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ISLAMIC BANKING AND FINANCE

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ABSTRACT

Islamic banking is grounded in the tenets of the Islamic faith as they relate to commercial transactions. The principles of Islamic banking are derived from the Quran–the central religious text of Islam. In Islamic banking, all transactions must comply with Shariah, the legal code of Islam (based on the teachings of the Quran). The rules that govern commercial transactions in Islamic banking are referred to as fiqh al-muamalat.

INTRODUCTION

Islamic banking, also referred to as Islamic finance or Shariah-compliant finance, refers to financial activities that adhere to Shariah (Islamic law). Two fundamental principles of Islamic banking are the sharing of profit and loss and the prohibition of the collection and payment of interest by lenders and investors.

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- Two fundamental principles of Islamic banking are the sharing of profit and loss and the prohibition of the collection and payment of interest by lenders and investors.
- Islamic banks make a profit through equity participation, which requires a borrower to give the bank a share in their profits rather than paying interest.
- Some conventional banks have windows or sections that provide designated Islamic banking services to their customers.

Islamic finance is a type of financing activity that must comply with Sharia (Islamic Law). The concept can also refer to the investments that are permissible under Sharia.

The common practices of Islamic finance and banking came into existence along with the foundation of Islam. However, the establishment of formal Islamic finance occurred only in the 20th century. Nowadays, the Islamic finance sector grows at 15%-25% per year, while Islamic financial institutions oversee over $2 trillion.

The main difference between conventional finance and Islamic finance is that some of the practices and principles that are used in conventional finance are strictly prohibited under Sharia laws.

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ANALYSIS OF THE LITERATURE ON THE SUBJECT

Islamic banking, Islamic finance (Arabic: مصرفية إسلامية), or Sharia-compliant finance is banking or financing activity that complies with Sharia (Islamic law) and its practical application through the development of Islamic economics. Some of the modes of Islamic banking/finance include Mudarabah (profit-sharing and loss-bearing), Wadiah (safekeeping), Musharaka (joint venture), Murabahah (cost-plus), and Ijara (leasing).

Sharia prohibits riba, or usury, defined as interest paid on all loans of money (although some Muslims dispute whether there is a consensus that interest is equivalent to riba). Investment in businesses that provide goods or services considered contrary to Islamic principles (e.g. pork or alcohol) is also haram ("sinful and prohibited").

These prohibitions have been applied historically in varying degrees in Muslim countries/communities to prevent un-Islamic practices. In the late 20th century, as part of the revival of Islamic identity, a number of Islamic banks formed to apply these principles to private or semi-private commercial institutions within the Muslim community. Their number and size has grown, so that by 2009, there were over 300 banks and 250 mutual funds around the world complying with Islamic principles, and around $2 trillion was Sharia-compliant by 2014. Sharia-compliant financial institutions represented approximately 1% of total world assets, concentrated in the Gulf Cooperation Council (GCC) countries, Pakistan, Iran, and Malaysia. Although Islamic banking still makes up only a fraction of the banking assets of Muslims, since its inception it has been growing faster than banking assets as a whole, and is projected to continue to do so.

The industry has been lauded for returning to the path of "divine guidance" in rejecting the "political and economic dominance" of the West, and noted as the "most visible mark" of Islamic revivalism, its most enthusiastic advocates promise "no inflation, no unemployment, no exploitation and no poverty" once it is fully implemented. However, it has also been criticized for failing to develop profit and loss sharing or more ethical modes of investment promised by early promoters, and instead selling banking products that "comply with the formal requirements of Islamic law", but use "ruses and subterfuges to conceal interest", and entail "higher costs, bigger risks" than conventional (ribawi) banks.

ANALYSIS AND RESULTS

At the global level, Islamic banking started as social finance in the middle of the twentieth century. In Egypt, Mit Ghamr Islamic Savings Bank was established in 1963 by El-Naggar. Almost at the same time, Tabung Haji or Pilgrims Fund Corporation started operations in 1963 in Malaysia to help Muslims save to meet expenses of the Hajj journey.Then, the Islamic Development Bank (IDB) was established in 1974 to provide financial support to member countries for economic and community development. After that, commercial banking started in 1970s with the establishment of the Dubai Islamic Bank. Ever since then, the Islamic financial institutions penetrated different parts of the world including the Middle East, East Asia, South Asia, Northern Africa, and Europe. Thomson Reuters reports that there were as many as 1,389 Islamic financial institutions operating globally by the end of 2017 and at least 45 countries have regulations supporting Islamic finance operations.

Table 1.1. Growth in Islamic banking and finance (2012–2017).

Year	Islamic Banking Assets ($ Billion)	Islamic Finance Assets ($ Billion)
2012	1,305	1,746
2013	1,565	2,050
2014	1,445	1,965
2015	1,604	2,190
2016	1,675	2,290
2017	1,721	2,438
2023	2,441 (Projected)	3,809 (Projected)

Source: Thomson Reuters Global Islamic Finance Report 2018.

