1. An introduction to Islamic banking

OUTLINE OF THIS BOOK

Twenty-five years ago Islamic banking was virtually unknown. Now 55 developing and emerging market countries have some involvement with Islamic banking and finance. In addition, there are Islamic financial institutions operating in 13 other locations: Australia, Bahamas, Canada, Cayman Islands, Denmark, Guernsey, Jersey, Ireland, Luxembourg, Switzerland, United Kingdom, United States and the Virgin Islands. In Pakistan, Iran and Sudan, all banks need to operate under Islamic financing principles. Elsewhere, in the mixed systems, the Islamic banks are in a minority and operate alongside conventional banks. Despite this expansion, Islamic banking remains poorly understood in many parts of the Muslim world and still continues to be almost an enigma in much of the West. Our objective is to provide a succinct analysis of the nature of Islamic banking and finance, accessible to a wide range of readers.

In fact, the basic idea of Islamic banking can be stated simply. The operations of Islamic financial institutions primarily are based on a profit-and-loss-sharing (PLS) principle. An Islamic bank does not charge interest but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined ratio. There is thus a partnership between the Islamic bank and its depositors, on one side, and between the bank and its investment clients, on the other side, as a manager of depositors’ resources in productive uses. This is in contrast with a conventional bank which mainly borrows funds at interest on one side of the balance sheet and lends funds at interest on the other. The complexity of Islamic banking comes from the variety (and nomenclature) of the instruments employed, and in understanding the underpinnings of Islamic law.

In conducting this examination of the subject, the volume seeks to bring a different perspective on a number of aspects. First, in the analytical part of this study, there is an outline of the prohibition of interest (riba) according to the doctrines of Islamic economics, along with an analysis of the implications which follow from this ban for the character of financial intermediation and governance structures in Islamic financing. This analysis is undertaken against the backdrop of modern theories of financial intermediation which are concerned with transactions costs, information problems and the design of
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incentive-compatible contracts. There is thus an attempt to integrate the Western-based literature with that developed in the Islamic tradition.

Second, the empirical aspect of the study deals with the workings of Islamic banks in both complete and mixed systems. Consideration is given to both the legal and institutional structure needed to support Islamic banking operations and the problems which have been encountered in putting the theory of Islamic banking into practice. The latter are often overlooked in criticisms of actual operations by Islamic scholars, while the former shape the special systems of corporate governance followed by Islamic banks.

Third, the book brings an historical dimension to the topic, for Islam is not the only (or indeed the first) religion to ban interest. In particular, Christianity maintained a prohibition (or severe restriction) for over 1400 years. What were the origins of the Christian stand and how was it enforced? Why has Islam succeeded where Christianity failed? The answers we provide to these questions shed an important new light on the achievements of Islamic banking methods, while at the same time revealing a number of interesting parallels with present day Islamic financing techniques.

WHAT IS ISLAMIC BANKING?

Islamic banking provides services to its customers free from interest, and the giving and taking of interest is prohibited in all transactions. Islam bans Muslims from taking or giving interest (the Arabic term for which is *riba*), and this prohibition makes an Islamic banking system differ fundamentally from a conventional banking system. Technically, *riba* refers to the addition in the amount of the principal of a loan according to the time for which it is loaned and the amount of the loan. While earlier there was a debate as to whether *riba* relates to interest or usury, there now appears to be consensus of opinion among Islamic scholars that the term extends to all forms of interest.

Later chapters explore in more detail the origins of the terms ‘interest’ and ‘usury’, and the way in which in Western usage the meanings have been transposed over time, so that the former meaning of usury and the present meaning of interest are practically identical (Divine, 1967). Usury (from the Latin *usura* meaning enjoyment, interest or money paid for the use of money) was a term originally used to describe interest generally, but in modern times has come to mean excessive interest, particularly that in excess of maximum rates fixed by law (Munn, Garcia and Woelfel, 1991). Some Islamic modernist views have contended that *riba* refers to usury practised by petty moneylenders and not to interest charged by modern banks and that no *riba* is involved when interest is imposed on productive loans. But these arguments have not won general acceptance amongst Muslim writers.
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In any case, it is doubtful if the distinction between interest and usury matters to the orthodox Muslim. The term riba, in Islamic law (the shari’a), means an addition, however slight, over and above the principal. According to the Federal Shariat Court of Pakistan, this means that the concept covers both usury and interest; that it is not restricted to doubled and redoubled interest; that it applies to all forms of interest, whether large or small, simple or compound, doubled or redoubled; and that the Islamic injunction is not only against exorbitant or excessive interest, but also against a minimal rate of interest (Hamid, 1992; M.S. Khan and Mirakhor, 1992). Financial systems based on Islamic tenets are therefore dedicated to the elimination of the payment and receipt of interest in all forms. It is this taboo that makes Islamic banks and other financial institutions different in principle from their Western counterparts.

