ISLAMIC BANKING

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In recent years the rise of Islamic banking has been one of the most important trends in the economic sphere, with an estimated 1.5 billion Muslims in the world, this arena has plenty of room for expansion.

Conforming to Shariah (Islamic Law) puts a huge demand among Muslims looking for financial products and services that adhere to their beliefs. If it weren't for the creation of such alternatives to conventional banking and finance, Muslims would find it hard to participate in our globalized world without violating their religious principles.

There are currently over 300 financial Institutions across the global sphere providing some type of Islamic financial product. According to some experts, the assets that are currently being managed under Shariah law, which range from investment to commercial banks and investment funds, are estimated to be no less than 300 billion.

Other experts in the industry estimate the assets under management to be much larger. The FSA (Financial Services Authority), a regulator for financial services based out of London, estimates the total amount associated with Shariah banking to be as much as 500 billion. Even the U.S rating agency, S & P, estimates the sukuk (deed) market has reached over 75 billion and will likely be over 150 billion by the end of the decade. It used to be that Islamic financial products were more of a niche market but over time they are now considered mainstream, with many well-known international financial institutions battling to get a little piece of the pie.

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With this industry being fairly new as compared to conventional areas, the profit margins associated with these products are still relatively high. Taking this fact into account along with the amount of Muslims worldwide, you can understand why many institutions are trying very hard to get a share of this market.

I
WHAT IS SHARIAH BANKING?

Some people like to say that Shariah banking, is banking with a conscience. Under this type of banking it is customary that banks have a board made up of financial experts and scholars that are well versed in Shariah Law. From this solid base these individuals are able to determine which activities are compliant and which are not. Some popular banking practices in world banking, such as gambling with derivatives and options, or investing in firms that support the production or distribution of alcohol, pornography or pork are not attainable by Islamic banking means.

There are two main financial principles that govern Islamic banking.

1. Interest free financing shall be provided for investment to the private sector.
2. All financial products developed are to be done on a basis of sharing risks and as well as sharing profit and losses.

Shariah law is the foundation for Islamic banking. Interest, the base of conventional banking, is strictly prohibited by Islamic law and considered unethical. Islam considers interest an unjustified increase of capital, with no effort made to earn it, it is considered of false value, and therefore is prohibited. However, there are many arguments about the prohibition of interest in Islam. The first argument is that interest rates have no moral foundation. The second is that abstinence from consumption is not a justification of rewards. Lastly, some argue that there are risks to justify the supplement of payment for capital lending if the loan is guaranteed.

To go along with the prohibition of interest, Islamic law considers money to be strictly a medium of exchange and therefore has no inherent value. If it has no value then it should not lead to the production of more money. In Islamic banking, the reditor/debtor relationship is defined differently than in the secular financial world. The creditor, or provider, of funds who becomes a partner in a project assumes the risk activity with the entrepreneur and shares profits as well as losses. The creation of incremental wealth justifies the share of profit between the borrower and the lender of money, but does not guarantee a fixed return.

Some of the main financial products used in the aforementioned form of resource mobilization include the following:

— Trade financing and cost-plus mark-up on traded goods (*murabaha*).
— Profit-sharing (*mudarabah*) and equity participation (*musharaka*) in which cost-sharing among partners is also included.
— Rental on purchased equipment (*ijara*).

II
ISLAMIC BANKING VS. CONVENTIONAL BANKING, WHAT ARE THE DIFFERENCES?

Both Islamic and modern Western banking systems are very similar in almost all functions. From this Islamic banks are able to mediate any limitations or excesses that may exist in a monetary exchange economy. The Islamic bank requires a careful management team to balance the different levels of credit (personal credit, secured credit, letters of credit), and also functions as a specialist in estimating projects risks and estimated returns.

The fundamental difference between these two banking systems lies in the fact that western banks charge and pay interest, whereas Islamic banks do not as they consider interest to be prohibited under Shariah law. Even though the operations of Islamic banking are different from conventional banking both types of banking fulfill the same needs.

Listed below is a graph summarizing a list of differences between Islamic and Conventional banking.

	Islamic Banking	*Conventional Banking*
Main Principle	The customer shares the profit and loss with the bank. High degree of risk with variable returns.	The customer obtains fixed interest from the banks and does not share the loss.
Stability	Higher degree of stability.	Lower degree of stability.
Treatment of interest	Uses profit and loss structure accounts. Interest is prohibited.	Interest based on products.
Profitability	Profit and loss is based on an agreement or musharaka (partnership) or joint venture without participation in management (mudaraba).	Higher concentration leads to higher interest rates, which leads to higher profitability. Higher rates of inflation lead to higher profit margins.

Since banks are prohibited from charging interest, they must act like their own investment company in which it sells its own stock to the public. In this concept the bank does not have maturity-matching problem or duration gap management, which is a functional problem with Western banks in general.

