The Rightful Way of Banking

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By

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Cambridge Scholars Publishing

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This book first published 2015

Cambridge Scholars Publishing

Lady Stephenson Library, Newcastle upon Tyne, NE6 2PA, UK

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN (10): 1-4438-7053-6
ISBN (13): 978-1-4438-7053-5

Dedicated to our children,
Nai’f and Musa’b

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ABOUT THE AUTHORS

Prof. Dr. Omar Masood (PhD) is a former Director of the Centre of Islamic Banking and Finance at the Royal Docks Business School, University of East London, United Kingdom. He had worked with financial advisors like Goldman Sachs. He is a lead advisor and trainer in the area of Islamic banking and finance worldwide, to financial as well as academic institutions. He is a founding member of Research Centres in Malaysia. Dr. Masood supervises PhD dissertations in the areas of banking, finance, corporate financial management, risk management, fund management, banking regulations, Islamic banking, international business and other finance, accounting and management related subjects, with a number of successful completions. He holds visiting professorships in universities all over the world, and has served as an advisor/consultant to a number of governments including the Turkish and Saudi Arabian. Dr. Masood has authored over a hundred peer reviewed research papers which have been published in international journals and presented at conferences. A number of his papers have been listed as highly recommended and most read by leading publishers. He has also authored a number of books, including the bestselling “Truth about the Global Financial Crisis” and the text book “Multiplying Money through Financial Management”.

Shahid M. K. Ghauri has over 13 years of banking experience. He has worked with peer institutions like Soneri Bank, Habib Bank AG Zurich, ABN AMRO Bank, The Royal Bank of Scotland and Faysal Bank. Presently, he holds the position of Regional Manager. He is a PhD candidate and research associate on Islamic Finance and has authored a number of books and research papers on Islamic finance in peer journals. He holds visiting lectureships in peer universities in Pakistan.

PREFACE

Banking was introduced in the 16th century by goldsmiths and evolved into the modern version of today's corporate world. Interest (*riba* or usury) is considered oxygen for the modern banking system implanted across the globe. From the core functions of banking like accepting deposits and lending advances, to modern tools like bills, bonds, derivatives, hedging and arbitrage, all are based on interest. But interest has been prohibited in various religions for centuries. Interest-free financial transactions were promulgated in the Torah, the Bible and later in the Quran. Interest or riba leads to capitalism, where all stakeholders care only for their own financial interests.

The prohibition of interest (usury) is found in the texts of different religions over the centuries. Hinduism and Buddhism (2000-1400 B.C.) stipulated that "interest beyond the legal rate being against (the law), cannot be recovered: they call that a usurious way (of lending)". Judaism (500 B.C.) termed it *neshekh*, *tarbit* or *marbit*, and condemned interest-taking in financial dealings. Sentiments related to the prohibition of usury were also addressed by the *Lex Genucia* reforms in Republican Rome (340 B.C.). In Christianity, the acceptance and demanding of usury in financial dealings is condemned in the Old Testament and was reiterated in the New Testament. The Roman Catholic Church prohibited the taking of interest in 400 A.D.

In Islam, riba is outlawed in the Quran, and the term riba-eater is one of the worst things to call someone. Riba-taking is included among some of the things that are reprimanded cruelly in Islamic teachings. The Prophet Mohammad (*sallallahu alayhi wa sallam*) stated that riba was one of the severest sins. Islamic scholars have explained that certain types of contract are acceptable according to jurisprudence laid out in the Quran and Sunnah of Prophet Mohammad (sallallahu alayhi wa sallam). Thus, a mode of banking and finance without riba is known as Islamic banking. Critics say the term Islamic banking is incorrect on the basis that there is no practical example of banking and finance in the Quran or the Sunnah of Prophet Mohammad (sallallahu alayhi wa sallam), but some authentic scholars have laid down certain stipulations from the teachings of the

Quran and Sunnah of Prophet Mohammad (sallallahu alayhi wa sallam) that give alternative financial solutions to riba-based transactions.

Some researchers have proved that the father of free-market capitalism was the advocate of establishing interest ceilings and restricting interest rates in economies. Adam Smith was in favour of restricting interest rate usage in laissez-fair economies, though he was not in favour of complete prohibition of interest usage in economies.