Some scholars have put forward economic reasons to explain why interest is banned in Islam. It has been argued, for instance, that interest, being a predetermined cost of production, tends to prevent full employment (M.A. Khan, 1968; Ahmad, 1952; Mannan, 1970). In the same vein, it has been contended that international monetary crises are largely due to the institution of interest (M.A. Khan, 1968), and that business cycles can in some measure be attributed to the phenomenon of interest (Ahmad, 1952; Su’ud, 1980). Others have taken a somewhat different tack by arguing that modern economic theory has not provided a justification for the existence of, or the need for, interest (Khan and Mirakhor, 1992).

But these arguments are strictly secondary to the religious underpinnings. The fundamental sources of Islam are the Holy Qur’an and the sunna, a term which in Ancient Arabia meant ‘ancestral precedent’ or the ‘custom of the tribe’, but which is now synonymous with the teachings and traditions of the Prophet Muhammad (may God bless him and grant him salvation) as transmitted by the relators of authentic tradition. Both of these sources treat interest as an act of exploitation and injustice and as such it is inconsistent with Islamic notions of fairness and property rights. While it is often claimed that there is more to Islamic banking, such as it contributing towards economic development and a more equitable distribution of income and wealth, and increased equity participation in the economy (Chapra, 1982), Islamic banking nevertheless derives its specific raison d’être from the fact that there is no place for the institution of interest in the Islamic order.

This rejection of interest poses the question of what replaces the interest rate mechanism in an Islamic framework. If the paying and receiving of interest is prohibited, how do Islamic banks operate? Here PLS comes in, substituting profit-and-loss-sharing for interest as a method of resource allocation. Although a large number of different contracts feature in Islamic financing, certain types of transaction are central: trustee finance (mudaraba); equity
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participation (musharaka); and ‘mark-up’ methods. Mudaraba is a profit- and risk-sharing contract where one party entrusts funds to an investor in return for a predetermined share in the profit/loss outcome of the project concerned. This principle lies at the heart of the system of Islamic banking since most funds are provided to an Islamic bank under such arrangements. Under musharaka, on the other hand, there is usually more than one single contributor of funds; all of the parties invest in varying proportions and the profits or the losses are shared according to their contributions in the project. The musharaka involves a more active partnership between entities who pool their capital and manage and control the enterprise together, with profits and losses divided amongst them according to a prearranged ratio. When we add to these two the idea of ‘mark-up’, for which there are a great number of variants, where assets and other items are acquired for later resale or lease with a mark-up on purchase price, we have the main ingredients of the Islamic alternatives to having banks borrow and lend at interest.

A BRIEF HISTORY

Profit-sharing arrangements such as mudaraba and musharaka almost certainly pre-date the genesis of Islam. Business partnerships based on what was in essence the mudaraba concept co-existed in the pre-Islamic Middle East along with interest loans as a means of financing economic activities (Crone, 1987; Kazarian, 1991; Cizaka, 1995). Following the birth of Islam, interest-based financial transactions were forbidden and all finance had to be conducted on a profit-sharing basis. The business partnership technique, utilizing the mudaraba principle, was employed by the Prophet Muhammad (pbuh) himself when acting as agent (mudarib) for his wife Khadija, while his second successor Umar ibin al-Khattab invested the money of orphans with merchants engaged in trade between Medina and Iraq. Simple profit-sharing business partnerships of this type continued in virtually unchanged form over the centuries, but they did not develop into vehicles for large-scale investment involving the collection of large amounts of funds from large numbers of individual savers – notwithstanding that it was usually legally possible under the law of partnership developed by the Hanefite legal school to expand mudaraba partnerships along such lines. This development did not happen until the growth of Islamic financial institutions.

The first known financial institution established by a Muslim community was created about ten years after the death in 632 CE of the Prophet Muhammad (pbuh) by the second Caliph (prince) Umar. The expansion of the Arab nation that began shortly after the Prophet Muhammad’s (pbuh) death under Caliph Abu Bakr (the Prophet’s (pbuh) father-in-law) was
fuelled by the sense of unity, common purpose and self-confidence produced by Islam. Nevertheless, the Bedouin warriors’ love of war and booty had not been entirely transcended and something had to be done about the distribution of the prizes of battle. Despite his armies’ triumphant defeat of the established empires of Byzantium and Persia, the two principal powers of the region, Umar retained the austerity and simplicity of his early life and had a strong moral purpose. All needy members of the Islamic state were to be allocated (according to specified criteria) an annual pension from the spoils of conquest and imperial revenue. The institution established, diwan, was inspired and adopted from the Persian bureaucracy, and aimed at registering all members of the community in order to facilitate the distribution of the acquired wealth (ata). The common funds acquired from the conquered territories were kept in a so-called house of wealth, bayt al-mal, which is a combination of the institution of ata and the institution of diwan (Kazarian, 1991). It was the duty of the leader of the new community to ensure that every individual should be guaranteed a ‘fair share’ of the wealth. Both Arab and non-Arab Muslims immediately were granted a share in the wealth on an equal basis.

