Trends in Islamic Finance and Banking Across the World

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Abstract

The aim of this paper is to review the available research studies on the subject of Islamic finance and banking. Islamic finance has been witnessing a spectacular growth across the world over the past decades. For this paper, specific search terms were used in the Google Scholar search engine and the results were shortlisted according to the year of publication. From the review of the available studies on the subject, it was highlighted that Islamic finance had witnessed tremendous growth over the last few years across geographies. Islamic finance has also been growing across the products of Islamic finance. There has also been a trend of demand for Islamic finance growing in non-Muslim countries. Studies have also claimed that the financial crisis of 2008 did not impact Islamic finance and banking.

Keywords: Islamic Finances, Islamic Banking, Trend, Review

Introduction

The Islamic financial services sector is estimated to be growing at double digit rates, with over 200 financial institutions and assets projected to exceed US$200 billion (Al-Dhahiri, Al-Khamiri, and Al-Hamli, 2003 – as cited in Bley & Kuehn, 2003). This growth has been most noticeable in Arab Muslim markets, but it has potential to grow beyond to non-Arab Muslim and non-Muslim consumers and businesses as well (Bley & Kuehn, 2003). According to Hesse, Jobst, & Solé (2008), the Islamic finance industry is in the midst of a phenomenal expansionary phase, exhibiting average annual grown rates of about 15 percent in recent years. This swift growth has been powered by a swelling demand for Shari'ah compliant products from financiers iin the Middle East and other Muslim countries. It has also been fueled by investors around the world, thus rendering the expansion of Islamic finance a global phenomenon (Hesse, Jobst, & Solé, 2008).

In this paper, we will review the studies which have been carried out on the subject of Islamic finance.

Methodology

In this paper, we will review some of the research studies which have been carried out on the subject of Islamic finance. Towards this end, specific search terms were used in Google Scholar search engine, such as "Islamic finance", "Halal finance", and "Islamic finance + banking". The results of these searches were shortlisted as per the year of publication. For the purpose of this study, only studies published after 2000 were used, in order to examine Islamic finance.

Results and Discussion

In recent years, Islamic finance has grown rapidly across the world, conservatively estimated at 10-15% a year (Ainley, Mashayekhi, Hicks, Rahman & Ravalia, 2007). According to El Qorchi (2005), Islamic finance is developing at a remarkable pace and since its inception three decades back, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 300 today in more than 75 countries. Islamic financial institutions are concentrated in the Middle

East and Southeast Asia (with Bahrain and Malaysia the biggest hubs) (El Qorchi, 2005). They are also appearing in Europe and the United States. Total assets worldwide are estimated to exceed $250 billion, and are growing at an estimated 15 percent a year (although cross-border data remain scarce) (El Qorchi, 2005).

Islamic Banking and Finance

The origin of Islamic finance dates back to the dawn of Islam 1,400 years ago. According to El-Gamal (2008), an “Islamic bank” was planned as a two-tier silent partnership. “Deposits seeking a return (as opposed to fiduciary deposits, for which 100% reserves are required) would not be guaranteed loans to the bank, but rather silent-partnership investments in the bank’s portfolio. In turn, the bank’s investments of those funds would not consist of loans and acquisition of debt instruments, but rather profit-and-loss sharing investments in other silent partnerships” (El-Gamal, 2008). Thus, the Islamic bank would serve its financial intermediation function (pooling of return-seeking savings and diversification of investments) through profit-and-loss sharing. This idea continues to serve as the keystone of Islamic banking today (El-Gamal, 2008). According to El-Gamal (2008), there is currently over US$800 billion worth of deposits and investments lodged in Islamic banks, mutual funds, insurance schemes (known as takaful), and Islamic branches of conventional banks.

Definition

According to Ainley, Mashayekhi, Hicks, Rahman & Ravalia (2007), “the Islamic economic model has been developed over time, based on the rulings of Shariah on commercial and financial transactions”. The Islamic economic model highlights justice and fairness, and this is reflected in the condition that everyone involved in a transaction makes informed decisions and is not misled or cheated. “On a macro-economic level, the Islamic model aims at social justice and the economic prosperity of the whole community; for example, specific Shariah rulings seek to reduce concentration of wealth in a few hands, which may be detrimental to society” (Ainley, Mashayekhi, Hicks, Rahman & Ravalia, 2007).

