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GLOBAL ISLAMIC BANKING EXPERIENCE: Financing Modes, Instruments, Services and Products

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1- Introduction

Islamic Banking Experience in the Islamic Countries:

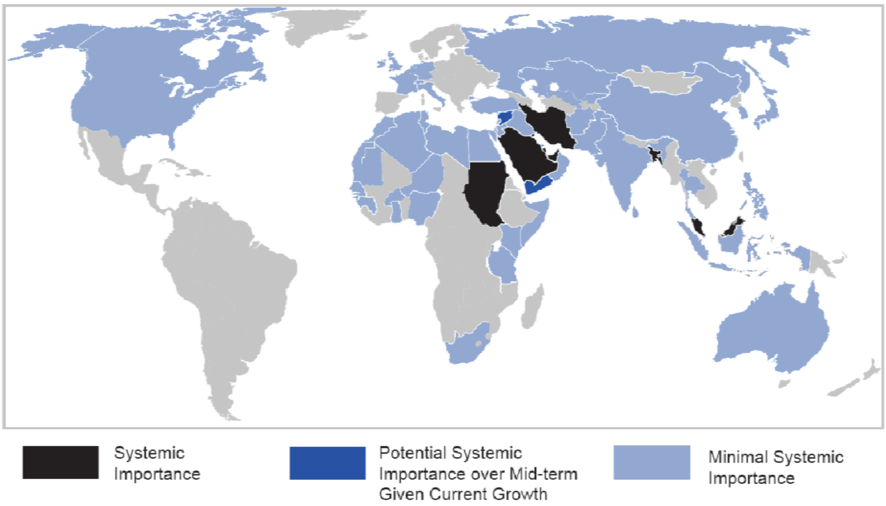
Dubai Islamic Bank was the first commercial bank that conducted its affairs along Islamic lines. It was established by His Excellency Saeed Bin Ahmad Al Lootah in 1975. In the same year, the Islamic Development Bank was established in Jeddah by a decision made by the Conference of Finance Ministers of Muslim countries in 1973. However, the first important international academic activity was marked by the First Islamic Economics Conference which took place in *Makkah al Mukarramah* in 1976. This conference has also led to the establishment of the Islamic Economics Research Centre by King Abdul Aziz University in Jeddah in 1978 as well as the sprouting of many other academic institutions around the world.

Today Islamic banking is no longer considered as an experiment to apply Shariah into the economic lives of Muslims. It is projected that Islamic banking would maintain high growth levels considering its low level of penetration, market potential, high level of demand for *Shariah*-compliant products especially in Muslim countries. With the rise in energy prices in the period between 2003 and 2008 which further enhanced the economic importance of oil-producing Islamic countries, Islamic financial institutions received a further boost. It is noteworthy that presently Islamic finance is systemically important in many countries including Iran, Sudan, Saudi Arabia, Kuwait, and Qatar (Figure 1).

Within the Islamic world, Islamic financial institutions have become major economic players. Five countries dominate Islamic banking: Iran with $345 billion in Islamic assets; followed by Saudi

Arabia $258 billion; Malaysia $142 billion; Kuwait $128 billion; and the United Arab Emirates $112[1]. Islamic Financial Service Board (IFSB) estimates that global Islamic banking assets stood at roughly $1,560 billion by the end of 2014, while outstanding *sukuk* accounts for $294.7 billion at the end of September 2014 recording a growth of 20.7 percent annually between 2008 and 2013. Other international organizations such as Deloitte and Moody's estimate that both Islamic banking and bond assets are expected to continue growing at double-digit rates in the coming years.

Figure (1): Islamic Finance Markets by Systemic Significance:



Source: KFHR

2- Islamic Banking Experience in other Countries:

Presently, Islamic banking is not limited to Arab and Muslim countries. It has spread from Eastern countries such as Malaysia and Iran to Western countries such as the UK and the US.

[1] Ibrahim Warde, 2000. Islamic Finance in the Global Economy

Moreover, a large number of conventional banks, including some major international banks, have started to offer Islamic banking products through what's known as Islamic windows. A few non-Islamic countries, among them the United Kingdom and Singapore, have announced their intention of becoming hubs of Islamic finance, and others (such as Australia, France, Japan and South Korea) have altered their legislation to become more hospitable to Islamic finance.[1]

Ariff (1988) opines that Islamic banking is not a negligible or merely temporary phenomenon but it is here to stay and there are signs that it will continue to grow and expand. It is currently one of the fastest growing industries. However, it's worth mentioning that the assets of all Islamic banks are less than those of any single conventional bank in the top 50 largest banks in the world. Put differently, the assets of the largest Islamic bank are equal to only 1 percent of the assets of the largest conventional bank in the world. However, the Islamic banking development experience is still a remarkable one considering the tremendous growth from a mere few dollars in 1975 to exceed 1.5 trillion dollars nowadays. During the last five years, Islamic banks assets have expanded by more than 15% per year.