In more recent times, early experiments with Islamic banking took place in Malaya in the mid 1940s, in Pakistan in the late 1950s, via the Indian Jamâ‘at Islãmi in 1969, Egypt’s Mit Gham Savings Banks (1963–67), and the Nasser Social Bank (1971). Most institutions had a rural orientation and most were unsuccessful (although not necessarily for that reason). For example, the aim of the Pakistani institution was to extend interest-free credit to the poorer landowners for agricultural purposes and improvements. The bank charged no interest on its lending and its moneyed landowner backers deposited money in this bank and received no interest (riba) on their deposits. It can be assumed that a higher standard of agricultural husbandry then led to an expansion of profits for all concerned since the bank’s landowner depositors had some say about the way in which loans and advances were extended and to whom. Nevertheless, the bank was disbanded after only a few years, although the debts were mostly cleared by the early 1960s as this bank’s debtors gradually met their obligations to the bank (Wilson, 1983, p. 75).

In the Arab world, the first modern experience with Islamic banking was undertaken in Mit Gham in Egypt in 1963. The experiment combined the idea of German savings banks with the principles of rural, cooperative banking within the general framework of Islamic financing precepts to cater for those unwilling on religious grounds to use conventional banks. However, the bank was formed under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism, which was anathema to the political regime. The project was closed for political reasons in the second half of 1967 and the operations taken over by the National Bank of Egypt and made interest-based. Nine such banks in the country were taken...
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over. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors, yet were functioning essentially as saving investment institutions rather than as full commercial banks.

It may be noted that similar political antagonism to Islamic banking like that in Egypt has occurred elsewhere in the Muslim world, where Islamic banking sometimes has been distrusted because of presumed associations with Islamic political opposition movements. At various times, Syria, Iraq, Oman and Saudi Arabia have ‘discouraged’ the formation of new Islamic financial institutions (Henry, 1999b), while populous Muslim countries such as Turkey and Indonesia have been slow to promote the idea. Pakistan has advanced only slowly towards its goal of an interest-free economy.

The only Islamic institutions to survive this early period are the Nasser Social Bank (Egypt) and Tabung Haji (Malaysia). The former was created as an interest-free commercial bank in 1971, under the Presidency of Mr Anwar Sadat, operating as a public authority with an autonomous status, but without a specific reference to Islam in its charter. It still exists as a social lending agency to the poor unable to meet unexpected debts, to provide loans to students and for small projects, and functions under the Ministry of Social Affairs and Insurance. The Muslim Pilgrims Savings Corporation was set up in 1963 to help Malaysians save for performing hajj (pilgrimage to Mecca and Medina). In 1969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Islamic law, but its role is rather limited, as a non-bank financial institution. The success of the Tabung Haji, however, provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which is a fully-fledged Islamic commercial bank in Malaysia.

A number of lessons would seem to be suggested by this experience. First, if the concept of Islamic banking was to take hold in a significant way, the institutions needed to provide a full range of commercial banking services, while conforming to Islamic rules and norms, rather than operate as specialised, limited savings institutions. Second, the activities of the banks had to be commercial as opposed to predominantly socio-economic. Some Muslim scholars have sought to force a distinction between an Islamic bank (one which has a socio-economic responsibility) and a halal bank, or interest-free bank (the activities of which are strictly commercial but based on interest-free financial products). However, this distinction has not gained support among Islamic jurists. Third, it seemed clear that Islamic financial institutions could not prosper in the face of hostility from government authorities (irrespective of whether this derived from fear of fundamentalism or from catering to the entrenched interests of conventional banks).
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As it turned out, an extraneous event intervened to bring about these preconditions. Arab oil wealth in the wake of the 1973–74 energy price rises provided the financial capital base needed to support large-scale commercial banking while creating a target market from amongst its recipients broad enough to support an expansion of conventional and Islamic banks alike. Oil resources enabled a wide range of institutions to participate in the social and economic development of Muslim countries, while facilitating a resurgence in self-confidence in the Middle East. The result was a change in the political climate in many Muslim countries so that there was no longer the need to establish Islamic financial institutions under cover. Almost all of the major Islamic banks and banking groups formed in the 1970s were funded to a large extent from oil-linked wealth.

GROWTH IN RECENT DECADES

Since the mid 1970s, Islamic banking has expanded so that at present there are nearly 70 countries encompassing most of the Muslim world, which have some form of Islamic financial institutions operating. Table 1.1 shows some of these countries and the institutions involved.

How many Islamic financial institutions are there in operation? Justice Mufti Usmani in 1998 estimated there to be 200 Islamic banks and financial institutions in 43 countries of the world, controlling a financial pool of US$100 billion. All of these figures are in fact considerable underestimates for reasons given below.

