A Historical Evolution of Islamic Banking and Capital Market: Where Are We Now?

Dr. Abu Umar Faruq Ahmad
Researcher at International Shari'ah Research
Academy for Islamic Finance (ISRA)

Islamic Banking

The thrust of Islamic banking is the elimination of riba or interest from banking operations. There are now two distinct and parallel approaches about the adoption of Islamic banking practices in the Muslim world: dual banking system whereby both Islamic and conventional banking co-exist and total adoption and immersion of Islamic finance. In the first approach, the governments of these countries have not committed themselves to the abolition of interest, and Islamic banks exist side by side with interest-based banks. In the second approach, the government of Iran, Pakistan and Sudan have elected to eliminate the practice of interest in the financial sector and real economy and instituted instead Islamic banking.

The first attempt to establish an Islamic banking was in Malaysia in the mid-1940s as a private initiative. The objective of this institution was to invest prospective pilgrim savings in real estate and plantations in accordance with Shari`ah but it was unsuccessful. In the late 1950's a small experimental Islamic bank was established in a rural area of Pakistan. The initial capital was provided by a group of small local landowners who deposited funds in the institution. On religious grounds, no interest was paid to these depositors. The bank provided interest-free loans to the poorer landowners for a small administrative charge. Unfortunately, the venture did not survive and the bank was closed after few years of operation due to lack of funds. Then, in 1963 Ahmad Al-Najjar founded a small savings bank in Myt Ghamr - a rural town near Cairo, Egypt. This bank also ran on Islamic principles of no-interest banking. It initially had 1,000 depositors and very quickly grew to more than 60,000 within its three years of operation. The appeal of Myt Ghamr savings bank was based on its appeal to the devouted Muslim population in these communities. However, this bank was also unsustainable and ceased operations in 1967 due to lack of funds. The lack of a clear alternative to interest, by which conventional banks earn income to operate on, was the primary reason for their inability to survive beyond a few years.

During the 1970s, Islamic banking as we recognise it today began to take shape. These new private Islamic banks were oriented toward profits. In 1972, Ahmad Al-Najjar, the founder of the defunct Myt Ghamr Savings Bank, established a new Islamic bank called Nasser Social Bank. This bank continued to offer many of the services that were offered by the Myt Ghamr Savings Banks in addition to allocating a portion of its resources to direct equity investment. Eventually, Ahmad Al-Najjar established the Dubai Islamic Bank in 1975, which was financed by a group of merchants in United Arab Emirates (UAE). He convinced Prince Muhammad Bin Faisal of Saudi Arabia to establish the Faisal Islamic Bank of Egypt and the Faisal Islamic Bank of Sudan in 1977, who put up 40% of the initial capital for the Faisal Islamic Bank of Sudan and 49% of the initial capital for the Faisal Islamic Bank of Egypt. These banks operated on the basis of profit-sharing with their depositors and offered two types of deposit accounts: savings accounts that are fully insured but earn no profits, and investment accounts that share in the profits and losses of the bank. They shifted their lending and investment activities from interest-free assistance loans to profitable equity investment and profit-and-loss sharing financing. As a result of this change in doing business, these three banks have been able to survive and compete with conventional banks for depositors. By 1980, the Dubai Islamic Bank was the largest Islamic bank with $13 million in paid up capital and nearly $100 million in deposits in 1980. Since then, many countries have seen the entry of similar Islamic bank into their financial system.

At the international level, two Islamic banks, namely the Islamic Development Bank (IDB) and Dar Al-Maal Al-Islami (DMI), were established by Saudi initiative during the 1970's and 1980's. IDB was established in 1975 by the approval of 38 Organisation of Islamic Cooperation (OIC) member countries. The main objective of this bank was to provide financial capital for industrial and agricultural projects in Islamic nations, and to promote international trade among them. The original capital for IDB was provided by Saudi Arabia, United Arab Emirates, Kuwait and Libya. During the first five years of operation, IDB had accumulated more than $1.5 billion in paid-up capital and financed numerous development and trade projects throughout the Muslim world. In addition to providing financial assistance to member countries, particularly the low-income nations wishing to establish and promote Islamic banks on their own. IDB also provides support in conducting and accelerating research in the area of Islamic banking.

The DMI was established in 1981. The stated objective of the bank was to support development projects in non-Arab Muslim countries. Although most of the depositors and shareholders were from the oil-rich Arab nations, DMI has tried to reduce its dependency on the Middle East by opening branches in other Muslim countries and particularly targeted the Muslim nations in Africa and Southeast Asia for future investment. Besides the IDB and DMI, there are several smaller international Islamic banks some of whose headquarters are located in European capitals, particularly London and Geneva. They are primarily involved in equity investment in European countries.

In addition to the above-mentioned experiences in Muslim countries, institutionalised use of Islamic modes of deposit mobilisation and financing, if not full-fledged Islamic banking, have also been introduced in a few non-Muslim countries. Products include retail financing (home, car, personal line of credit and charge card), business financing (trade, project and line of credit) and corporate funding. There are a number of

1. Abu Umar Faruq Ahmad, Associate Professor and Senior Researcher at International Shari'ah Research Academy for Islamic Finance (ISRA). The author can be contacted by email at: faruq@isra.my

conventional financial institutions in non-Muslim countries that offer Islamic financial services for Muslims and non-Muslim clients alike and in some Muslim countries conventional banks have been permitted to open "Islamic banking windows" in order to fulfill the strong and persistent demand of their Muslim customers for Islamic banking services.