Some countries have adopted this mode of finance but have not termed it Islamic banking; for example, a similar form is known as Savings Banking in Turkey, and there is an identical conceptual foundation in European countries. Today, the worth of Islamic financial assets has reached the benchmark of US$6 trillion, and it is implemented in more than 100 countries by 2,000 financial institutions across the globe. The modern version of riba-free banking evolved in 1950s through a savings scheme in Pakistan, then another cooperation council in 1963 in Mitghamar village in Egypt. Dubai Islamic Bank (DIB) was founded in 1974 in the United Arab Emirates (UAE) as the first full-fledged commercial bank to be operated on a riba-free banking model. This model grew rapidly in the 1990s due to excessive influx of petrol-dollars, and the value of its assets reached US$300 billion. Though it became popular across the globe, South East Asia became the hub of this banking model and contributes 85% to this stream of banking. Bahrain, Iran, Malaysia and the UAE are prominent countries where the economy has either beenr transformed or is undergoing the transformation to a riba-free financial model.

The credit crisis of 2008 proved that the capitalist approach to a financial system would collapse because of its own controlling factors, while the riba-free financial system grew rapidly during this era, being the alternative option. The conventional financial system is based on risk-taking and mitigating risk exposures through paper based techniques, and the value of money plays a vital role in the game, while the riba-free banking system is based on risk participation and risk sharing techniques backed by real assets and ventures where the value of assets is the key.

This book explains the philosophies behind the modern riba-free banking which is generally known to the world as Islamic banking. This book is divided into six sections. The first section is related to the introduction of riba-free banking, its origin, evolution and standing today. It includes brief notes about famous Islamic financial institutions, Islamic financial models, and riba-free jurisprudence in different religions.

The second section is related to the fundamental concepts and beliefs about the riba-free banking setup. This section includes discussion of different techniques which combine to constitute a riba-free banking model.

The third section is related to the diversity of two streams of financial model. It includes the differences between conventional and riba-free techniques in banking, insurance, fund management, bonds, income resources, project financing, capital structure, money and commodity markets, futures, options, derivatives, swaps, arbitrage, hedging, and risk exposures.

The fourth section is specifically related to the concept of risk management in riba-free banking. It includes special emphasis on asset-liability management and the risks of credit, liquidity, the market, regulations, Shariah supervision and Basel accord implementation.

The fifth section is related to international institutions connected with riba-free financial systems. These institutions help in the development and growth of riba-free banking systems, academic research and its application in these systems. These institutions have engaged peer scholars related to this type of financial system, and they include IDB, AAOIFI, IRTI, IIFM, IIRA, IFSB, LMC, etc.

The last section of this book includes case studies and discussions of the riba-free banking model and its application in different regions of the world. The book includes a glossary related to riba-free financial systems, an index of terms for readers, and the bibliography used in the compilation of this book.

Generally, the manuscripts of books on Islamic banking are authored by either Islamic scholars or financial experts, therefore relevant manuscripts remain restricted to only one perspective. The authors of this book are associated with academics as well as practical Islamic banking, and have been associated with Goldman Sachs, Merill Lynch, ABN AMRO Bank, The Royal Bank of Scotland and Faysal Bank. Secondly, this book is written from an international perspective and is not limited to the Islamic banking model of a specific country, so it is helpful in understanding the core themes of Islamic banking worldwide. Thirdly, this book is scripted in an easy to understand sequence, and can be adopted as a text book in universities, at undergraduate and postgraduate levels, and in Islamic banks who wish for their staff to train and better understand Islamic banking as a subject.

The contents of this book were put together from research articles and speeches which have been presented at various conferences in different parts of the world. We have tried to convert this material into the manuscript of a text book. However, we apologize in advance for errors or omissions, if any have been overlooked. Any suggestions or comments will be greatly appreciated and help us to improve the material.

Prof. Dr. Omar Masood **Shahid M. K. Ghauri**

List of Abbreviations

AAOIFI	Accounting and Auditing Organization Of Islamic Financial Institutions
BCBS	Basel Committee for Banking Supervision
BIS	Bank of International Settlement
CAGR	Capital Assets Growth Rate
CBE	Central Bank of Egypt
DIFX	Dubai International Financial Exchange
DJIMI	Dow Jones Islamic Market Index
DSM	Doha Securities Market
ETF	Exchange Traded Funds
GCC	Gulf Cooperation Council
IBS	Islamic Banking Scheme (Malaysia)
IDB	Islamic Development Bank
IFSB	Islamic Financial Service Board
IIBOR	Islamic Interbank Offer Rate
IIFM	International Islamic Financial Market
IIMM	International Islamic Money Market
IIRA	International Islamic Rating Agency
IOU	I Owe You – financial instruments
ISEO	Iranian Securities and Exchange Organization
KFH	Kuwait Finance House
MCC	Money and Credit Council (Iran)
MCCA	Muslim Community Cooperative Australia
ODA	Open Deposit Account (Iran)
OMO	Open Market Operations
ORR	Official Repo Rate
PSIA	Profit Sharing Investment Account