According to Ainley, Mashayekhi, Hicks, Rahman & Ravalia (2007), Islam promotes the right of individuals to pursue personal economic wellbeing, but makes a clear distinction between what commercial activities are allowed and what are forbidden. Transactions involving alcohol, pork related products, armaments, gambling and other socially detrimental activities are forbidden (Ainley, Mashayekhi, Hicks, Rahman & Ravalia, 2007).

According El Qorchi (2005), the fact that Islamic laws prohibit both paying and receiving of interest does not imply that making money is prohibited as well. Neither does Islamic law encourage reverting to an all-cash or barter economy. They encourage all parties in a financial transaction to share the risk and profit or loss of the venture. Depositors in Islamic banking can be compared to investors or shareholders, who earn dividends when the bank makes a profit or lose part of their savings if the bank posts a loss. The rationale is to link the return in an Islamic contract to productivity and the quality of the project, thereby ensuring a more equitable distribution of wealth. Islamic financial instruments take the form of contracts between providers and users of funds to manage risk. On the asset side, Islamic banks engage in investment and trading activities according to the various contracts available. On the deposit side, funds are mainly mobilized on the basis of a Mudaraba contract or an interest-free loan contract (Qard Al Hasan – as cited in El Qorchi, 2005). Overall, Islamic banks offer their depositors four classes of accounts: current, savings, investment, and special purpose investment accounts (El Qorchi, 2005).

According to Ainley, Mashayekhi, Hicks, Rahman & Ravalia (2007), “one key Shariah ruling on economic activities of Muslims is the strict and explicit prohibition of Riba, most usually described as usury or interest”. Sharia scholars consider exchanging interest payments within the conventional banking system as a type of Riba. Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources, such as returns from wealth generating investment activities and operations. These include profits from trading in (real) assets and cash flows from the transfer of usufruct (the right to use an asset), for example, rental income (Ainley, Mashayekhi, Hicks, Rahman & Ravalia, 2007).

The Islamic economic model is based on a risk and profit-sharing (and loss-bearing) philosophy. So, in this respect, Islamic transactions are similar to, if not the same as, equity-based transactions in rewarding performance. However, Sharia requirements go further to ensure that in distributing profits more emphasis is placed on reward for effort rather than reward for merely owning capital.

The Islamic Law of Contracts plays a pivotal role within the Islamic financial system. Islamic commercial jurisprudence consists of principles and rules that must be observed for transactions to be acceptable in Islam; and the Islamic Law of Contracts is at the heart of this. One important principle is contractual certainty. Under this body of law, uncertainties or ambiguities that can lead to disputes may render a contract void under Sharia. While some of these principles and rules are based on clear and explicit rulings of Sharia, others are derived from Sharia scholars’ interpretations and understanding of the law, known as Fiqh, as set out in the Qur’an. These interpretations can and do differ between Sharia scholars. Certain contractual terms deemed to be valid under Sharia by the scholars of one school of Fiqh may not be acceptable to scholars from another school.

According to Alharbi (2015), Islamic banks can be defined as a financial institution that (a) abides by Shariah principles in all of its activities through its role as a financial intermediary between savers and investors;(b) provides banking services within the framework of legitimate contracts; and (c) achieves a balance between economic and social return.

Though Islamic banking and finance is not a new concept, it has seen unprecedented and rapid growth in the past few decades. According to Hanif (2014), by 2012, Islamic finance made up for USD 1460 billion in asset across 50 nations. Islamic banking and finance can be said to be formulated, especially to cater to the financial needs and requirements of the global Muslim population. But it is not limited only to Muslims. Across the globe, the popularity of Islamic banking and finance is growing even with non-Muslims.

Islamic banking and finance developed as a reaction to some practices in conventional finance and banking which were not lawful according to Islam. As per Hanif (2014), Islamic banking and finance developed in order to overcome practices in the conventional finance and banking industry which were questionable as per the tenets of Islam. These included transactions based on the charging of interest, the absolute risk of an outcome (or ‘Gharar’), winning of a party being equal to the losing of the other (or ‘Myser’ and ‘Qimar’), lack of risk sharing by the financer. It was also developed to curtail the financing for ‘Haram’ activities (or unlawful under Islam). It was for all these reasons that Islamic banking and finance developed as an option, particularly for Muslims, to the conventional finance industry.