The way Islamic financing goes about their business is fundamentally different as compared to conventional finance. Profit and loss is their main structure in providing financing. What this means is that rather than lending money to their clients, these financial institutions actually invest with their client in order to meet their client's needs. This relationship is like a joint venture, where returns are handed out based on the profits earned. This risk component of actually having to participate in the venture is the key component to Shariah-compliant finance. Most importantly customers are assured that these products that are offered are compliant to Islamic law, in achieving this Islamic institutions employ a panel of scholars and financial experts to a Shariah board. This board then analyzes and approves the products compliance to Shariah law.

Shariah compliant products mean the arrangements of financing where the return of investment for the Islamic Financial

Institution (IFI) is predetermined and fixed but within Shariah constraints. The tools which harmonize the operations of Islamic financial system with conventional banking are the following:

— *Ijara:* is a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are born by IFI while expenses relating to use the asset are the responsibility of client. The difference between Ijara and sale is that ownership in Ijara remains with lessor while in case of sales it is transferred to purchaser. Ending Ijara in a sale of asset is allowed by the IFA through a separate contract at the completion of the lease. The contract can be executed prior to purchase and possession of asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or as per normal course of business. The lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the copartner. Inter Bank Rate can be used as a benchmark for amount of rentals. At the completion of Ijara term either asset is returned to IFI or purchased by client. Ijara has replaced successfully the facility of leasing under conventional financial system.
— *Murabaha* is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary. Under Murabaha arrangement customer requests to the IFI to purchase an asset for him and sell on deferred payment. An essential feature «of Murabaha is that IFI must purchase the required commodity from supplier first and then sell to customer. Bank charges a certain profit usually linked with Inter Bank Offered Rate. Recovery could be agreed in installments or a balloon payment. The amount of installment or price of the asset cannot be increased or decreased in case of default or early payment. In order to create pressure on client for prompt payment a penalty is imposed upon customer as agreed in Murabaha contract. Amount of penalty for default in prompt payment recovered cannot be included in income of IFI in any case and must be spent for charity. Murabaha has successfully replaced the overdraft and short term loans facility under conventional banking.

— *Salam*: Salam is a form of sale contract where by IFIs purchase goods for spot payment with deferred delivery. Practically it is used in financing of agricultural needs of farmers. Farmers sell their crops prior to harvesting to IFIs in order to get money to purchase seeds and fertilizers. Generally spot price agreed is lesser than future the actual date of delivery, hence IFIs are making profit. As a matter of practice IFIs are entering into a parallel Salam contract with third party to sell the proceeds once taken over however execution of second contract is not conditional to the fulfillment of first.
— *Istisna*: A contractual agreement for manufacturing goods and commodities, allowing cash payment to be made in advance with a set date for future delivery, or a future payment and delivery. A manufacturer or builder agrees to produce or build a well-described good or building at a given price on a given date in the future. Price can be paid in installments, or as agreed between the parties. *Istisna* can be used for providing the construction of houses, plants, projects, and building of bridges, roads and highways.
— *Wakala*: A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.
— *Commodity Murabaha*: A sale consisting of a cost plus profit basis, based on a mutual exchange of specific commodities. If the customer wishes to invest money with the bank, he or she will purchase commodities at «Cost Y» from «Broker B» and sell them to the bank at «Cost Y» plus «Profit X,» which equals the «Contract Price.» The bank will repay the «Contract Price» over a duration of time.
— *Tawarruq*: A customer buys the commodities on a deferred payment from the bank at a cost-plus plus profit. The customer then turns around and sells the commodities for cash to a third party on a spot basis.
— *Ijarawa Iqtina*: A contract where an Islamic bank finances equipment, building or other facilities for a client against a rental agreement. There is a unilateral undertaking by the bank or the client so that at the end of the lease period, the ownership of the asset is transferred to the lessee. The undertaking or

the promise does not have to become an integral part of the lease contract in order to make it conditional. The rental as well as the purchase price is fixed in such a manner that the bank receives back its cost price along with some profit, which is usually determined in advance of the transaction.

— *Diminishing Musharaka*: is a form of declining partnership between IFI and the client generally used to finance real estates. When a customer requests to financing from the IFI to purchase an asset, the IFI participates in the ownership of asset by contributing required finance. Certain portion must be contributed by customer. Total equity of bank is divided into units of smaller amounts which are purchased by client in installments. Under this mode of financing one of the partner's promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally IFI rents his share to the client and earns rentals. Any profit accruing on property is distributed among the coowners according to agreed ratio however losses must be shared in proportion of equity. Diminishing Musharaka is used for house financing by IFIs and has replaced successfully conventional mortgages.