PWSH	Perbadanan Wang Simpanan Bakal-Bakal Hajji of Malaysia
QIB	Qatar Islamic Bank
RBI	Reserve Bank of India
RRR	Reserve Requirement Ratio (Iran)
RWA	Risk Weighted Assets
SAMA	Saudi Arabia Monetary Agency
SBP	State Bank of Pakistan
SFH	Special Finance House of Turkey
SPV	Special Purpose Vehicle
TWA	Tahawwut (Hedging) Master Agreement
VAR	Value At Risk
WAPDA	Water And Power Development Authority (Pakistan)

GLOSSARY

Adl	Justice
Adl wa Ihsan	Equilibrium
Amanah	Trust
Aqad	Contract
Aqal	Human Reasoning
Arbbun	Option in trade
Bai	Trade
Brahmans	Hindu priests
Fard	Responsibility
Fasid	Void
Fatwa	Valid statement/decision stated by an Islamic scholar
Fiqh	Jurisprudence
Fiqh al-muamalat	Islamic Jurisprudence
Gharrar	Uncertainty
Halaal	Permissible
Haraam	Prohibitive
Hawala	Money Transfer
Hibbah	Gift
Ibra	Financing agreement
Ikhtiar	Free Will
Ijab	Offer
Ijarah	Leasing
Ijma	Jurisprudence
Inah	Sale and Buy Back Agreement
Joalah	Transactions based on commission
Khatriyas	Hindu warriors
Khiyar	Option
Maysir	Gambling
Modaraba	Partnership where one partner invest other provides services
Musharakah	Partnership where all partners invest
Muwadat	Exchange
Muzare'a	Partnership where one owns land and other provides harvesting services
Qobul	Acceptance
Qimar	Gambling
Qiyas	Analogical deduction

Rahnu	Holding agreement
Riba	Interest or Usury
Sa	Measurement unit in old Arab
Tabarru	Cooperation, Brotherhood
Tawheed	Unity of Allah
Wadiah	Trust where safe keeper can use entrusted items
Wakalah	Agency contract

Chapter One

Introduction

Chapter layout

This chapter includes a definition of riba-free banking, its origin and evolution, the growth and prominence of the riba-free financial system, riba-free finance at present, leading riba-free financial institutions, riba-free economic models, and riba-free jurisprudence in different religions. Key definitions and glossary terms used in this chapter are listed separately.

1.1 Definition

The core functions of a bank include accepting deposits (lending) and sanctioning advances (financing). The bank earns a return (interest income) on advances and pays return (interest expense) on deposits. The net difference between the income and the expense is known as the bank's margin. When the margin is expressed in terms of percentile, it is called "bank spread". Since riba is strictly prohibited in financial dealings and contracts according to religious teachings, a banking model which does not use riba in incomes or expenses is known as riba-free banking. Considering that Muslims practice the avoidance of riba in their financial dealings, riba-free banking is also known as Islamic banking. We will discuss in later chapters the fact that riba is prohibited in many other religions as well, such as Buddhism, Hinduism, Judaism, and Christianity, so in fact riba-free banking is a unanimous concept, rather than one specifically used by Muslims. It is therefore better to call it riba-free banking than Islamic banking.

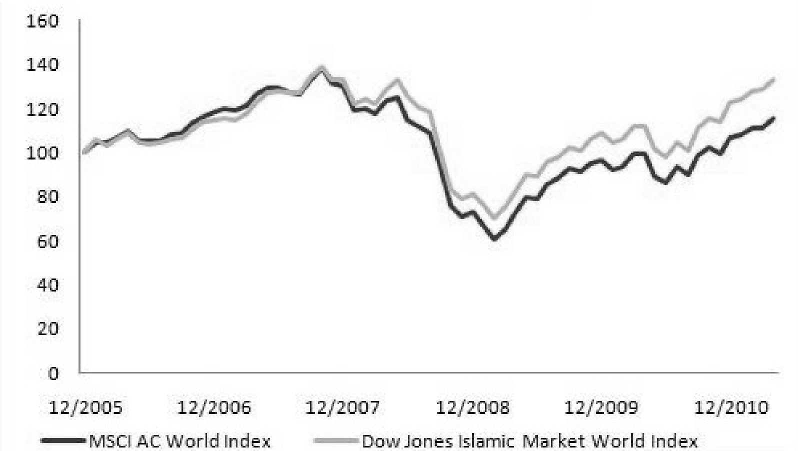


Figure 1.1: S&P Dow Jones Islamic Index Performance
Source (S&P Dow Jones, 2014):