Islamic banking has always been criticized for being conservative when it comes to financial innovation. This is due to the restrictions of *Shariah* in which Islamic financial institutions' transactions and operations must comply with the Islamic law. However, Islamic institutions proved their resilience during the subprime crisis in 2007 that hit the conventional banking sector massively. During the same year, the Islamic financial sector grew by 33 percent. However, considering the high level of linkage between the Islamic financial sector and real economy, the Islamic

[1] Ibid.

sector was adversely affected in the following year of the crisis when the financial crisis took its toll on the real economy.

3- Modes of Financing, Resource Mobilization and Services of International Islamic Banks and Financial Institutions:

Islamic banking has offered a new approach but the experience and contributions made so far are far short of what is required. The Islamic approach is rooted in a different vision of the economy; one that is equity-based as against credit-based. The only existing sort of loan will be *qard hasan* (benevolent loan), which serves to meet genuine individual or business needs. Within the Islamic system, the structure of the economy would be on a very different footing where capital and entrepreneurship would be co-participants, sharing the risks as well as the rewards of the enterprise.

Modes of Financing:

Islamic banks have thus far relied too heavily on those permissible instruments of financing which are closest to the conventional system such as *Murabahah* and *Ijarah*. Records show that almost 80 to 90 percent of financing has been done through these instruments. Whilst such instruments are permissible according to certain scholars it has been strongly criticised by others as introducing interest from the back door. The fixed income nature of such financing instruments make it less risky to the banks and quite convenient to the users of finance who have to pay by fixed amounts of instalments. The popular *Bay'Al- Inah* which is an instrument widely used for fixed payment financing is also the most heavily criticised.

The real alternative instruments such as *Mudarabah* and *Musharakah* have been resorted to only to a very limited extent. Both domestic and external climates were not supportive; the tax system is partial towards the interest system and almost inimical to a profit sharing system; the state of competition between the

Islamic and conventional banking systems has also restricted Islamic banks to very few options. Efforts have been made but the real concept in its all comprehensiveness is yet to be fully translated into reality. Efforts to move away from such fixed income financing to a more acceptable instrument was made a couple of years ago when the *tawarruq* which essentially is a *murabahah* transaction with at least three parties involved was introduced to the industry. However, the mechanism becomes messy because of difficulty of getting the third party to participate in the transaction and the extra documentation it requires to be implemented. The *tawarruq* died a natural death and was replaced by commodity murabahah where the securitised assets are commodities. Even this instrument is becoming cumbersome because of the limited amount of commodities available to be traded. The amount of commodities to be traded is limiting the financing operations of the banks.

The other more appealing instrument is the *musharakah mutanakisah* which involves the sharing of the asset to be financed by the financier (bank) and the user of finance (customer). The ownership of the asset being financed is proportional to the amount of finance being paid by the two parties. Suppose the customer has paid up to 60% of the total value of the asset, then the customer owns 60% of the asset and the bank owns 40%. As the customer pays more, his ownership of the asset increases in accordance with the payment he has made. When the customer has paid for the asset in full, he owns the asset 100%.

The recent move by the Bank Negara Malaysia (BNM), the Central Bank of Malaysia in introducing the new Act called the Islamic Finance Services Act 2013 is to try to provide a clear path towards the risk sharing approach of financing. The Act gives the Islamic Banks a grace period of five years to move towards *mudharabah* contracts in all its financing. The Act recognizes that there are customers who are completely risk averse and would not be prepared to lose any portion of their savings in the banks. These customers will continue to have deposit accounts based on *al-Wadiáh* contract or a contract of safe custody. The customers would not be prepared to allow the banks to utilise their savings in any transaction. The banks are obliged to keep their savings safely. On the other hand, there are customers who are risk takers and are prepared to allow the banks to use their deposits for risky business undertakings. The customers and the banks will share the profits and losses in some agreed proportion. For such customers, the banks have made it clear that their deposits will be used by the banks to finance businesses on *mudharabah* basis. The banks, in this case, are the *mudharrib* and the customers are the *rabbul* mal. These customers no longer keep their money as savings only but convert their deposits into investment accounts. However, the only difference between the previous savings accounts under *al-Wadiáh* contract and the present *mudharabah* contract is that the bank is allowed to use the deposits for its businesses. All other services remain the same. In other words, the customer can withdraw the money at any time and in any amount through ATM machines or other means. In other words all services rendered by the bank under the checking accounts remains. As under conventional system. At the same time, it will continue to earn dividends or profits in this case.