An obvious starting point is Table 1.2. This is based on the 176 banks which report financial data to the International Association of Islamic Banks (IAIB). The table sets out the number of banks, paid up capital, total deposits and total assets of these Islamic banks, classified by region. It shows that the total assets of these reporting banks amounted to US$148 billion in 1997, with principal operations in terms of the value of deposits and assets in the Middle East, Gulf countries and South Asia.

However, there are some significant omissions from Table 1.2. In terms of assets, the major omissions are the Islamic Development Bank (IDB) and the business groups associated with the two large Islamic groups, DMI and Al-Baraka. The IDB, based in Jeddah, was the first Islamic financial institution to benefit from the inflow of oil-related wealth. Established in 1974 with the support of the Saudi Arabian government and the Organization of Islamic Countries (OIC) it is primarily an intergovernmental bank aimed at providing funds for development projects in member countries. The IDB provides fee-based financial services and profit-sharing financial assistance to member countries. Operations are free of interest and are explicitly based on
Table 1.1. Islamic financial institutions excluding Iran, Pakistan and Sudan (date of establishment where known)

<table>
<thead>
<tr>
<th>Country</th>
<th>Islamic Financial Institutions</th>
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<tbody>
<tr>
<td>Albania</td>
<td>Arab Albanian Bank (1992)</td>
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<td>Algeria</td>
<td>Banque Al Baraka D’Algerie (1991)</td>
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<td>Australia</td>
<td>Muslim Community Cooperative (Aust) (MCCA), Melbourne (1989)</td>
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<td>Islamic Investment Company of the Gulf (1978)</td>
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<td>Masraf Faisal Islamic Bank &amp; Trust, Bahamas Ltd (1982)</td>
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<td>Bahrain</td>
<td>ABC Islamic Bank (1985)</td>
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<td>Al-Amin Co. for Securities and Inv. Funds (1987)</td>
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<td>Albaraka Islamic Investment Bank (1984)</td>
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<td>Al Tawfeek Company for Investment Funds (1987)</td>
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<td>Arab Islamic Bank (1990)</td>
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<td>Bahrain Islamic Bank (1979)</td>
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<td>Bahrain Islamic Investment Co. (1981)</td>
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<td>Citi Islamic Investment Bank (1996)</td>
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<td>Faysal Investment Bank of Bahrain (1984)</td>
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<td>Faysal Islamic Bank of Bahrain (1982)</td>
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<td>First Islamic Investment Bank (1996)</td>
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<td>Gulf Finance House (1999)</td>
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<td>Islamic Investment Co. of the Gulf (1983)</td>
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<td>Islamic Leasing Company</td>
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<td>Bangladesh</td>
<td>Al-Arafah Islami Bank (1995)</td>
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<td>Albaraka Bank Bangladesh (1987)</td>
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<td>Islamic Bank Bangladesh (1983)</td>
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<td>Prime Bank (1995)</td>
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<td>Social Investment Bank (1995)</td>
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<td>Brunei</td>
<td>Perbadanan Tabung Amanah Islam (1991)</td>
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<td>Islamic Bank of Brunei Berhad (1998)</td>
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<td>Canada</td>
<td>Islamic Cooperative Housing Corporation, Toronto (1980)</td>
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<td>Qurtaba Housing Society, Montreal</td>
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<td>Cayman Islands</td>
<td>Ibn Majid Emerging Marketing Fund (1992)</td>
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<tr>
<td>Côte D’Ivoire</td>
<td>International Trading Company of Africa</td>
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<td>Denmark</td>
<td>Islamic Bank International of Denmark, Copenhagen (1983)</td>
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<td>Djibouti</td>
<td>Banque Albaraka Djibouti (1989)</td>
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<td>Egypt</td>
<td>Alwatany Bank of Egypt (1980), Cairo (One Islamic Branch)</td>
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<tr>
<th>Country</th>
<th>Islamic Financial Institutions</th>
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<tr>
<td>Arab</td>
<td>Investment Bank (Islamic Banking Operations), Cairo</td>
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<td>Bank Misr (Islamic Branches), Cairo (window opened in 1980)</td>
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<td>Faisal Islamic Bank of Egypt, Cairo (1977)</td>
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<td>International Islamic Bank for Investment and Development, Cairo (1980)</td>
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<td>Islamic Investment and Development Company, Cairo (1983)</td>
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<td>Nasir Social Bank, Cairo (1971)</td>
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<td>Egyptian Saudi Finance Bank (1980)</td>
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<td>Gambia</td>
<td>Arab Gambian Islamic Bank (1994)</td>
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<td>Guernsey</td>
<td>Al-Fahah Investment Company</td>
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<td>Masraf Faisal al Islami de Guinea, Conakry (1983)</td>
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<td>Banque Islamique de Guinee (1983)</td>
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<td>India</td>
<td>Al-Ameen Financial and Investment Corporation, Bangalore (1985)</td>
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<td>Baitun Nasr Urban Cooperative Society, Bombay</td>
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<td>Albaraka Finance House (1989)</td>
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<td>Indonesia</td>
<td>Bank Muamalat Indonesia (1992)</td>
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<td>Bank IFI (syariah unit, 1999)</td>
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<td>Bank Syariah Mandiri (1999)</td>
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<td>Iraq</td>
<td>Iraqi Islamic Bank for Investment and Development (1993)</td>
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<td>Ireland</td>
<td>Al Meezan Commodity Fund, IES, Dublin (1996)</td>
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<td>Jersey</td>
<td>The Islamic Investment Company, St Helier</td>
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<td></td>
<td>Masraf Faisal al-Islami (Jersey), St Helier</td>
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<td>Faisal Finance Jersey (1996)</td>
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<td>Jordan Islamic Bank for Finance and Investment (1978)</td>
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<td>Islamic International Arab Bank (1998)</td>
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<td>Kazakhstan</td>
<td>Lariba Bank, Alma Ata (1995)</td>
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<td>Kibris (Turkish Cyprus)</td>
<td>Faisal Islamic Bank of Kibris, Lefkosa (1982)</td>
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<td>Kuwait</td>
<td>International Investment Group (1993)</td>
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<td>Kuwait Finance House, Safat (1977)</td>
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<td>The International Investor (1992)</td>
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<td>Lebanon</td>
<td>Al Baraka Bank Lebanon (1992)</td>
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### Islamic Banking System Finance SA, Vaduz