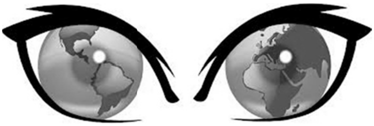
In later chapters, we will discuss certain techniques explained by teachings from the Quran and the Sunnah[1] of Prophet Mohammad (sallallahu alayhi wa sallam). These techniques are related to financial contracts and dealings, and the modern banking model is based on similar techniques, therefore it can be accurately called riba-free banking. Facts sometimes vary as they are presented. Most of the literature and research on riba-free banking has been conducted by non-Muslims. Similarly, most riba-free institutions are managed, sponsored or underwritten by non-Muslims[2]. So it may be inferred that riba-free banking and financial models are equally important to non-Muslims.

Figure 1.1 reflects the Shariah[3] index operated by Dow Jones and illustrates the growing performance of the index. This means the popularity of the index is improving day by day.

[1] Sunnah refers to the verbal saying and practical actions of the Prophet Muhammad (sallallahu alayhi wa sallam)
[2] This refers to the Dow Jones Islamic index, Citi Islamic index and the owners of the Islamic Bank of Britain. All these institutions are owned, managed and financed by non-Muslims
[3] The Shariah index refers to the capital market index for the scripts of companies which operate on Islamic principles.

Box 1

From the practical world



World Islamic Economic Forum: UK first non-Muslim country to issue Islamic bonds

The ninth World Islamic Economic Forum (WIEF) was launched on Tuesday at London's ExCel Centre, in a non-Muslim country for the first time ever. Entitled "Changing Worlds, New Relationships", the forum's main focus is on enhancing relations between Islamic countries and the Western world.

Malaysian Prime Minister Najib Abdul-Razak initiated proceedings before an audience which included 18 global leaders, among whom were Sheikh Salem Abdul Aziz Al-Saud Al Sabah, the Deputy Prime Minister of Kuwait, and King Abdullah II of the Hashemite Kingdom of Jordan.

British Prime Minister David Cameron rounded off the first day's proceedings by outlining Britain's plans to boost its role in accommodating Islamic finance. Cameron was clear that Britain recognizes the importance of Islamic finance and incorporating it within Western markets.

"Already London is the biggest centre for Islamic finance outside the Islamic world. But today, our ambition is to go further still," said Cameron.

"I don't just want London to be a great capital of Islamic finance in the western world, I want London to stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance anywhere in the world."

He announced that London will be launching a new Islamic Market Index on the London Stock Exchange (LSE) "to be launched as early as next year." This measure will make the UK the first non-Islamic country to issue Islamic bonds—known as *sukuk*. An Islamic bond is issued in recognition of ownership of an underlying asset by the bond holder, and structures returns, with no charges, in accordance with Islamic finance.

The riba-free financial model is very vast nowadays, and lots of research has been conducted on this topic already. The development of innovative financial products originated in South Asian Muslim countries, aiming to provide a complete range of alternatives to the products of conventional banking. Now, riba-free financial product development has been taken up by European countries. London chaired an International Islamic Finance Conference in 2014, and British Premier announced that "London will become an international hub for Islamic finance". The British Government has also waived double taxation on Islamic mortgage transactions. Canada, France, Germany, India and the United States are also planning to initiate the process of incorporating riba-free financial institutions. Since the concept of riba-free banking is very important in Islamic teachings, such a financial setup is known as Islamic finance, but some countries have evolved it under a discrete name, e.g. Savings Banks in Turkey.