In the past, there were some deposit accounts, although based on *al-Wadiáh* contract, that were paid dividends by banks. This has been the practice of commercial banks that pay interest to the depositors for keeping money with them. The interest is an incentive for the customers to deposit their money in selected banks. In order to compete with such conventional practice, the Islamic banks introduced dividend payments to selected deposit accounts. With the introduction of the new investment accounts, the savings accounts will not earn any dividend anymore.

For the moment, the banks are using the customers capital to finance the activities based mainly on *musharakah mutanakisah*. The bulk of the activities are still the house financing, vehicle financing, *ijarah* financing, etc. The *mudharabah* part is only between the depositors and the banks. The banks and its customers whom it finances still practise the fixed income model of *musharakah mutanakisah, murabahah* and the like.

Resource Mobilization:

Greater success has been achieved in the field of resource mobilization on the liability side of Islamic banks' financial statements. The prevalent method of *Mudarabah* financing ties compensation on the outcome of the project. Under a *Mudarabah* contract, the manager is free to choose the optimal level of investment in each state dependent on his contractually specified level of effort.

The main issue in regard to resource mobilization is the efficient utilization of funds. For instance, employment generation and the flow of resources towards the lower and middle classes of society, particularly in the rural sector, where the great potential and needs exist, has not taken place. Providing access to finance to the poor through microfinance has not been successfully done by banks in most countries. The well-known microfinance activity is still undertaken by non-bank institutions or by Non-Government Organisations (NGO). Some have been successful and sustainable, such as the Grameen bank in Bangladesh, the Amanah Ikhtiar Malaysia (AIM) in Malaysia[1].

[1] AIM is a replica of Grameen Bank, except it introduces service charge in order to be Islamic at a rate much lower than that charged by Grameen Bank. However, today AIM is charging for services rendered up to 10% which is much higher than the fixed deposit rate.

But there are other microfinance activities in Iran, Pakistan and Indonesia that have been utilising Islamic instruments such as *qardh hasan* to provide financial access to the poor.

Presently, the most notable instrument in the Islamic finance industry that catapulted the methods of resource mobilization is *sukuk* (known as Islamic bonds). Governments as well as corporations have been resorting to *sukuk* in order to raise money in a *Shariah*-compliant way. One of the essentialities of this instrument is that it could be traded on the secondary market. In this case, Malaysia has for the past few years emerged as the leading issuer of *sukuk* in the world. It issues not less than 60% of the world *sukuk* every year.

Services of International Islamic Banks and Financial Institutions:

Islamic financial institutions have a unique nature in which all transactions must comply with the Islamic law, which has been derived from *Shariah* primary sources; the Quran and Sunnah. *Shariah* governance system has been established in order to ensure this *Shariah* compliance system also mitigates *Shariah* risk. However, the latter system does not have to disobey other governance systems or bodies, unless they contradict *Shariah*. In fact, Islam encourages the practice of adapting previous achievements of other civilizations; the Prophet SAW adapted the idea of digging a trench in the Battle of the Trench from Salman Al-Farisi. He also validated the contract of *Mudarabah*, which was practiced before Islam. Additionally, He modified the contract of Salam, which included uncertainty in order to eliminate any ambiguity in the contract (fixed date and specifications in terms of quality and quantity).

The present comprehensive *Shariah* governance frameworks were issued by AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain), BNM (Bank Negara Malaysia) and IFSB (The Islamic Financial Services Board, Malaysia). Both BNM and IFSB frameworks concentrate on four main key elements:

- Competence: Fit and proper criteria, professional training and formal assessment.
- Independence: Adequate capability to exercise objective judgment and complete, adequate and timely information.
- Confidentiality: Strictly observe the confidentiality.
- Consistency: There must be consistency in all ex ante and ex post *Shariah* governance processes.