— *Arbun Contract*: A down payment; a nonrefundable deposit that a buyer makes to retain the right of confirming or canceling a sale.

Now that we have discussed the products that a have fixed rate of return, Shariah Compliant Financing, we will now discuss Shariah Based Financing. Shariah Based Financing differs from the other conventional products we just discussed by having a rate of return that is not fixed in advance rather it depends upon the outcome of the project. There are two types of financing, Musharaka (partnership in capital) and Mudaraba (partnership of capital and skill).

— *Musharaka*: means a joint enterprise formed conducting some business in which all partners share the profit according to a pre agreed ratio while loss is shared according to the ratio of contribution. However for there to be a valid Musharaka agreement certain conditions must be met. First, there must be a written agreement among partners stating clearly the terms and conditions. Second, capital can be contributed in cash as well as in assets. Third, profit is distributed according to the written agreement however any silent partners can't claim a share in the profit for more than is proportionate share of equity is.

— *Mudaraba:* is a type of partnership whereby skill and money are brought together to conduct business. Profit is shared according to the agreement while loss is born by capital provider only. Under this scheme of financing IFIs provide capital to financially weak but skillful people to do the business and share outcome with IFIs. This scheme is also used in deposit collection. Mudaraba contract can be restricted or unrestricted. No one can claim a lump sum amount of profit it must be based on actual outcome.

The geographic distribution and economic power in this industry has been quite remarkable. More than 280 Islamic financial institutions now operate in over 40 countries around the world, ranging from commercial banks, investment banks, investment companies to leasing and insurance companies. The first Islamic financial institutions in the Middle East were Kuwait Finance House, Dubai Islamic Bank, Al-Rajhi in Saudi Arabia, and Faisal Islamic Banks in Egypt and Sudan. The GCC (Saudi Arabia, Kuwait, Bahrain, United Arab Emirates, Qatar and Oman) region currently remains the primary financier of Islamic finance worldwide.

In Saudi Arabia, for instance, the economy grew by 6.4 percent in 2005 – its highest growth rate since the oil boom of the 1970s. Growth was reflected in the increased amounts of both personal and small business deposits in Shariah-compliant facilities. Across the Gulf in Iran, despite the country's political challenges, 2005 was one of the best years for the country's banks, which have been Shariah-compliant ever since 1983. Again, the boom in oil and prices lead to a gross domestic product increase of 6.2 percent.

Bank Melli, Iran's largest bank and the leading Islamic bank worldwide in terms of assets, saw its total assets rise to more than $25 billion. Trade finance is especially important for Iran's Islamic banks, usually conducted on a *murabahah* basis. Many consumer imports enter Iran through the United Arab Emirates (UAE), where all major Iranian banks have branches. More than 4,400 Iranian businesses are active in Dubai, but the movement is not all one way.

Listed below is a short list of Major Islamic Banks:

IRAN	BAHRAIN
• BANK MELLI IRAN • BANK SEDERAT IRAN • BANK MELLAT • BANK TEJARAT • BANK SEPAH • BANK REFAH • EXPORT DEVELOPMENT BANK OF IRAN • BANK SANAAT O MAADAN • BANK KESHAVARZI • BANK MASKAN • KARAFARIN BANK • SAMAN BANK-E –NOVIN • BANK PARISIAN	• BAHRAIN ISLAMIC BANK • ABC ISLAMIC BANK • SHAMIL BANK • NORIBA BANK • GULF FINANCE HOUSE • ALBARAK BANK BAHRAIN • CITI ISLAMIC INVESTMENT BANK, E.C. • FIRT ISLAMIC INVESTMENT BANK • AL-AMIN BANK
QATAR	**LEBANON**
• QATAR ISLAMIC BANK • QATAR INTERNATIONAL ISLAMIC BANK • QATAR ISLAMIC INSURANCE COMPANY	• AL-BARAKA BANK LEBANON
SAUDI ARABIA	**KUWAIT**
• ISLAMIC DEVELOPMENT BANK • AL BARAKA INVESTMENT & DEVELOPMENT CO. • AL RAJHI BANKING & DEVELOPMENT CORPORATION	• KUWAIT INTERNATIONAL BANK • KUWAIT FINANCE HOUSE • BOUBYAN BANK
UAE	**JORDAN**
• DUBAI ISLAMIC BANK • ABU DHABI ISLAMIC BANK • NATIONAL BANK OF SHARJAH	• JORDAN ISLAMIC BANK • ISLAMIC INTERNATIONAL ARAB BANK

It was a little over ten years ago that there were no Islamic Investment banks. You have now at least 10 major institutions servicing the needs of many Muslims. Currently the largest ones are the following: Gulf Finance House of Bahrain, International Investor of Kuwait, Al Tawfeek Company for Investment of Saudi Arabia and the First Islamic Investment Bank of Bahrain. All these companies have been able to expand their investment banking sector due to the booming economic growth derived from the increase in oil revenues. Due to this, many say that that this growth shows how Islamic banking activity is very pro cyclical as compared to commercial banking in this area of the world.