1_Germany
– Land of Saxony-Anhalt *sukuk*
2_Kuwait
– International Investment Group convertible sukuk
– National Industries Group *sukuk* programme
3_Bahrain
– Gulf International Bank *sukuk*
– Kingdom of Bahrain *sukuk*
4_Qatar
– Qatar Islamic Bank *sukuk*
– Qatar Islamic Bank *sukuk* programme
– Qatar International Islamic Bank *sukuk*
– State of Qatar *sukuk*
5_Saudi Arabia
– AJIL Financial Services Company *sukuk*
– Almarai Company *sukuk* programme
– Banque Saudi Fransi Tier II *sukuk*
– Banque Saudi Fransi *sukuk* programme
– GACA *sukuk*
– Islamic Development Bank *sukuk*
– SABIC *sukuk*
– SATORP project *sukuk*
– Saudi British Bank *sukuk*
– Saudi Electricity Company *sukuk*
– Sadara project *sukuk*
– The Savola Group *sukuk* programme
– Saudi ORIX Leasing Company *sukuk*
– Dar Al Arkan *sukuk* programme
– Saudi Hollandi Bank Tier II *sukuk*
– Sipchem *sukuk*
– Tasnee *sukuk* programme
6_UAE, Dubai
– DEWA *sukuk*
– DIFC *sukuk*
– Dubai Bank *sukuk* programme
– Dubai Islamic Bank *sukuk*
– Dubai Islamic Bank *sukuk* programme
– Dubai Islamic Bank Tier I *sukuk*
– Emaar Properties sukuk programme
– Emirates Islamic Bank *sukuk* programme
– Emirates *sukuk*
– Government of Dubai *sukuk* programme
– JAFZA *sukuk*
– Majid Al Futtaim Properties *sukuk* programme
– Tamweel *sukuk*
– Tamweel *sukuk* programme
7_UAE, Abu Dhabi
– Abu Dhabi Commercial Bank *sukuk*
– Abu Dhabi Islamic Bank *sukuk* programme
– Aldar Properties *sukuk*
– Etisalat *sukuk* programme
– First Gulf Bank *sukuk* programme
– Tabreed mandatory exchangeable *sukuk*
– Tabreed *sukuk*
8_UAE, Ras Al Khaimah
– RAKIA *sukuk*
– Ras Al Khaimah *sukuk* programme
9_Pakistan
– Government of Pakistan *sukuk*
10_Indonesia
– Republic of Indonesia *sukuk*
– Republic of Indonesia *sukuk* programme
11_Malaysia
– Axiata *sukuk* programme
– Government of Malaysia *sukuk*
– IILM short-term *sukuk* programme
– Kumpulan Guthrie Berhad *sukuk*
– Maybank *sukuk*
– Sime Darby *sukuk* programme
– State of Sarawak *sukuk*
12_Brunei
– Brunei *sukuk*
13_United States
– GE Capital *sukuk*
14_Turkey
– Bank Asya Tier II *sukuk*
– Kuveyt Türk *sukuk*

Riba-free banking is strengthening its roots in the international financial scene. International financial institutions like Standard & Poor's (S&P), NASDAQ, Citigroup, FTSE, etc. are supporting the concept and have developed relevant riba-free financial institutions, products and services within their respective economies and international markets. Today, riba-free institutions are leading the global financial scene.

A riba-free banking system offers more just and proficient substitutes than the conventional financial system, which is based on interest. Based on the archetype delved into by experts over the past decades, such organizations have been in place in the Middle East since the 1970s. This example was followed by other Muslim countries, who later established their own riba-free financial corporations. Some of these Muslim countries, like Iran, Pakistan and Sudan, decided to convert their banking systems to an Islamic mode. Some banks based in non-Muslim countries (including in the West) also launched products based on riba-free modes of banking to attract the Muslim population. Resultantly, riba-free banking made importunate growth. It grew unparalleled due to core features like a steady petro-dollar income, thriving Middle Eastern economies, growing innovation in riba-free banking products, clientele and markets, and developed world politics. Middle Eastern and Asian governments have become very positive in the promotion of riba-free banking and financial structuring, which is very effective in the further intensification of regional financial associations. Global financial markets have been deeply influenced by the development of riba-free banking and financial setups in South East Asia and the Middle East. Western financial institutions are increasingly depending upon riba-free financial products to innovate and diversify their operations and attract oil wealth (petro-dollars) and domestic Muslim populations. Local and western financial institutions are partnering up in the promotion of riba-free financial products in European and western markets, and western markets have introduced more favourable for riba-free banking practices. These financial developments are very heartening and have given riba-free banking the chance to become a truly vital, incorporated and integral part of international finance.

1.2 Origin and Evolution

Riba-free banking is growing at an expeditious speed. New clients are opting for this stream of banking because of its Shariah-based financial services. Due to the efforts of religious scholars and aggressive marketing campaigns, people are now adopting riba-free banking products.

Resultantly, a number of new riba-free financial institutions have started operating on the global financial market. Existing riba-free banks are also expanding by opening new outlets in urban and semi-urban areas. Therefore, riba-free banks are enhancing their market share in the overall banking industry quite impressively. The main reason for the expansion of riba-free banks, as reported by Ameen (2012), seems to be the growing confidence levels in Shariah-based services as compared to the traditional banking system (Ameen, 2012).

Riba-free banks have mushroomed rapidly in the last two decades. The basic difference between them and conventional banks is that the latter operates on an equity and debt system, while the former operates on equity participation mechanisms. Essentially, riba-free banks work under Shariah principles while competing with conventional banks' wide range of products and services, which provides new opportunities for the innovation of new products and services[1] (Naser & Moutinho, 1997). The structural pattern of Islamic banks is similar to that of conventional banks[2] (Hasan, 2008). The key difference between the two modes of banking is that conventional banking operates on a debt model, where assets and liabilities sides are administered through margins or spread among interest received on debt and paid on deposits. On the contrary, Islamic banking operates on a profit and risk sharing model in accordance with Shariah principles. These Shariah principles advise the prohibition of riba (usury) and other concepts such as gambling, poker, liquor, etc.

