Islamic Banking - A Fast-Growing Industry

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By Nimrod Raphaeli*

Introduction

The last two decades have seen a mushrooming of Islamic banks - institutions practicing a banking system - Islamic banking - which is consistent with shari'a (Islamic law) and guided by Islamic economics. The heart of the system is the prohibition of collecting riba (interest or usury). The argument against riba is that money is not "goods" and that profit should be earned on goods and services only - not on control of money itself (i.e., return on assets). Iranian professor of economics Iraj Toutounchian considers Western economic treatment of interest to be "dangerous and fatal," contributing to inflation, unemployment, recession and stagflation. However, the real danger, from his perspective, is that in an interest-based banking system the bank "would not necessarily know for what kind of activity the loan is being used."(1) One may question whether this alleged danger has, in fact, to do with economics or whether it has more to do with a regime that abhors personal choice of any kind.

Generally, shari'a prohibits trading in financial risk (gharar), as doing so is seen as a form of gambling. Moreover, shari'a prohibits investing in businesses that are considered haram (not religiously permitted, in contrast to halal, which means religiously permitted), such as businesses that sell alcohol or pork, or businesses that are engaged in gambling or produce un-Islamic media.

Hadith vs. Fiqh

Islamic scholars distinguish between two parts of the Islamic law, the Hadith (traditions attributed to Prophet Mohammad) and fiqh (Islamic jurisprudence). Mabid al-Jarhi and Munawar Iqbal of the Islamic Development Bank (Jeddah, Saudi Arabia) elucidate the distinction between the two parts of the law, as follows:

"As for the Hadith, the rule is clear cut: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, payment being made hand by hand. If anyone gives more or asks for more, he has dealt in riba. The receiver and giver are equally guilty."

The fiqh or fiqh al-Muamalat (Islamic rules on transactions) refers to the whole corpus of Islamic jurisprudence. In contrast to conventional (secular) law, fiqh covers all aspects of life - religious, political, social, and economic. It is based on interpretation of the Koran and, secondarily, on ijma (consensus). While the Koran is immutable, fiqh verdicts may change due to changing circumstances.(2) This distinction is significant because fiqh offers Islamic bankers a certain space for innovation and maneuvering as they seek to design new financial instruments that are profit-making while at the same time not conflicting with the rules of shari'a.

While borrowing per se is not prohibited by Islam, a Muslim is reminded of Prophet Muhammad's warning: "Beware of borrowing - it is a concern at night and a disgrace during the day." Hence, borrowing needs religious and legal justification.

The Rapid Growth of Islamic Banking

Islamic banking institutions worldwide have grown at a remarkable pace since the inception of the first such institution in Malaysia three decades ago. According to a study by the International Monetary Fund, the number of Islamic institutions rose from 75 in 1975 to over 300 in 2005, in more than 75 countries. Total assets worldwide are estimated at $250 billion, and growing at about 15 percent per annum.(3) However, the size of Islamic banking assets of $250-300 billion should be considered in perspective. The three top banking groups in assets in 2005 were UBS of Switzerland ($1,533 billion); Citigroup of the U.S. ($1,484 billion); and Mizuho Financial Group of Japan ($1,296 billion). Bank of America, ranked tenth among the top banking groups, has assets of $1,110 billion, which are 400 percent greater than the assets of all Islamic institutions.

Islamic banking is expanding beyond Arab and Muslim countries. The vast liquidity in the oil exporting countries, particularly the six member countries which make up the Gulf Cooperation Council (Saudi Arabia, United Arab Emirates, Qatar, Oman, Bahrain and Kuwait) is attracting a lot of bankers and borrowers who are prepared to adhere to the Islamic restrictions on the use of capital. 'Adnan Yousef, Executive Director of al-Baraka, the largest Islamic banking group, expects the Islamic banks' share of banking activities in the next decade to rise up to 50 percent of all bank activities in the Arab world.(4) In the United Arab Emirates, which is considered a hub for Islamic banking, the number of Islamic banks has increased from one to six banks in six years.(5)

Financial Vehicles of Islamic Banking

The financial vehicles of Islamic banking are numerous, but the most commonly used are those with reference to wadi'ah (safekeeping), mudharabah (profit sharing), murabahah (cost plus), ijarah (leasing), qardh al-hassan (benevolent loan), and musharakah (joint venture).

