asset side through profit-loss sharing principle, so side effects are minimal. Therefore I proved that theoretically my hypothesis holds, as Islamic banking perform better during the subprime mortgage crisis (and it would probably never occur in the Islamic banking sector itself)

However, I also discovered divergence between theoretical and real shape of Islamic banking. I collected some empirical data in order to prove my point. The outcome of empirical studies supports my hypothesis as well, however reasons were slightly different that in theoretical cases. Islamic banks really fared better than conventional one during a crisis. However as long as profit-loss sharing products create minority of Islamic bank's assets, favorable arguments based on it are no longer valid. I discovered that Islamic banks fared better for this reasons – behind mention prohibition of debt trading and emphasis on the real economic purpose of business plus several others. Major Islamic banks are much smaller compared to conventional ones which make them more stable. Also, from various reasons, Islamic banks hold much more liquidity. It makes them more resilient to sudden external shocks. There is also no such a thing as complete standardization of Islamic banking which make them less connected on an international scale. The most important empirical finding is, that Islamic banks were not hit by the crisis so hard in comparing to conventional ones, however as second round effects of the crisis spilled over to the real economy, Islamic banks witnessed decreased in their revenues as well. It means that as much as Islamic banking look like a viable alternative to the conventional ones, further research is needed to assess if it is truly worth it to try to implement some of its features on the global scale.

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