Riba-free banking assets have reached $1.3 trillion, with 1,100 riba-free financial institutions existing across 75 countries in 2010. The CAGR (Capital Assets Growth Rate) of riba-free financial institutions is 23% (compared with 17% for conventional institutions) for the last five years (SBP, 2010). The trend of riba-free banking was spread on the wave of with the wealth of oil exploration due to a sharp rise in oil prices accompanied by religious fervour centred in many Islamic and Arab countries, exemplified by Algeria, Egypt, Iran, Jordan, Lebanon, Morocco, Palestine, Sudan, Syria and Tunisia (Naser & Moutinho, 1997). This same wave also reached other Asian regions, like the Gulf, and southern and

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[1] Naser, Kamal and Moutinho, Luiz (1997), Strategic marketing management: the case of Islamic banks, International Journal of Bank Marketing 15/6 [1997] 187–203

[2] Hasan, Zubair (2008), Credit creation and control: an unresolved issue in Islamic banking, International Journal of Islamic and Middle Eastern Finance and Management Vol. 1 No. 1, 2008 pp. 69-81

south eastern parts (Bhatti & Khan, 2008). Some non-Muslim countries, like India, and western countries like Australia, Canada, Germany, the United Kingdom and the United States of America also contributed to this emerging field (Bhatti & Khan, 2008) (Ranzini, 2007) (Sharif, 2006) (Croft, 2007). Many renowned international financial institutions also benefited from the wave of Islamic finance, including Citigroup in 2004, HSBC in 2005, Standard Chartered Bank, Deutsche group, City Bank of London, Barclays Bank, Lloyds, Devon Bank in Chicago, ABN AMRO Bank, Goldman Sachs and Kleinwort Benson (Naser & Moutinho, 1997) (Hassan & Al-Zahrani, 2005) (Croft, 2007) (Ranzini, 2007) (Bhatti & Khan, 2008).

Figure 1.2 reflects the global wealth trend and the growth of riba-free funds in the world. Masood[3] (2009) defined riba-free banking as similar to conventional banking except for a few changes including the involvement of commodities in financial transactions and refraining from prohibited businesses and means of income. The sub-prime crisis has popularized Islamic mortgages globally, which has been statistically proven in the UK. Riba-free financial products are based on a risk sharing concept, rather than risk shifting. All parties attached to a financial deal share the risk up to the level of their contribution. Masood, in later research[4 5 6] (2010 & 2011) showed that the emerging stream of riba-free finance is safe from certain risks (including debt risk, interest risk, collateral risk, etc.) due to the participation concept used in all aspects of riba-free finance.

1.3 Growth and Recognition of Riba-Free Finance

Considering the riba-free financial market has spread to more than 100 countries globally, with a volume of more than US$6 trillion, and is still rapidly growing at a pace of 23% per annum, we can observe an attraction towards this field.

[3] Development and scope of Islamic bonds (Sukuk) by Prof. Dr. Omar Masood (2009)
[4] Islamic screening of Captial indexes by Prof. Dr. Omar Masood (2010)
[5] Effects of yield volatility on bond pricing models by Prof. Dr. Omar Masood (2010)
[6] Impact of Islamic bonds on value of generic bond portfolios by Prof. Dr. Omar Masood (2011)