It is for this reason that Islamic banking is very different from conventional banking. Even though there is no actual difference between the two based on the returns of transactions, the process of transactions through financial contracts is what makes Islamic finance different from conventional finance. Some authors have opined that the differences between Islamic banking and conventional banking are not clearly understood. According to Ahmad, Rustam & Dent (2011), though religion is the main driver behind people's choice to opt for Islamic banking, the differences between Islamic and conventional banking are not understood properly. Many people perceive Islamic banking to be equivalent to banking services 'without being charged any interest'. This perception is very simplistic and limits the meaning of what all is entailed in Islamic banking. This could also be one of the reasons why Islamic banking and finance is still a niche market.

Despite being a niche market, Islamic finance does face stiff competition from conventional banking and finance. For this reason, Islamic banking and financial institutions have to offer something extra for their customers, in addition to the 'Halal' aspect to it. Islamic banking and financial institutions offer competitive prices on the services they offer, mainly due to the competition they face from the conventional finance industry (Hanif, 2014).

Trade Modes of Islamic Finance

Modes of trade in Islamic finance include:

Murabaha – In such type of sales, the seller is required to disclose both the cost of the goods as well as the profit he/she is making on the product to the customers. The Murabaha contract is similar to conventional loans and hence, is used across the globe by Islamic Financial Institutions (IFIs). In these contracts, customers request IFIs to supply them products such as computers, inventory or machinery. Here, the IFIs actually purchase the products and then, sell them to the customers. In this case, the price charged to the customers is decided by the IFI and is dependent upon the length of the payment period. The IFI discloses both the purchase price and the profit to the customer. (Hanif, 2014).

Muajjal – Muajjal sales are credit sales which do not disclose the amount of profit charged (Hanif, 2014).

Salam – The Salam contracts are more commonly used in agricultural finance. Usually, at the time of crop harvesting, the IFI pays the farmer for delivery of agricultural produce. In these contracts, the IFI estimates future price for the agricultural produce, with the bank's profit being the difference in the future price and the price negotiated at the time of the contract (or the spot price) (Hanif, 2014).

Ijarah

Another mode of financing used by Islamic Financial Institutions is the Ijarah contract which is rental based. Under this contract, the bank purchases the asset and leases it to the customers. Once the term of the lease is completed, the asset is handed over to the customer, either completely free or for a specific sum. During the tenure of Ijarah contract, the asset is owned by the bank and hence, it also bears the risk and reward of ownership. The customer is charged the same amount, which is competitive with the conventional finance industry. Here, the difference is that under conventional finance contracts, the only risk to the financier is the default risk whereas the IFI has to bear other risks as well including theft, accident, repair and maintenance, technology changes, foreign exchange risk and disposal of asset etc., along with the credit risk (Hanif, 2014).

Musharaka Contracts (or partnerships)

According to the study by Hanif (2014), the third type of contracts, used by Islamic finance industry, are based upon the principles of Musharaka (partnership). According to Islamic law, any partners can agree upon any kind of profit-sharing ratio, provided that the sleeping partner's share cannot be in excess of his equity stake; the loss is shared on the basis of the amount of equity stake by each partner (Hanif, 2014). These are the types of partnership contracts:

Musharaka: In this type of partnership contract, the capital is contributed by all partners and the management of the contract is overseen by either all or few of the partners.

Mudaraba: In case of Mudaraba partnership, either one or more of the partners do not contribute capital and instead, only act as the manager of the business. Under the Mudaraba contract, the profit from the business is shared amongst the partners as per the agreed-upon ratio. Here, the total loss is borne by the providers of capital (Hanif, 2014).

Islamic banks and financial institutions (IBFIs)

The first Islamic bank was established in 1975 in Gulf, institutional development took the 'commercial form' (Asutay, 2012). Since then, IBFIs have successfully expanded, both in the number of these institutions and also in terms of their asset bases. According to Bley & Kuehn (2003), Islamic finance institutions have produced growth rates of 15-18 percent; twice the average growth rate of conventional banks. Not only do Islamic banks grow faster than their conventional counterparts, but their numbers seem to be increasing rapidly as well (Bley & Kuehn, 2003). An important success of IBFIs is the institutional developments that have taken place in West as well, such as in London, Paris, Rome, and Luxembourg among other countries that have attracted IBFIs (Asutay, 2012). In 2012-13, two conventional financial institutions have converted to Islamic principles; While the multinational Hong Kong Shanghai Banking Corporation (HSBC) is expanding its Islamic finance operations, others are contemplating joining the lucrative Islamic finance market through the offering of Islamic Finance products (Bley & Kuehn, 2003). According to Alharbi (2015) many conventional banks have established Islamic windows, and still other conventional banks have fully converted to Islamic banking. Furthermore, several Islamic bodies were established to regulate and promote the Islamic finance industry. Finally, Iran and Sudan Islamized their entire financial systems (Alharbi, 2015).