- **African Arabian Islamic Bank, Monrovia**
- **Liberia African Arabian Islamic Bank, Monrovia**
- **Liberia African Arabian Islamic Bank, Monrovia**
- **Liechtenstein Arinco Arab Investment Company, Vaduz**
- **Luxembourg Islamic Finance House Universal Holding SA (1979)**
- **Luxembourg Islamic Finance House Universal Holding SA (1979)**
- **Malaysia Bank Islam Malaysia Berhad, Kuala Lumpur (1983)**
- **Malaysia Bank Islam Malaysia Berhad, Kuala Lumpur (1983)**
- **Tabung Haji (Pilgrims Management and Fund Board), Kuala Lumpur (1963)**
- **Tabung Haji (Pilgrims Management and Fund Board), Kuala Lumpur (1963)**
- **Bank Bumi-Muamalat Malaysia Bhd (1999)**
- **Bank Bumi-Muamalat Malaysia Bhd (1999)**
- **Malayan Banking Berhad, KL (window 1993)**
- **Malayan Banking Berhad, KL (window 1993)**
- **United Malayan Banking Corporation Berhad, KL (window 1993)**
- **United Malayan Banking Corporation Berhad, KL (window 1993)**
- **Dallah Al Baraka (Malaysia) Holding (1991)**
- **Dallah Al Baraka (Malaysia) Holding (1991)**
- **Adil Islamic Growth Fund, Labuan (1996)**
- **Adil Islamic Growth Fund, Labuan (1996)**
- **Arab-Malaysian Merchant Bank Berhad, KL**
- **Arab-Malaysian Merchant Bank Berhad, KL**
- **Al-Baraka Islamic Bank, Mauritania (1985)**
- **Al-Baraka Islamic Bank, Mauritania (1985)**
- **Niger Banque Islamique du Niger (1983)**
- **Niger Banque Islamique du Niger (1983)**
- **Nigeria Habib Nigeria Bank, Kaduna (Islamic windows 1999)**
- **Nigeria Habib Nigeria Bank, Kaduna (Islamic windows 1999)**
- **Philippines Amanah Islamic Investment Bank, Manila (1990)**
- **Philippines Amanah Islamic Investment Bank, Manila (1990)**
- **Qatar Al-Jazeera Investment Company, Doha (1989)**
- **Qatar Al-Jazeera Investment Company, Doha (1989)**
- **Qatar Islamic Bank (SAQ) (1983)**
- **Qatar Islamic Bank (SAQ) (1983)**
- **Qatar International Islamic Bank (1990)**
- **Qatar International Islamic Bank (1990)**
- **Russia Badr Bank, Moscow (1998)**
- **Russia Badr Bank, Moscow (1998)**
- **Saudi Arabia Al-Baraka Investment and Development Company, Jeddah (1982)**
- **Saudi Arabia Al-Baraka Investment and Development Company, Jeddah (1982)**
- **Islamic Development Bank, Jeddah (1975)**
- **Islamic Development Bank, Jeddah (1975)**
- **Al Rajhi Banking and Investment Corporation (1988)**
- **Al Rajhi Banking and Investment Corporation (1988)**
- **Senegal Banque Islamique du Senegal (1983)**
- **Senegal Banque Islamique du Senegal (1983)**
- **South Africa Albaraka Bank, Durban (1989)**
- **South Africa Albaraka Bank, Durban (1989)**
- **Switzerland Dar al Mal al Islami Trust, Geneva (1984)**
- **Switzerland Dar al Mal al Islami Trust, Geneva (1984)**
- **Faisal Finance (Switzerland) SA (1990)**
- **Faisal Finance (Switzerland) SA (1990)**
- **Islamic Investment Fund (1985)**
- **Islamic Investment Fund (1985)**
- **Pan Islamic Consultancy Services Istishara (1991)**
- **Pan Islamic Consultancy Services Istishara (1991)**
- **Thailand Arabian Thai Investment Company Ltd, Bangkok Bank for Agriculture and Agricultural Cooperatives (30 Islamic branches, 1999)**
- **Thailand Arabian Thai Investment Company Ltd, Bangkok Bank for Agriculture and Agricultural Cooperatives (30 Islamic branches, 1999)**
- **Tunisia Bank al Tamwil al Saudi al Tunisi (1983)**
- **Tunisia Bank al Tamwil al Saudi al Tunisi (1983)**
- **Turkey Al-Baraka Turkish Finance House, Istanbul (1985)**
- **Turkey Al-Baraka Turkish Finance House, Istanbul (1985)**
- **Faisal Finance Institution, Istanbul (1985)**
- **Faisal Finance Institution, Istanbul (1985)**
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Country | Islamic Financial Institutions
---------|-------------------------------------------------|
UAE      | Turkish–Kuwaiti Finance House, Istanbul (1989)
         | Andalu Finance Kurumu As, Ankara
         | Dubai Islamic Bank, Dubai (1975)
         | Islamic Investment Company of the Gulf, Sharjah (1977)
         | Abu Dhabi Islamic Bank (1977)
         | Al Rajhi Company for Islamic Investment Ltd, London
         | ANZ Global Islamic Finance (1989)
         | Dallah Albaraka Europe, London (1993)
         | The International Investor Advisory Group (1992)
United States | Albaraka Bancorp (Chicago) Inc. (1989)
             | Albaraka Bancorp (California) Inc. (1987)
             | Albaraka Bancorp (Texas) Inc. (1987)
             | Al Manzil Islamic Financial Services, New York (1998)
             | Amana Income Fund (1994)
Yemen    | Saba Islamic Bank (1997)
         | Tadhamon Islamic Bank (1996)
         | Yemen Islamic Bank for Finance and Investment (1996)

