Developments in Islamic Banking

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The phenomenon of Islamic banking has been attracting increasing attention, not only because of the train of geopolitical events set off by the September 11th attacks, but also because of developments within the Islamic banking community itself and the alleged business opportunities that could await banks that decide to provide Islamic banking services. Witness to this increased interest was the conference recently held in Rome, designed to introduce the Italian banking community to Islamic banking. Information about Islamic banking can, however, be hard to get, or contradictory. On the one hand, it is often said that Islamic banking has been growing at 15% per year for the last 10 years, well above growth rates in other banking sectors, and that billions of dollars are in the hands of Muslims around the world. On the other hand, one of the speakers at the Rome conference emphasised that Islamic banking is a "Third World banking industry, and needs to be measured by these standards".[1] Similarly, the editor of *Islamic Banker*, writing in *Newsweek* last January, pointed out that the size of the Islamic banking market has been quoted as $200 billion for years, which hardly tallies with the alleged 15% growth rate for a decade.[2] More accurate information is thus needed to respond to the awakened interest in this phenomenon. As well as reporting on the Rome conference, we will take a brief look at two recent developments in the field of Islamic banking.

Islamic banking: conference hosted at the Italian Banking Association (ABI), Rome

Dr Ahmad Mohammed Ali, President of the Islamic Development Bank (IsDB), based in Jeddah, Saudi Arabia, described the aim of this conference, held on December 19th 2002, as: to provide an opportunity to both bankers and academicians to acquaint themselves more with the basic features of the Islamic banking model and to provide a forum to bankers and businessmen from Italy and the IsDB member countries to interact with a view to increase [sic] mutual cooperation.

Speakers included representatives of the Italian banking community, of the Islamic banks and of major international banks that have also developed Islamic banking activities, university professors from Italy and the UK, and official diplomatic figures including the Saudi Arabian ambassador and the Director General of the Italian Ministry of Foreign Affairs.

The phenomenon of Islamic banking began, according to Ali, around 25 years ago. The main difference between Islamic banks and other banks is that the former are prohibited by Islamic law from charging or receiving interest (though see below for developments on this front). They have therefore developed other techniques for performing financial intermediation. On the assets side, probably the best-known technique is that of sharing in the profit and loss of a company, *mudarabah*, described by Stanislaus Ordody in his October 2001 article in OIKONOMIA. Both Ordody and some of the speakers at the ABI conference recognise that this technique owes much to the financing models of the cooperative banking sector, which began around 1850 with the simultaneous initiatives in Germany of Friedrich Wilhelm Raiffeisen (Catholic) and Herman Schulze Delizsch (Protestant).[3] Funds are also advanced on a sales-finance basis, involving buying goods in cash and selling them to clients on credit, taking a fixed profit from the difference between buying and selling prices. On the liabilities side, according to Ali, Islamic banks mobilize funds on a profit-sharing basis. They can also accept demand deposits that are treated as interest-free loans from clients and are guaranteed. . . An Islamic bank shares its net earnings with its depositors in a way that depends on the size and date-to-maturity of each deposit. Depositors must be informed beforehand of the formula used for sharing the net earnings with the bank.

Islamic banks also offer fund management services, and insofar as they are banned from investing in certain kinds of activity, function somewhat like the "ethical" or "socially-responsible" funds found elsewhere. Since Islamic banks also hold equity in corporations, trade in goods and services, provide insurance and operate in financial markets, they are more akin to the universal banking model, which dominates in Germany, Switzerland, the Netherlands and Japan, than to the commercial banking model of the UK and US.

Several of the speakers during the conference were at pains to emphasise that Islamic banking practices could provide advantages over current conventional financial practices, especially as regards reducing inequality and exclusion from credit facilities and stabilising international financial systems. On the first point, for instance, Ali argued that:

“Under conventional banking, all that matters to a bank is that its loan and the interest thereupon are paid to it on time. Therefore, in granting loans, the dominant consideration is the credit-worthiness of the borrower. This leads to concentration of credit and wealth in a few hands... Under Profit Loss Sharing (PLS) banking, the bank will receive a return only if the project succeeds and produces a profit. Therefore an Islamic bank will be more concerned with the soundness of the project and the business acumen and managerial competence of the entrepreneur. His credit-worthiness assumes a secondary consideration [sic]. This feature has important implications for the distribution of credit and wealth.”[4]

Regarding the second point, Dr Umer Chapra, advisor to the Islamic Research and Training Institute of the IsDB, aimed to show that the fundamental cause of recent instability in the international financial system is not so much the collapse of the Bretton Woods system or the lack of a new financial architecture as it is lack of market discipline caused by the insulation of deposits and banks from sharing in the risks of enterprise:

“Thus we see that there is a strong rationale behind the prohibition of interest by major religio[n]s of the world. The rationale is not merely to prevent the exploitation of the poor but also to make the financial system healthier and more stable by injecting in it greater discipline. If the share of equity is increased and that of debt is reduced substantially, the volatility now prevailing in the international financial markets will hopefully be substantially reduced. The result may be even better if credit is confined primarily to the purchase or lease of real goods and services. As a result of this a great deal of the speculative expansion of credit may be eliminated. The ultimate outcome may be not only reduction in financial instability but also better allocation of resources and faster economic growth.”[5]

Although these positive aspects are important to note, speakers did not address the problem of attracting funds from those who are risk-averse, and the possible reduction in capital made available for productive investment that could result.