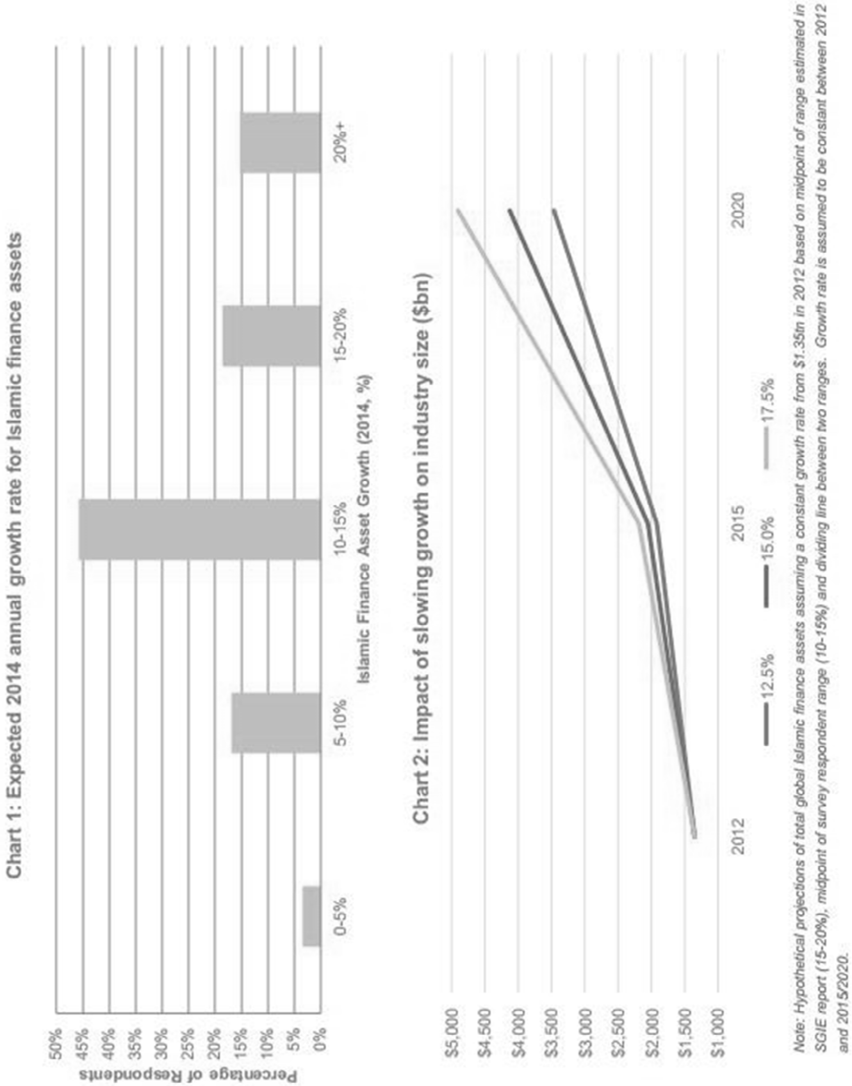

Figure 1.2: Global wealth trend and growth of Islamic funds

1.3.1 Region-Wise Riba-free Finance & Money Market

Historians divide the world into three colonial regions: the British, the French, and the Roman. Countries separated from their respective colonial empires are still under the influence of the previous parent country socially, culturally and financially. Therefore, a related banking system is in operation in these countries.

It is very hard to date the emergence of the first Islamic financial institution, whereas the first purposeful Islamic bank, MitGhamr Bank, was created in Egypt in 1963 (Business-Today, 2007). The idea became popularized in the last two decades of the twentieth century, when Asian and African Muslim countries contributed to the Islamic financial world resulting in the emergence of Middle East Asia as the hub of the Islamic financial world, especially the United Arab Emirates, followed by Malaysia and Bahrain (Bhatti & Khan, 2008). Some of these countries have adopted it as the core financial system, while others have adopted it alongside the conventional financial system to fit the international market.

To take a deeper look into the Islamic banking system across the globe, we will study it region by region.

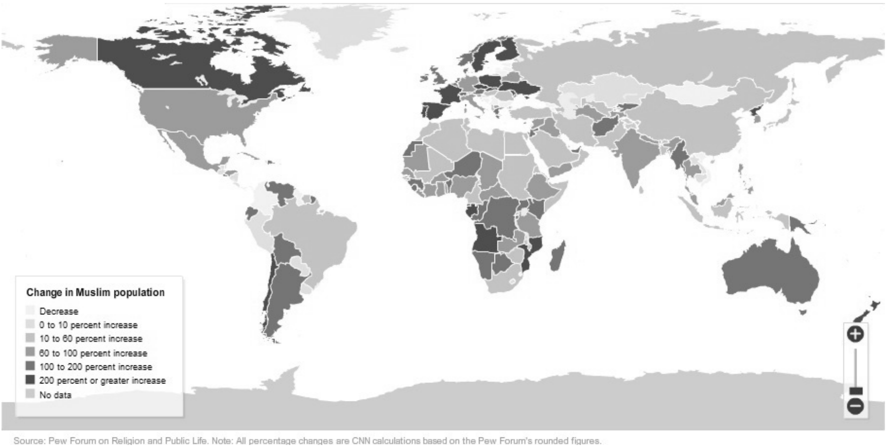

Figure 1.3: The riba-free financial world

The above global analysis reflects the saturation of Islamic finance; dominant in South East Asia at 85.26%, followed by the GCC with 6%. The main hub of Islamic finance in South East Asia is Malaysia, of course, accompanied by nourishing structures in Bahrain, Qatar, Indonesia and Pakistan. Many non-Muslim and western countries are also joining this emerging business stream. A detailed analysis of regional Islamic financial markets follows.