In addition, the years of late have also shown a substantial increase in the degree of professionalism across Gulf-based Islamic investment companies. Some companies even started to seek listing on the Alternative Investment Market in London, such as the Dubai-based Islamic complaint company Tejoori – the first Shariah-complaint investment company to gain international status.

Thanks to the innovation of Islamic financial companies that are part of the GCC, Shariah compliant investments have expanded into all financial sectors. Media, advertising, real estate, industrial and textiles, information technology and insurance coverage are just some of the sectors where you can find these products.

Within the last ten years, Islamic banking has gone from a small niche market to an international finance industry. This industry is expected to continue to grow far into the future, especially due to the fact that high oil revenues are being generated throughout the Gulf. There will be intense competition among western banks and borrowers who will want access to these funds that are flowing into the region. It was only a little over ten years ago, that there were only a few Islamic-branded investment funds; now there are at least 230 worldwide. The Islamic finance industry is booming, and as a consequence it must offer a more diverse range of services and products for middle and low-income depositors. Additionally, it must train professional managers, helping them to become well versed in both theoretical concepts and practice.

The growth of Islamic banking is something that cannot be ignored. The surpluses of money that are being generated from oil revenues in the region have been quite enticing for many international banks to get involved in this growing industry. Deutsche Bank, HSBC, UBS and Citigroup are just some of the institutions that have established subsidiaries in these regions to get a piece of the market share.

IPOs, mergers and acquisitions and corporate financial restructuring are usually the fundamental business transactions of investment banking in the international markets. However in the Gulf region and among many Muslim markets these types of business transactions are much less seen. IPOs have been the most common transaction as of recently due to the stock market boom throughout the Gulf and in 2005 a record was set for the number of IPOs established in one year. The majority of Shariah compliant investment banking has focused more on the mutual funds and wealth management.

Until recently only a few Western banks had been running Islamic operations. Citigroup, BNP Paribas, HSBC and Standard Chartered were some of the first ones to take advantage of this market, however new competition has been bringing other big names in to this sector. Deutsche Bank, Barclays, Morgan Stanley and West LB are some of the newer participants joining the ranks and arranging billions of dollars in Islamic deals.

The rewards that have come with the growing demand for Islamic products, have also brought their fair share of challenges. As this industry starts to mature, you have more investors and banks demanding new structures and products that are compliant with Shariah principles. But while the products must be often syndicated with Shariah scholars, English and American financial lawyers are finding ways of making Islamic products work. This syndication allows the Muslims who recognize Shariah law to use and benefit from the Shariahcompliant financial tools at Western banks or companies.

Some other trends that you are starting to see in the Islamic banking industry is project fundraising according to Islamic principles and bond financing by Islamic governments and government agencies. Recently fundraising for infrastructure projects across the Middle East have been made possible through Shariah compliant financing. One of the first projects to use Islamic financing was in Abu Dhabi where a project to expand water desalination and electricity worth 2.2 billion, included 540 million of Islamic financing. Al-Hidd power project in Bahrain was another project of which 55 million of the total 255 million came from Islamic financing raised by Kuwait Finance House and Islamic Development Bank.

In concluding, Islamic banking is based on the principle of sharing risk along with profit and loss between financial institutions and individuals. All this must be done in accordance to Islamic principle and laws.

One key fundamental difference between Islamic banks and conventional banks is the prohibition of interest on loans, which is referred to as riba. Islamic law does not allow unjustified capital increases, and emphasizes on deriving capital increases through investment. Gross revenues and profitability are derived from several Islamic financial products, based on sharing risk and revenues with customers. Ijara, musharaka, murabaha and tawaroq are some of products that achieve this goal. Islamic banks will always refer to Shariah boards made up of scholars and experts to make sure the level of compliance of their products are in accordance with Islamic laws.

The demand for Shariah compliant financial products along with the growth of Islamic financial institutions has increased substantially in recent years. The reason lies in the fact that there has been a boom in oil and gas price revenue. Islamic financial industry has evolved from a niche market to a global financial market. That boom has led to a huge growth for local Islamic financial institutions and even led international financial institutions to enter and compete in the market.

This growth and increased demand requires innovation and product development of Shariah-compliant financial products, and it also needs an increase in the variety of offerings. Even though there has been major innovation by IFIs in several areas, like industrial projects, information technology and even offering insurance against political risk, the industry still has much more room for improvement in innovating sophisticated instruments to take advantage of western financial experience that would standardize and streamline Shariah compliant products.

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