Wadi'ah (Safekeeping)

The Wadi'ah (safekeeping of funds) is of two categories: The first category is the current account which, as in conventional banking, gives no return to depositors. It is essentially an arrangement between depositors and banks which allows depositors to withdraw their money at any time but permits the banks to use depositors' money in pursuit of their banking operations. The second category is the savings account, which is also operated on Wadi'ah basis, but the bank may at its own discretion pay the depositors a positive return periodically in the form of hiba (gift), depending on its own profitability. In this case, the bank compensates depositors for the time-value of their money (essentially interest payment), but refers to it as hiba because there is no a priori guarantee of benefits. The Bahrain Islamic Bank, for example, offers depositors in saving accounts "an annual rate of return based on what Allah has granted in the form of profits."(6)

Mudharabah (Profit Sharing)

The mutharabah represents investment accounts which are based on unrestricted contract. These accounts are term deposits that cannot be withdrawn prior to maturity without a penalty. A bank acting as an agent under a mudharabah contract is referred to a mudharib. For a project, e.g., a factory, which yields an identifiable rate of return, the government would issue a Mudharabah certificate to investors. This instrument is equity-based and hence marketable in secondary markets, with the secondary market price determined by the performance prospect of the underlying project.(7)

Murabahah (Cost Plus)

Murabahah means a sale of an item on mutually agreed profit. Technically, it is a contract of sale in which the seller declared his cost and profit. Islamic banks have adopted this as a mode of financing. As a financing technique, it involved a request by the client to the bank to purchase certain goods for him. The bank does that for a definite profit over the cost, calculated either on a percentage of cost basis or as a fixed amount. This vehicle is used mostly to assist short-term trade transactions.

Ijara (Leasing)

Ijara, also known as ijara waqtina (lease and purchase), is a leasing contract whereby a party leases an asset for a specified rent and term. The owner of the asset (the bank) bears all risks associated with ownership. The asset can be sold at a negotiated market price, effectively resulting in the sale of the ijara contract. The ijara contract can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life. Such contracts are also common in real estate transactions in the United States.(8) This system is disadvantageous for the buyer, who is unable to refinance a property he lives in at more favorable terms because it is registered in the name of the bank. Such a restriction if applied to the U.S. real estate market would have enormously negative economic consequences for the entire real estate sector.

Qardh al-hassan (Benevolent Loan)

This is a loan extended on a goodwill basis, wherein the debtor is required to repay only the amount borrowed. However, the debtor may, at his discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. Muslims consider this type of loan to be the only type that does not violate the prohibition on riba because none is promised or paid.

Musharakah (Joint Venture): The Rising Importance of Sukuk

Musharakah is a form of an equity participation contract under which a bank and its client contribute jointly to finance a project. It is done through the issuance of "Participation Securities," commonly referred to as sukuk or Islamic bonds. The sukuk is becoming so lucrative that many banks are rushing to set up shari'a-compliant operation. With abundant oil-windfall revenues and with many mega infrastructure projects which are either underway or on the drawing board, the Gulf is fast becoming the logical choice of new and established players alike to set up shop.

Over the past five years the sukuk market has grown to $41 billion, with $11 billion coming from the Gulf countries. According to Khalid Yousef, director of Islamic Finance at Dubai International Financial Center, the Gulf countries are likely to issue another $9 billion of new sukuk in the next six months.(9) For example, SABIC, the Saudi petrochemicals group, has announced the issuance of up to $800 million of sukuk. The issue was quickly over-subscribed, which caused the lead managing bank, HSBC, to limit the amount of each sukuk to $13,300.(10)

The issuing of sukuk continues to expand. While Malaysia and the United Arab Emirates lead the Muslim world in this regard, there are a growing number of issuers in the non-Muslim world. There are several recent examples:

* East Cameron Partners. It is the first American firm to issue a sukuk for $166 million for gas drilling in Louisiana offshore

* Saxony-Anhalt State (Germany) issued a sukuk for 100 million Euros

* The World Bank issued its first sukuk for 760 million Malaysian ringgit ($202 million)

* The Japanese International Bank is scheduled to issue sukuk for $300-500 million to tap petrodollar before the end of the year.

Sukuk are also beginning to attract foreign investors who represent, according to Neale Downers, partner at Trowers & Hamlin, of the U.K., "an increasingly dominant segment of the market for Islamically-compliant debt." These investors are now comfortable buying corporate sukuk, and not just those issued by sovereign borrowers (government).(11)

Characteristics and Benefits of Sukuk

The issuance of international sukuk is a significant mechanism for raising money in the international capital markets. Unlike other Islamic banking vehicles, sukuk have unique characteristics and offer significant benefits:

* They are tradable in secondary markets

* They are assessed for quality by international rating agencies, as are all other conventional financial instruments before their issuance

* They offer a regular income stream and a possibility of capital appreciation(12)