Notes:
1. The list includes Islamic banks as well as Islamic investment companies but it does not include Islamic insurance or Takaful companies.
2. All banks in Iran, Pakistan and Sudan operate on a profit-and-loss-sharing basis. There are 10 banks in Iran, 45 banks in Pakistan and 26 banks in Sudan.
3. Faisal Islamic Bank of Bahrain and the Islamic Investment Company of the Gulf (Bahrain), two sister companies of the DMI group, merged in 2000 to form the Shamil Bank of Bahrain (Islamic Bankers), with authorised capital of $500 million and paid up capital of $230 million. Earlier, the Arab Islamic Bank agreed to merge with The Islamic Investment Company of the Gulf.


shari’a principles; with capital of two billion Islamic dinárs (the dinár is on a par with the SDR), it is the largest Islamic financial institution. Its present membership comprises 50 countries, but the majority shareownership is held by Saudi Arabia, Kuwait, UAE and Libya. Despite the IDB’s multilateral origins, it gave momentum to the Islamic banking movement generally, being followed soon afterwards by both private (for example, Dubai Islamic Bank,
Islamic banking

Table 1.2 Profile of Islamic banks, 1997 (no. of institutions and US$ million)

<table>
<thead>
<tr>
<th>Region</th>
<th>No. of banks</th>
<th>Paid-up capital</th>
<th>Total deposits</th>
<th>Total assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Middle East</td>
<td>26</td>
<td>3 684</td>
<td>69 076</td>
<td>83 136</td>
</tr>
<tr>
<td>Gulf countries (GCC)</td>
<td>21</td>
<td>1 787</td>
<td>14 088</td>
<td>20 449</td>
</tr>
<tr>
<td>United States &amp; Europe</td>
<td>9</td>
<td>617</td>
<td>1 139</td>
<td>908</td>
</tr>
<tr>
<td>South East Asia</td>
<td>31</td>
<td>149</td>
<td>1 887</td>
<td>2 332</td>
</tr>
<tr>
<td>South Asia</td>
<td>51</td>
<td>888</td>
<td>25 665</td>
<td>39 273</td>
</tr>
<tr>
<td>Central Asia</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>Africa</td>
<td>35</td>
<td>202</td>
<td>730</td>
<td>1 574</td>
</tr>
<tr>
<td>Australia</td>
<td>1</td>
<td>5</td>
<td>n.a.</td>
<td>6</td>
</tr>
<tr>
<td>Total</td>
<td>176</td>
<td>7 333</td>
<td>112 589</td>
<td>147 685</td>
</tr>
</tbody>
</table>

Source: The International Association of Islamic Banks.