Islamic Capital Market

There were two separate developments within the purview of Islamic Capital Markets. The first relates to the equity aspect of the capital markets as represented by the launch of the Dow Jones Islamic Index in 1998, and the second, to the finance aspect involving securitisation of Islamic contracts starting in 2001 with the Sukuk issuances by the Bahrain Monetary Authority. A possible offshoot from the first development occurred relatively recently, this pertaining to Islamic venture capital, private equity and hedge funds.

When Dow Jones introduced its Dow Jones Islamic Market ™ Index (DJIMI) in 1993, the main issue confronting its Shari`ah board was whether the stock of a company that engages in activities prohibited by the Shari`ah would be eligible for the index. The main concern with the equity aspect is the level of Shari`ah permissibility in the operations of any of the companies concerned and issues relating to "purification" of any tainted income. These issues were addressed in the fatwa of the DJIMI Shari`ah Board in 1998 (which was amended in 2003) with the introduction of a two-tier screening system for non-controlling investment in such companies: activities or industry screen and financial screen. To this end, there was recognition of certain impermissibility that if they fell within a prescribed variance, may be cleansed or purified through mechanisms such as donating or gifting any interest earned to charitable purposes.

Following the DJIMI, various other market indices were introduced at international levels such as FTSE Global Index Series in 2006, followed by FTSE SGX Shari`ah Index Series, FTSE DIFX Shari`ah Index Series and FTSE Bursa Malaysia Index Series and others such as MSCI Global Islamic Indices and KMI-30 Islamic Market Index of Pakistan.

In the past decade, there has been increasing issuances of Islamic capital market securities by corporate and public sector entities owing in large part to enabling capital market regulations, a favorable macroeconomic environment, and financial innovation aimed at establishing Shari`ah compliance. Asset securitisation plays a special role in this regard. For this financial-side to the Islamic capital markets, the primary concerns are the creation of asset based debts to securitise and the avoidance of the transfer of debt in consideration of an increased return (ba`y al-dayn): the legal issues involve sale of debt and riba and trade in real assets as opposed to financial receivables.

In 2007 Sheikh Taqi Usmani, who was at the time the chairman of the Shari`ah board for AAOIFI, remarked that most Islamic investment certificates or Sukuk issued at the time did not comply with the Shari`ah. AAOIFI followed by establishing standards for investment in Sukuk in 2008. Now, latter day Sukuk issuers are more mindful of the legal issues involved. Although the concepts of asset-backing and absolute transfer of ownership are a prerequisite to most Islamic exchanges, before this very few Islamic structured credit transactions were executed following the precepts of the Shari`ah. While Sukuk are structured in a similar way to conventional asset-backed securities (ABS) or covered bonds in that there are multiple instruments involved, they have significantly different underlying structures and provisions. Sukuk commoditise capital gains from bilateral risk sharing between borrowers and lenders in Shari`ah -compliant finance contracts - such as lending transactions (instalment sale) or trust-based investments in existing or future assets - into marketable securities.

Securitisation of debt in Islamic finance began in the early 1990s with the first experience being the Malaysian Shell MDS Islamic Private Debt Securities issuance for RM125 million. The idea became popular and eventually Kumpulan Guthrie Bhd, also of Malaysia, issued the first international US dollar Sukuk in 2001 followed by several sovereign international Sukuk issuances by the Malaysian, Bahraini, Qatari, Pakistani and Dubai governments. Gross issuance rose from US$7.2 billion in 2004 to close to US$39 billion by the end of 2007. At the end of 2007, the outstanding volume of Sukuk globally exceeded US$90 billion. However, in 2008, Sukuk volumes declined sharply to US$17.2 billion (about 50%) as a result of challenging market conditions due to the financial crisis of 2007, liquidity constraints, and the presentation of new rules on the Shari`ah compliance of Sukuk. In particular, the less supportive economic environment in the Gulf Corporation Council (GCC) countries and the regional real estate sector troubled by the slowdown of global trade and foreign direct investment contributed to this reversal, even in countries that were driving forces in the Sukuk market. Amid a gradual normalisation of credit conditions in early 2009, incipient demand helped stabilise the primary market for Sukuk. During the first seven months of 2009 new issuance exceeded US$9 billion, compared with US$11.1 billion during the same period in 2008.

In spite of having been hemmed in by the credit crisis, the Sukuk market is expected to gain momentum again over the medium term, with an estimated US$50 billion worth of planned transactions in the pipeline. With more than US$2 trillion of credit demand projected to be unmet in the next three years as the conventional private-label securitisation market remains dysfunctional, the current market situation provides a window of opportunity for Sukuk. Given the ongoing efforts to resolve the major difficulties impeding market development, Sukuk is likely to register ever more as an alternative and diversified funding option that broadens the pricing spectrum and asset supply.