4- Review of Innovation in the Islamic Republic of Iran's Banking System:

At least three countries have tried to make a beginning in the direction of developing a state-sponsored process for the elimination of *riba* from among the entire banking system. The strategy wasn't to establish interest-free banks in the private sector. Instead, their strategy was to first establish 'interest-free counters' within the system, and then extend the interest-free system to the whole banking sector, as so to operate on new principles under the protection of state policy and central bank guidelines.While Pakistan somehow aborted the process primarily because of lack of potential will. Iran and Sudan are still moving in that direction, with much mileage yet to cover. They have not followed the exact routes yet the strategy of total and state-sponsored change is common between the two. Their goal is not just one or some Islamic banks at the micro level but the transformation of the entire financial and banking system. Ultimately, the whole economy is to conform to Islamic norms.

In 1983, four years after the revolution, the government issued the *Riba*-Free Banking Act forcing all Iranian banks to rebuild their business around *Shariah*-compliant products. Presently, after more than thirty years of Islamic banking, the industry is still regulated by the *Shariah*. However, on the one hand, the sanctions on the economy slowed down the financial performance of the Islamic institutions. On the other hand, the Islamic institutions currently are expected to regain access to international markets after agreements with the West. This will open the door for another player to compete on the emerging markets' level.

The current challenge facing the Iranian banks is the ability to overcome the global acceptance of Islamic banking products structured similarly. The international Islamic banks go through a unique sort of screening, called *Shariah* screening, in order to be listed on different *Shariah* indices. Islamic Iranian institutions need to dynamically restructure their products to meet the existing requirements of global *Shariah* screening processes.

5- The Experience of the Islamic Republic of Iran's Banking System with the International Islamic and other Banking Institutions:

Unlike countries such as Malaysia and UAE where a dual banking system exist, the entire Iranian financial industry is structured on *Shariah* basis, similar to Sudan. Statistically, Iran accounts for more than 40 percent of the world's total Islamic banking assets. Considering the adverse effect of the sanctions, the Iranian absence on the global level gave other countries such as Malaysia and Saudi Arabia the chance to take the leadership of the global *sukuk* market even though these countries' world's total Islamic banking assets account for 9.56 and 18.5 percent respectively.

Thus, if the Iranian companies succeed to enter the international market overcoming the existing challenges, the potential of the Iranian economy, considering the size of local resources and population of 77 million, will certainly attract foreign investors. The Iranian regulators seem to aim at taking this opportunity as the Security and Exchange Organization is organizing a conference focused entirely on attracting foreign investors into the Iranian capital market.

Another potential incentive for foreign investors is profits. Records show mid-term yields on bonds and deposits range between 20 to 30 percent in local currencies. Noting that many of these returns are adjusted to inflation and foreign exchange currencies, that puts Iran on top of the list as one of the most profitable countries in the world.

6. Conclusion

Four decades of Islamic banking has seen tremendous progress in the establishment of a large number of Islamic banks, a significant increase in products and services as well as considerable increase in assets. However, despite such progress, apart from only Iran and Sudan which concentrate in developing a completely Islamic financial system, all other countries practise the dual system. The most important observations are twofold. First, despite significant difference in the growth rate of Islamic banks compared to their conventional counterparts, the amount of assets of Islamic finance industry as whole is not even 1% of the assets of the conventional banks. In most countries the Islamic financial assets hover below 10%. Only a few countries such as Saudi Arabia and Malaysia has more than 15% of the financial assets under the control of the Islamic financial institutions.

Secondly, because the amount of assets of Islamic financial institutions are still much less than the assets owned by their conventional counterparts, the Islamic finance industry is still not the dominating sector in these countries. The consequence of this situation is that the public policies, particularly the monetary and fiscal policies formulated by the Central Banks and the governments are all based on the conventional principles. Zakat which is the basis of Islamic fiscal system still remains at the periphery. Individuals and corporations who pay zakat to fulfil their religious obligation do not get any advantage when paying income tax.[1] The monetary policies are still based on *riba* to determine the money supply and demand. We have heard of banks in England manipulated the LIBOR to their advantage for so many years. The link between the real and financial sectors does not make sense any longer when the financial sector is at least 38 times more than the real sector. This will certainly create more booms and busts along the way.

I am personally proposing that when we talk of Islamic finance sector we should not confine ourselves to only the Islamic financial institutions. This is because, finance is the source of energy in any economic activity and hence it permeates throughout every sector of the economy. Since that be the case, we should now look at other corporations, NGOs, and all other organisations, which are not considered as financial institutions to also work towards applying the *Shariah* completely in their financial transactions. If we have this move in our countries, we should in no time dominate the financial sector and convert the whole sector into Islamic. This should be our goal. *Wallahu Aálam*

[1] In Malaysia, individuals who pay zakat will get rebate from income tax but not the corporations.

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