1975, Faisal Islamic Bank of Egypt, 1977, Bahrain Islamic Bank, 1979) and government institutions (for example, Kuwait Finance House, 1977).

Not all banks created in the early 1970s can be traced to oil wealth. The Philippine Amanah Bank (PAB) was established in 1973 by President Marcos as a specialized banking institution without reference to its Islamic character in the bank’s charter. The establishment of the PAB was a response by the Philippines Government to the Muslim rebellion in the south, ostensibly to serve the special banking needs of the Muslim community, but also to assist rehabilitation and reconstruction in Mindanao, Sulu and Palawan in the south (Mastura, 1988). The PAB, however, was not strictly an Islamic bank, since interest-based operations continued to coexist with the Islamic modes of financing and the PAB operated two ‘windows’ for deposit transactions, that is, conventional and Islamic. Its later failure was because it was seen as a political move rather than a genuine attempt at Islamic banking. Another Islamic bank, Amanah Islamic Investment Bank, was established in 1990.

The next important development in Islamic banking took place in the early 1980s with the formation of the two international Islamic holding companies, namely, the Dar al-Maal al-Islami (DMI) Trust (House of Islamic Funds) in 1981 and the Al-Baraka group in 1982. Founded in the Bahamas and headquartered in Geneva, DMI operates 10 banks, 7 investment companies, 7 business companies and 3 Islamic (Takaful) insurance companies in 15 countries. Dallah Al-Baraka was established in Saudi Arabia, and operates 15 banks and over 2000 other companies, including insurance companies, production companies, research and training centres with activities in 43 countries. Banks
associated with Al-Baraka, the larger of the two groups, hold 26 per cent of the assets and 23 per cent of the deposits of private Islamic banks.6

While the banks affiliated with the two groups are included in the IAIB statistics, most of the other companies are not. These include the Takaful and Retakaful (Insurance and Reinsurance) Companies, along with the business and trading companies. They are part of the network of institutions established by the groups in order to provide channels for the utilisation and investment of funds collected by the group banks. For example, DMI collects deposits from its Jeddah office or through its offshore banking unit in Bahrain, which are then funnelled into projects, trading activities and other Islamically-approved investments on a global basis. These companies also allow businessmen and other financial institutions to participate directly in agricultural, commercial, industrial, real estate, leasing and inventory management activities, all in conformity with Islamic financing precepts. Various investment funds have been set up in Bahrain, Luxembourg, Labuan and Jersey to facilitate individual investment of this type in the form of Islamic mutual funds. These developments are examined in later chapters.

In terms of the statistics of numbers of Islamic institutions (although relatively unimportant in terms of assets), IAIB data neglect the many hundreds of financial institutions operating Islamically at the local level. For example, India has no Islamic banks because the Indian Banking Act does not provide for interest-free banking operations. A number of Islamic Investment Companies are registered under the Companies Act of India, including Al-Ameen, Albaraka and Buit-un-Nas’r (for example, Barkat leasing). Nevertheless, there are over 300 Islamic financial institutions operating in India as Islamic cooperative credit societies, Islamic welfare societies, and financial associations (‘Baitulmas’) in the unorganised financial sector (Bagsiraj, 2000). Indonesia – the most populous Muslim country – has only one general purpose Islamic bank, Bank Muamalat. That has 30 outlets, hardly a large number for a population of 200 million with 250 distinct languages and 300 different ethnic groups scattered over an archipelago 5000 kilometres long. Some of that void is filled by the Bait Al-Maal Wa At-Tumwil (BMT) and Shari’a Rural Banks (BPRS). The former are cooperative organisations which focus on small business entities, such as traders and street dealers. In 1998, there were 898 BMTs in Indonesia (Arifin, 1998). Rural banks are limited in their fund-gathering activities but contribute actively in the finance of Muslim business entities in the regions. In 1999, there were 78 Islamic rural banks operating in Indonesia (Karim, 2000). Broadly equivalent types of cooperative institutions and rural-based organisations operate in other countries.

As noted at the beginning of this chapter, this expansion of Islamic banking has basically taken two forms. The first form that the development of Islamic
banking has taken involves the restructuring of the whole financial system to accord with Islamic precepts. Three countries where this transformation of the system is underway are Iran, Sudan and Pakistan. In Iran all banks have operated under Islamic law since March 1984 when *riba* (interest) was abolished from banking operations, and profit-sharing techniques substituted. In Sudan, conventional banks were instructed to turn Islamic from July 1984, but the transition was not implemented fully until July 1990 when Islamic scholars were involved in the governance of the banks – an issue emphasised in Chapter 7 below. Pakistan was the first country to move towards full conversion of its financial system, but has adopted a gradualist approach. An Advisory Council of Islamic Ideology was formed under the Constitution of 1962 to advise on the legal and institutional framework for an interest-free economic system. In 1977, the President of Pakistan asked the Council to prepare a blueprint for the transition. Following its recommendations in 1980, profit-and-loss-sharing accounts were introduced in 1981. From July 1985, all commercial banking in rupees was made interest-free, and there is the objective of moving the whole system to this basis in 2001.