Other speakers discussed the different situation of Islamic banking in Muslim countries, such as Pakistan, Iran, Sudan Malaysia. While the first three have tried to introduce a largely Islamic financial system, though at least in some cases allowing foreign currency accounts to continue bearing interest, Malaysia instead has attempted to introduce parallel conventional and Islamic systems. Two speakers focussed on the situation of Islamic finance in Western countries. Development can be hampered here by the fact that the Islamic community is a minority of the population and it is often not cost effective to provide special services, at least at the consumer banking level. It is more feasible to consider commercial banking for the many small Asian/Islamic businesses, especially in the UK. Other problems faced by Islamic banking practices in the West include legal frameworks which do not take the special needs to Islamic financing into account. For instance, where an Islamic bank buys a house and then sells it back to a customer (to avoid interest payments on a mortgage), stamp duty on the purchase is liable twice instead of once. As the BBC reported in February 2002, however, at least in the UK the Bank of England and the Treasury (Ministry of Finance) are actively looking for ways to avoid this and thus to promote Islamic finance of house buying.[6]

Two recent Developments in Islamic Banking

One of the important developments in the financial sector in general following on the September 11th attacks has been the increased effort to prevent the financing of terrorism through international financial networks, reported on in the October 2002 number of OIKONOMIA. Although the Islamic Financial Services Board, set up in November 2002, is not aimed primarily to deal with this set of issues, the timing of its creation clearly connects it to the general efforts now being undertaken to starve terrorism of funds. As the BBC report on the founding of the IFSB put it: "it will set tougher rules for accounting and transparency and that will make money laundering more difficult".[7] This international organisation joins other new international Islamic financial institutions, such as the International Islamic Financial Market (IIFM), set up in 2001 and launched in Bahrain in 2002, and the International Islamic rating Agency (IIRA) also recently registered in Bahrain. The first lowers liquidity risk for Islamic banks by providing a secondary market for Islamic financial instruments, while the second provides complementary rating information on Islamic banks to that produced by other rating agencies, including measures of their compliance with *Shari'ah* law.

A second important development at the end of 2002 was the vote taken by the Islamic theological research committee of Al-Azhar, based in Cairo, and one of Islam's most important universities, on the question of fixed interest rates. According to classical Muslim thought, banks cannot pay depositors fixed interest rates, although they can pay variable rates that are linked to the bank's profits. The Al-Azhar committee, however, voted 21-1 in favour of re-interpreting the Koran so as to allow for fixed interest rates.[8] The head of the research committee secretariat, Sheikh Saber Talaab, was reported as saying: "Religious jurisprudence means change, and it is illogical to remain frozen while the world changes around us... So long as we do not go against what is written (in the Koran) or the Sunna (Islamic tradition), we have a clear conscience".

The flexibility in interpretation that this re-thinking indicates was echoed by one of the speakers at the Rome conference when he suggested that the development of financial instruments by the Islamic banks, such as credit cards or overdrafts, "have nothing to do with risk sharing and everything to do with utility" (emphasis original).[9]

NOTES

[1] Dr Adnan Al-Bahar, *How Islamic Investment Banking Works*, Paper presented at the Seminar on Islamic Banking, December 19th 2002.

[2] Mushtak Parker, "Counting Change", *Newsweek*, Jan 6th 2003, p. 21.

[3] On the other hand, another of the speakers at the conference suggested that someof the basic concept and technical terms used in finance are derived from earlier Islamic ideas, such as the Arabic term for "document of title", *sakk*, which entered some Western languages as *cheque*. See Iqbal Khan, *Islamic Financial Practice in Western Legal Frameworks*, Paper presented at the Seminar on Islamic Banking, December 19th 2002.

[4] H. E. Dr Ahmad Mohamed Ali, Opening Session Speech, Seminar on Islamic Banking, December 19th 2002.

[5] M. Umer Chapra, *Islamic Banking: An Alternative Model for Financial Intermediation*, Paper presented at the Seminar on Islamic Banking, December 19th 2002.

[6] See Andrew Verity, "UK to encourage Islamic Mortgages", *BBC News*, February 18th 2002, at http://news.bbc.co.uk/1/hi/business/1826834.stm

[7] Jonathan Kent, "Muslim countries agree bank watchdog", *BBC News*, November 3rd 2002, at http://news.bbc.co.uk/2/low/business/2393685.stm

A symposium was held over two days in Kuala Lumpur as part of the inauguration of the Board. Some of the papers of the symposium are available at the web site: http://www.ifsb.org/index.php?ch=3&pg=35&ac=18

[8] See the article, based on an Agence France-Presse report, "Islamic institute blesses interest", *BBC News*, November 18th 2002,
http://news.bbc.co.uk/2/low/business/2488525.stm

[9] Duncan Smith, *Islamic Fund Management*, Paper presented at the Seminar on Islamic Banking, December 19th 2002.