According to the Global Islamic Finance Report 2019, global Islamic finance assets reached $2.6 trillion in 2018. Table 1.1 gives a snapshot of growth in Islamic banking and Islamic finance since 2012. As much as 71% of the global Islamic financial assets are held by Islamic banking institutions including full-fledged Islamic banks and Islamic banking windows of conventional banks. The total number of Islamic banks and Islamic windows operating globally has reached 505 in 2017. Among individual countries, the market share of Islamic banking in national banking in Saudi Arabia, Kuwait, Bahrain, Qatar, United Arab
Emirates, Malaysia, Pakistan, and Indonesia remains at 52%, 46%, 30%, 26%, 22%, 26%, 15%, and 6%, respectively. Table 1.2 gives the share of different countries in the global Islamic banking assets. In more recent years, Islamic finance industry assets grew by a Compound Annual Growth Rate (CAGR) of 6% to $2.6 trillion in 2018 as compared to 2012. Quarterly panel data from 2013 to 2018Q1 in Table 1.3 reveal that profitability in Islamic banks has generally been impressive. Furthermore, in Brunei, Egypt, Kuwait, Malaysia, Sudan, and Turkey,
the cost to income ratio is below 50%. Except in Bahrain, the gross nonperforming finance ratio is lower than 10% in all countries. It shows high asset quality in Islamic banking with low infection ratios. Finally, the capital adequacy ratio on average is greater than 13% in all countries.

Table 1.2. Share of countries in global Islamic banking assets.

Country	Share in Global Islamic Banking Assets (%)
Iran	34.40
Saudi Arabia	20.40
UAE	9.30
Malaysia	9.10
Qatar	6.00
Kuwait	6.00
Turkey	2.60
Bangladesh	1.90
Indonesia	1.80
Bahrain	1.70
Sudan	1.60
Pakistan	1.20
Egypt	0.80
Jordan	0.70
Oman	0.60
Brunei	0.50
Others	1.40

Source: Islamic Financial Services Industry Stability Report 2018.

This shows that Islamic banks are solvent and have the ability to withstand financial shocks. There is a significant potential for further growth in enabling financial inclusion in Muslim majority developing countries. A survey of 65,000 people from 64 countries highlights that Muslims are comparatively less likely than non-Muslims to have a formal account or save at a formal financial institution.46 In countries like Afghanistan, Morocco, Iraq, Niger, and Djibouti, the percentage of the adult population with no bank

Table 1.3. Islamic banking indicators globally.

Country/ Indicators	Capital Adequacy Ratio (%)	Gross Non-Performing Financing (%)	Return on Assets (%)	Return on Equity (%)	Net Profit Margin (%)	Cost to Income (%)	Liquid Assets to Total Assets (%)
Bahrain	19.0	12.1	1.3	9.8	26.5	82.3	17.6
Brunei	21.2	5.7	1.7	12.3	52.4	40.5	49.9
Egypt	13.5	7.6	2.7	47.9	59.2	31.5	68.4
Indonesia	15.7	4.7	0.9	9.4	9.0	91.1	12.9
Jordan	22.3	3.0	1.7	17.9	48.3	51.7	36.7
Kuwait	18.0	3.0	1.2	10.3	21.4	36.7	32.0
Malaysia	15.7	1.3	1.1	15.2	39.4	41.6	11.2
Nigeria	38.3	1.7	0.1	0.7	4.9	89.9	21.1
Oman	40.7	0.1	−2.0	−3.4	−71.0	158.2	20.4
Pakistan	14.1	6.0	1.0	15.9	24.6	74.8	30.7
KSA	20.3	1.2	2.1	14.4	47.7	52.0	26.3
Sudan	18.7	6.0	2.6	25.7	52.9	43.8	37.1
Turkey	15.5	4.3	1.1	12.4	18.7	49.3	48.7
UAE	16.5	7.9	1.5	12.6	33.9	66.2	15.0

Source: Authors' calculations from IFSB Data.

accounts for religious reasons stands at 33.6%, 26.8%, 25.6%, 23.6%, and 22.8%, respectively. Furthermore, Sub-Saharan Africa accounts for less than 2% of the Islamic finance assets globally even though the continent's Muslim population is 250 million, and according to the World Bank, as many as 350 million Africans do not have a bank account. In June 2014, Britain became the first non-Muslim country to issue Sukuk, which is an Islamic substitute for the bond. Besides that, Singapore and Hong Kong are other non-Muslim-majority countries that have also issued Sukuk in the past. Among the major companies, Goldman Sachs and General Electric's GE Capital have also sold Islamic bonds in the past few years. The Economist reports that some non-Muslims may be drawn to pious banks for ethical reasons since Islamic law forbids investments in stocks of companies which deal in arms, alcoholic drinks, and tobacco.

CONCLUSION

This chapter has introduced the basic foundational principles and economic value proposition of Islamic finance. It has provided a brief look at the variety of Islamic finance institutions that are operating globally. The recent statistics on the Islamic finance industry exhibit exemplary growth and penetration in the Muslim as well as non-Muslim customer base in banking, investments, and insurance. In later chapters, the product structures on which these institutions operate will be explained in more detail.

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