Western Banks Adopt Shari'a Rules

With so much business potential and high liquidity in Gulf countries, coupled with a rising demand for Islamic banking instruments from a growing Muslim population in European countries, it is understandable that many Western banks are gearing up to take advantage of opportunities and to provide tailor-made services to new clientele. Examples:

* Lloyds TSD (U.K.) announced in June 2006 that it would be offering Islamic financial services in all its branches in the U.K. "From today, Britain's two million Muslims will have access to current accounts and mortgages which comply with Islamic law (sharia), in every one of the Bank's 2000 branches."(13)

* In 2006, Deutsche Bank opened an "Islamic Window" - or a dedicated pool of money for its Islamic business, headquartered in London but, according to The Financial Times, "strictly ring-fenced from the rest of the bank."(14)

* Deutsche Bank announced, also in June 2006, that it acted as a joint bookrunner for $500 million of sukuk securities for the Islamic Development Bank (IDB), headquartered in Jeddah, Saudi Arabia. Firas Chakra, a director at Deutsche Bank, said "This Trust Certificate issuance Programme by IDB is the first of its kind, and will be a key driver of the further development of Islamic financing on a global basis by successfully introducing Islamic financing transactions to the international investor base."(15)

* In June 2005, Dow Jones Indexes, New York, and RHB Securities, Kuala Lampur (Malaysia), teamed up to launch a new "Islamic Malaysia Index"- a collection of 45 stocks representing Malaysian companies that comply with a variety of shari'a-based criteria.

* In April 2006, Dow Jones and Citigroup Corporate and Investment Bank launched the Dow Jones Citigroup Sukuk Index, which seeks to measure their global performance in complying with Islamic investment guidelines. It was created primarily for use as the benchmark for investors seeking exposure to Shari'a-compliant fixed-income investments.16

* In September 2006, Islamic Bank of Britain, the first Islamic bank in the U.K., will start operating in the city of Birmingham.

Political Support for Islamic Banking

Support for Islamic banking is also being offered by Western governments. In a speech at the Muslim Council of Britain, Gordon Brown, the Chancellor of the Exchequer, declared his ambition to make Britain "the gateway to Islamic finance and trade." In the same speech, Chancellor Brown said, "As the hadith [teachings] from the prophet Mohammed said, the umma [community of Muslims] is like a body. When one part of the body feels pain, every other part feels pain."(17) The Financial Times wrote a few months later that Brown opened his speech with the traditional Muslim greeting of "Asalaam aleikum," enunciating the greeting very slowly "as he feared offending with a mispronunciation."(18) However, The Islamic Banker, which also reported the speech, added ominously: "To the militant Muslims, this flirtation between the West and Islamic banking is a way of 'colonizing' Muslim money with the banking major acting as willing conduit."(19)

In a speech delivered on March 2, 2005 before the "Seminar on Legal Issues in the Islamic Financial Services Industry," Thomas C. Baxter, Jr., Executive Vice President and General Counsel of the Federal Reserve Bank of New York, offered a number of interesting remarks. As a general rule, the U.S. law is "broad enough to encompass shari'a compliant structures." Practitioners can produce products that simultaneously satisfy the demands of secular and religious law. This is so because the U.S. law is silent on matters of religion and because the common law tradition of the Anglo-Saxon legal system is flexible and adaptive. The challenges facing U.S. and Western regulators is to accommodate the free exercise of religion and still carry the secular mandate of fostering safe and sound practices in the banks that they supervise. Mr. Baxter gave a number of examples of a number of U.S. banks which have opened special windows for shari'a-compliant banking activities as a trend for the future.

Singapore is also seeking to become a hub for Islamic banking. To that effect, the minister of finance promised to align the tax policy in the treatment of Islamic contracts with the tax treatment of conventional financing contracts to which they are economically equivalent.(20)

Criticism of Islamic Banking

Some Muslim critics maintain that the Islamic banks hide the payment of interest behind legal tricks. They compare Islamic banking to "contractum trinium" - a legal trick designed by European bankers in the Middle Ages intended to allow the charging of interest for borrowed money, which was against Church teachings. The trick was in the form of three different contractual agreements, which in and of themselves were not prohibited by the Church.(21)

Islamic economic institutions connected with Islamic banking claim to operate on the basis of "zero interest." Critics of Islamic economics argue, however, that the fundamental characteristic of charging interest (.e.g., charging a premium on the principal amount of the loan, for the time value of the loaned money) is not truly eliminated in Islamic banking but is merely hidden and relabeled. The Financial Times, drawing upon the book Islamic Banking - A $300 Billion Deception by Mohammad Saleem, a disillusioned former adviser to Islamic banks, refers to many of these practices as "financial smoke and mirrors."(22) But the most cogent comment came from Shahid Malik, a Member of British Parliament. Writing in The Times, Malik told his Muslim co-religionists, "If you want sharia law, you should go live in Saudi Arabia.(23)