The second form has been an attempt to establish Islamic financial institutions side by side with traditional banks. In such mixed systems, the types of institutions which have evolved are Islamic banks created mostly in Muslim countries, and Islamic investment and holding companies operating in some Muslim countries, but mainly in non-Muslim countries. These banks, which neither charge nor pay interest, invest predominantly by engaging in trade and industry, directly or in partnership with others, and sharing the profits with their depositors. In both cases, generally, the banking operations are subject to regulations that apply to all banks.

A number of institutions have located at the international level, outside Muslim countries. DMI (including the Islamic Investment Company of the Gulf) and Al-Baraka are examples, and Al Rajhi Banking and Investment Company of Saudi Arabia is another, the latter having operations in London and Luxembourg. At the same time, banks such as Citibank (USA), ANZ (Australia), ABN Amro (Netherlands), Goldman Sachs (USA), HSBC (UK), Deutsche Bank (Germany), Saudi American Bank (USA–Saudi), Saudi British Bank (UK–Saudi), and Société Generale (France) have Islamic banking units or subsidiaries. Banks such as these have been active in Islamic finance from the beginning of the movement, assisting with the investment of interbank funds (in accordance with Islamic principles) and in arranging lease financing and other appropriate avenues of investment. Otherwise, through their ‘Islamic windows’ from which they offer their own products, the focus of their attention has been in providing banking services in Islamic countries, even when the windows or Islamic banking units operate in Western locations.

Our examination of the workings of Islamic banking focuses on the two
main types of systems, and the study proceeds as follows. Chapter 2 examines
the basis of Islamic law and its rulings on financial dealings. Chapter 3
analyses the basic principles of Islamic banking, while Chapter 4 compares
these principles with those of conventional banking in the light of the theories
of financial intermediation. These two chapters identify the incentive
problems in Islamic banking. Chapter 5 examines the legal and other
conditions which must be met in order to create an entire financial system
based on Islamic principles, and uses the case of Pakistan to illustrate these
requirements based on a study of the evolution of Pakistani laws and rulings
of the Federal Shariat Court. Chapter 6 looks at the operations of the mixed
system, and assesses some of the criticisms of Islamic banks from Islamic
scholars. Then the next three chapters, in different ways, consider the success
factors shaping the future of the concept. Chapter 7 looks at corporate
governance in Islamic banking and the distinctive features of the corporate
culture. In marked contrast, Chapter 8 uses historical analogy, asking why
Islam has succeeded in keeping the issue of usury alive when other religions,
most notably Christianity, failed. Finally, Chapter 9 outlines new directions
and innovations in Islamic banking and finance, followed by some conclusions
in Chapter 10.

NOTES

1. These countries are: Afghanistan, Albania, Algeria, Azerbaijan, Bahrain, Bangladesh, Benin,
Brunei Darussalam, Burkina Faso, Cameroon, Chad, Comoros, Côte D’Ivoire, Djibouti,
Egypt, Gabon, Guinea Bissau, Guinea, Indonesia, Iraq, Islamic Republic of Iran, Jordan,
Kazakhstan, Kibris (North Cyprus), Kuwait, Kyrgyz Republic, Lebanon, Malaysia, Maldives,
Mali, Mauritania, Morocco, Niger, Nigeria, Oman, Pakistan, Philippines, Qatar, Republic of
Yemen, Russia, Saudi Arabia, Senegal, Sierra Leone, Socialist People’s Libyan Arab
Jamahiriya, Somalia, Sri Lanka, Sudan, Syria Arab Republic, The Gambia, Tunisia, Turkey,
Turkmenistan, Uganda, United Arab Emirates, West Bank and Gaza (WBG).
2. Mudaraba, mudarabha, mudarabah, mudarba, and modarabah are all different English
spellings of the same Arabic word.
3. Caliph, Calipha or Khalifa from the Arabic word meaning ‘successor’. Although elected
temporal princes, as rulers of the Islamic state they were also spiritual heads of Islam and
came to be known as ‘Commanders of the Faithful’.
4. New Horizon, No. 82, December 1998, p. 17. He is Chairman of Centre for Islamic
Economics, Pakistan, and a judge of the Islamic Shariat Court.
5. An independent body, the IAIB supervises the workings of the individual Shari’a boards
which monitor the operations of Islamic banks to ensure conformity with religious precepts.
Chapter 7 examines the role of the Shari’a boards.
7. For example, ABC International Bank, Arab Bank, Bank Rydah, Citibank International, Gulf
International Bank, IBJ International, J Aron (Goldman Sachs), Dresdener Kleinwort Benson,
United Bank of Kuwait all have Islamic units (‘windows’) in London, but deal with Middle
Eastern and Asian clients from these offices.