1.3.1.1 South Asia & Far East Asia

Malaysia: This is the second largest developed hub of Islamic finance. Islamic finance was established in Malaysia in 1963 with the founding of the Perbadanan Wang Simpanan Bakal-Bakal Hajji (PWSH) fund; later, in 1983, a formal riba-free commercial bank was established. Currently, Islamic banking assets are worth US$32.06 million (RM117,393 million), comprising an 11.8% share of the country's total banking assets, with observed growth of 27% in the last 10 years. BNM had issued licenses to 10 dedicated riba-free banks by 2006. The Malaysian Government has set a target of attaining a 20% share of total banking assets by 2010.[7] Malaysia was the first to launch the Islamic money market in 1983 (which records a monthly turnover of US$37 billion), launched Islamic indices in 1994, 1999 and 2005, and opened the international sukuk centre in 2006 (which is worth US$32 billion, comprising a 52% share of total capital market in Malaysia) (Alvi, 2006) (Othman, 2006). Statistics from 2008 show that more than 70 Islamic unit trust funds and 886 Shariah-compliant securities comprise a large share, 85%, of the Malaysian Stock Market (Securities_Commission-Malaysia, 2006).

Saudi Arabia: This kingdom enjoys the largest financial system in the Gulf region (Al-Muharrami, 2009). A dual banking system is operative in the kingdom, however, riba-free banks enjoy 64% of total market share. Now, large numbers of banks are moving towards riba-free ways of finance. *Takaful* business is also becoming popular, with an expected growth rate of 15% over the next 15 years, reaching up to US$1 billion gross premium income (Jaffer, 2006). The Saudi stock market has observed a growing demand for Shariah-compliant stocks and instruments. In 2006, the first sukuk launched for US$800 million (Al-Humaidi, 2006). Many multinational banks, such as Standard Chartered and Barclays, are planning to start providing Shariah-compliant services in the country (Naser & Moutinho, 1997). The Saudi Arabia Monetary Agency (SAMA, the regulatory authority) holds a fixed exchange rate with US dollars. Therefore, there are no direct controls for money market operations,

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[7] International Herald Tribune, 2007, p.3

especially with respect to managing interest and foreign exchange rates (Ramady, 2009). Derivatives are not allowed in Saudi Arabia. However, SAMA uses foreign exchange swaps and OMOs (Open Market Operations) as money market instruments. Swaps do not affect liquidity under the fixed exchange rate mechanism of Saudi Arabia (Jasser & Banafe, 2003). The kingdom enjoyed a period of of hefty liquidity in 2000-2007 due to the steady rise in oil prices (Akhtar, 2010).

Jordan: Riba-free banking emerged in 1978 through the establishment of the Jordan Islamic Bank, and gained 10.8% of total banking share by 2005 (Jordan_Islamic-Bank, 2005). Takaful and sukuk are gaining popularity in Jordon (Saleh & Zeitun, 2006) (Bhatti & Khan, 2008).

Lebanon: Riba-free banks emerged at the end of 2006 in Lebanon, and some applications are still in the approval phase. A unique version of the dual banking system is allowed in the country, since conventional banks are encouraged to initiate riba-free banking operations, but are not allowed to open riba-free banking windows. The worth of riba-free banking assets in Lebanon stands at US$60 billion, with an enormous growth rate of 10% annually (Bhatti & Khan, 2008).

Qatar: Riba-free banking was initiated in 1983 in Qatar, and currently there are four riba-free banks, representing a 30% share of the whole banking industry, which is expected to reach 50% in coming years (Jaidah, 2006) (Bhatti & Khan, 2008). Takaful business was initiated in 1994, whereas sukuk bonds were launched in 2003 and at present constitute 20-35% of all project financing in Qatar (Anon., 2006). The FTSE DIFX Qatar-10 Shariah Index is listed at DIFX. Islamic Mutual Funds are gaining popularity in the capital markets of Qatar. A major sponsor of these mutual funds in Qatar is QIB (Qatar Islamic Bank), whereas DSM (Doha Securities Market) is a key player in the promotion of capital and secondary markets based on Islamic principles in the country.

Indonesia: Indonesia is one of the countries with the largest Muslim population in the world. It started riba-free banking with the establishment of the first riba-free bank in 1992. The central bank of Indonesia, Bank Indonesia, encourages domestic conventional banks to offer products based on Islamic principles in a dual banking system. Riba-free banking assets grew by an average of 60% during 2002-2006. Bank Indonesia developed a plan to ensure that the industry of riba-free banking would