According to Asutay (2012), if the progress, expansion and performance of IBFIs is critically analysed, it can be seen that "the values and norms of IBF are compromised for 'financialisation' through financial engineering, which helped to endogenise the problems of the 'current fi nancial system' into the IBFI realm". Asutay (2012) says it is important to make a reference to the norms and values of IBFIs as formulated by the Islamic moral economy (IME), which give meaning to the 'Islamicness of IBF.'

Islamic Bonds

According to Hesse, Jobst & Solé (2008), Islamic finance is not only expanding globally, it is also expanding across the whole spectrum of financial activities, ranging from retail banking to insurance and capital market investments. The most striking growth has been that of sukuk or Islamic bonds, the most popular form of securitized credit finance within Islamic finance. In the last decade, the Islamic bond issuance has soared in response to the growing demand for alternative investments (Jobst et al., 2008 – as cited in Hesse, Jobst & Solé, 2008). Sukuk largely escaped the retrenchment of investment in structured finance after the global financial.

Financial Crisis

According to Ahmed (2009), Islamic economists claim that the inherent weaknesses of the conventional financial system were revealed by the financial crisis. Chapra (2008) attributes the crisis to “inadequate market discipline resulting from lack of using profit-loss sharing modes of financing, expansion of the size of the derivatives, and the policy of ‘too big to fail’. He calls for a ‘new architecture’ to prevent occurrence of similar crises” (as cited in Ahmed, 2009). Siddiqi (2008) identifies the root cause of the crisis as ‘a moral failure that leads to exploitation and corruption’ (as cited in Ahmed, 2009). Siddiqui identifies credit (liquidity) crunch, over-extended leverage, complexity of the products, and speculation and gambling (risk shifting) as the main features of the crisis (as cited in Ahmed, 2009).

According to Ahmed (2009), the supporters of Islamic finance claim that if the Islamic principles related to economics and finance had been applied, the financial crisis could have been prevented. With emphasis on equity modes of financing, financing would not only require higher standards of due diligence, but also have active monitoring. As debt cannot be traded because it can lead to Riba, products like CDO /MBS would not exist in an Islamic system (Ahmed, 2009). Hence, derivative products like CDS are prohibited under Islamic law due to the existence of Gharar. As Islamic financial institutions were not exposed to the toxic securities that caused the crisis due to the Shariah prohibitions, they were not directly affected by the crisis (Desai 2008; Brewster 2008 – as cited in Ahmed, 2009).

According to Asutay (2012), against the backdrop of the global financial crisis, IBFIs have managed to achieve modest growth in their asset bases and also in other institutional and financial variables. As per Asutay (2012), the ‘resilience of IBFIs’ has become “a popular topic in conferences and writing, and in such articulations this ‘resilience’ is attributed to the religo-ethical foundations of Islamic banking and finance (IBF)”. However, defaults in IBFIs have happened as well, in particular in Dubai, which has brought the whole idea of resilience into ‘question’ (Asutay, 2012)

Brand Preference in Islamic Banking

People opt for Islamic banking over conventional banking primarily due to religion. Hence, religion is the key driver behind the choice of Islamic banking. But there are factors which influence these people in selecting a particular Islamic bank. These factors include the bank’s strong Islamic reputation, and better financial and banking services (Ahmad, Rustam, & Dent, 2011). These authors say that the brand of the bank, which acts as an indicator of its credibility, and convenience factors were the major drivers of choice when it came to selecting Islamic banks, especially when the customers were young.

In their study carried out at an Islamic university in Malaysia, Ahmad, Rustam & Dent (2011) found that the knowledge that young customers had about Islamic financial products was limited and most of them were unaware of the services available to them through Islamic banks.

Conclusion

In this paper, we reviewed available studies on the subject of Islamic finance and banking. It was highlighted that Islamic finance had witnessed tremendous growth over the last few years across geographies. Islamic finance has also been growing across the products of Islamic finance. There has also been a trend of demand for Islamic finance growing in non-Muslim countries. Studies have also claimed that the financial crisis of 2008 did not impact Islamic finance and banking.

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