There remain differing interpretations of the religious principles behind Islamic finance - a problem that could impede the development of a uniform, global market for Islamic debt securities. The case of the World Bank sukuk mentioned earlier underscores the difficulty of defining a no-interest-bearing bond. The underlying transaction for the World Bank bond is a complicated one and involves the purchase and sale of a financial asset, akin to a certificate of deposit. In Malaysia, where the bond was arranged, this transaction was deemed shari'a-compliant. But some Middle East bankers said the World Bank issue met none of the shari'a criteria because they felt it was based on the purchase and sale of money itself, rather than a shari'a-compliant asset. Nevertheless, the sukuk, priced at a profit rate of 3.58 percent, well below the equivalent U.S. Treasury rate, was almost twice oversubscribed.(24) In short, in the absence of uniformly accepted standards governing the practices of Islamic banking, the risks of certain deviations from appropriate banking standards cannot be ignored.

The dilemma for religious Muslims is seen through the predicament of a Kuwaiti woman who sought a fatwa from Sheikh D. 'Adel Mubarak al-Mutairat. The woman tried to deposit money in her checking account in the ladies' branch of the Islamic Ahli Bank but, alas, she found it closed. What was she to do? Here is the fatwa:

"Depositing money in a checking account in an interest-paying bank is all right. But, in your case, there is an Islamic bank for men only. You should go there with your guardian to deposit your money."(25)

Financial instruments are rated by a variety of rating agencies which focus on the credit risk of such instruments and the expected loss on each investment relative to its promise. Moody's, one of the key rating agencies, points out that "Shari'a or Islamic law adds an extra dimension to the legal analysis that needs to be considered if there is possibility that its inclusion will have a material impact on the credit risk profile" of the instrument.(26) In other words, an Islamic financial instrument, such as sukuk, introduces exogenous factors in the rating methodology which are not encountered in the case of financial instruments issued by traditional commercial banks or corporations.

Islamic Banks and Terrorism

Some elements of the Islamic banking network may have been involved in the transfer and/or laundering of money intended for terrorist organizations. Saudi Islamic support system was channeled through a complex banking system that had at its center two entities created in the early 1980s - Dar al-Maal al-Islami (DMI), founded in 1981 with headquarters in Geneva, Switzerland, and al-Baraka, founded in 1982, with headquarters in Jeddah, Saudi Arabia. Prince Mohammad al-Faisal was the chairman of the DMI group and Muazzam Ali its vice-chairman. Ali left the group after 19 years to establish the Institute of Islamic Banking and Insurance, primarily as a training institute in Islamic banking.

While theologically denied the authority to pay interest to their depositors and, at least, in the case of Saudi Arabia, legally not required to pay income tax but expected only to pay zakat [alms], some Islamic banks often provide zakat off the books. Zakat may be used for whatever purpose. Some of the zakat money continues to flow to terrorist organizations, including those operating in Iraq. There are enormous difficulties tracing financial transactions involving some Islamic financial institutions:

* Terrorist organizations often transact money through third parties, numbered accounts, offshore accounts, charitable organizations and disguised fronts.

* There are a considerable number of banks operating offshore that are also not subject to scrutiny.

* Some countries invoke banking secrecy, often to conceal illegal activities.

* Many organizations suspected of terrorist or terrorist-related activities use multiple aliases. For example, the largest Saudi charitable organization, al-Haramain Islamic Foundation, appears under 26 different spelling and configurations.(27)

Conclusion

A study by the International Monetary Fund has highlighted the complexity of designing market-based instruments for monetary control and government financing "which satisfy the Islamic prohibition on ex-ante interest payments, and provide for a sharing of profits and losses on underlying transactions." The primary complexity is methodological - computing appropriate profits and rates and of return. This is particularly the case when projects, such as highways, which are considered public goods, but whose costs and benefits are often variable.(28)

There is also the broader question about the capacity of the Islamic economic model to survive in the age of globalization. The Organization of European Cooperation and Development (OECD) suggests, for example, that "Increasing integration of world markets and the interdependence of national economies are leaving less and less room for idiosyncratic institutions or economic policies."(29)

Chances are that Islamic banking will survive, and even grow, because it provides a national identity for the millions of Muslim citizens and immigrants in Western countries who may feel otherwise threatened by rising anti-Muslim or anti-immigrant sentiments.

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