UNIT-2

History of Islamic Banking and Finance

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Explore experiences of different countries with Islamic Banking
- ✓ Describe the Work of Islamic Banks & Financial Institutions in Mixed Environment.
- ✓ Identify the International Islamic Financial Institutions

Unit 2

History of Islamic Banking and Finance

While credit societies and cooperatives (working on an interest-free basis) existed in several Muslim countries even during the colonial period, the appearance of banking institutions started emerging in the early 1960s. A pioneering experiment of putting the Islamic principles governing financial dealings into practice was conducted in MitGhamar, Egypt, from 1963 to 1967. Deriving inspiration from the idea of German saving banks, the MitGhamar initiative mobilized small savings from the rural sector largely through savings accounts. No interest was paid to the account holders. However, as an incentive they were eligible for small, short-term, interest-free loans for productive purposes. They were allowed to withdraw their deposits on demand. In addition, investment accounts on the basis of profit sharing were also introduced. The funds so mobilized were invested on the basis of profit-sharing with entrepreneurs.

The first interest-free institution with 'bank' in its name, Nasser Social Bank, was also established in Egypt in 1971. This was the first time that a government in a Muslim country had shown an interest in incorporating an interest-free institution. Even though the objectives of the Nasser Social Bank were mainly social, such as providing interest-free loans to the poor and needy, scholarships to students, and micro-credits to small projects on a profit-sharing basis, the involvement of a public authority in interest-free banking sent important signals to Muslim businessmen who had surplus funds. A group of such businessmen took the initiative of establishing the Dubai Islamic Bank in 1975 in Dubai in the United Arab Emirates (UAE). This was the first Islamic Bank established on private initiative. However, official support was crucial with the governments of the UAE and Kuwait contributing respectively 20 per cent and 10 per cent of the capital.

The most important development in the history of Islamic banking took place with the establishment of the Islamic Development Bank (IDB) in 1975. The IDB was established as an international financial institution in pursuance of the declaration of intent issued by a conference of finance ministers of Islamic countries held in Jeddah, Saudi Arabia, in December 1973. The declaration was signed by the representatives of 23 member countries of the OIC. The second conference of finance ministers, held in Jeddah in August 1974, adopted the Articles of Agreement establishing the Islamic Development Bank. The inaugural meeting of the Board of Governors of the IDB took place in Riyadh, Saudi Arabia, in July 1975 and it started functioning on 20 October 1975.

The period between 1975 and 1990 was the most important period in the history of development of Islamic financial industry. During this period, it matured into a viable alternative model of financial intermediation. It won respect and credibility in terms of both theoretical developments and practical experiences. On the one hand, several financial products compatible with the *Shari'a* were developed and, on the other hand, Islamic banks showed good results while using these products. The period was not only marked by the establishment of a large number of Islamic financial institutions in the private corporate sector under different socio-economic conditions, but also witnessed the expression of intent from three countries – Pakistan, Iran and Sudan – gradually to eliminate interest from their entire economies and substitute it with a complete banking system based on Islamic principles. Several practical steps were also

taken in these countries towards achieving that objective. Even more important was the fact that several important multinational banks started offering Islamic financial products. That was a clear recognition of the viability of the new model and its acceptance by international players. The International Monetary Fund (IMF) and the World Bank also recognized Islamic financial products as a genuine means of financial intermediation and produced papers to that effect. In the 1990s, while the growth of the banking industry continued (though at a slower rate), attention was also given to non-bank financial institutions. Islamic financial institutions other than banks started coming on the scene in increasing numbers. These included insurance companies and investment funds. While the Islamic insurance sector has not registered sufficient growth, Islamic investment funds have witnessed significant progress.
Initiatives for the establishment of some of infrastructure institutions supporting the Islamic financial industry also started in the 1990s. At the beginning, Islamic banking institutions had to work within the institutional framework that supports conventional banking. They were at a comparative disadvantage because that framework was not specifically geared to their needs. A beginning has been made towards constructing a network of supporting institutions for the Islamic financial industry.

Various Manifestations of the Islamic Financial industry

The practice of Islamic banking as it has developed during the last 30 years has four main manifestations:

(a) banks and financial institutions in those countries where the promotion of an Islamic financial system is receiving active government support;
(b) Islamic banks and financial institutions in the private corporate sector working in a mixed environment;
(c) Islamic banking practices by some conventional commercial banks and non-bank financial institutions;
(d) multinational financial institutions working on *Shari'a* principles.

In the following sections, a brief account of each category is given, followed by a survey of other institutions.

Country Experiences with Islamic Banking

Pakistan

Iran

Sudan

Malaysia

Pakistan

The process of economy-wide Islamisation of the banking system in Pakistan was initiated soon after a declaration by the then President of Pakistan in February 1979 that the government planned to remove interest from the economy within a period of three years and that a decision had been taken to make a beginning in this direction with the elimination of interest from the operations of the House Building Finance Corporation, National Investment Trust and mutual funds of the Investment Corporation of Pakistan. Within a few months of this announcement, these specialized financial institutions took the necessary steps to reorient their activities on a non-interest basis.

The conversion of the operations of commercial banks to a non-interest basis was a much more complex task and took a longer time span. To begin with, steps were taken in January 1981 to set up separate counters for accepting deposits on a profit- and loss-sharing basis in all the domestic branches of the five nationalized commercial banks. The parallel system, in which savers had the option to keep their money with the banks either in interest-bearing deposits or PLS deposits, continued to operate until the end of June 1985.

As of July 1985, no banking company was allowed to accept any interest bearing deposits (except foreign currency deposits which continued to earn interest). As from that date, all deposits accepted by banking companies shared in the profit and loss of the bank, except deposits in current accounts on which no interest or profit was given and whose capital sum was guaranteed.

The central bank of the country issued instructions specifying twelve modes of financing in which funds mobilized by the banks can be employed.

These were broadly classified into three groups:

- **(i)** Loan financing;
- **(ii)** Trade-related modes of financing;
- **(iii)** Investment modes of financing.

Loan financing took the form either of *qard al-hasan* loans given on compassionate grounds free of any interest or service charge (repayable if and when the borrower is able to repay) or of loans with a service charge not exceeding the proportionate cost of the operation. Trade-related modes of financing included the following:

- **(i)** purchase of goods by banks and their sale to clients at an appropriate mark-up on a deferred payment basis,
- **(ii)** purchase of trade bills,
- **(iii)** purchase of moveable or immoveable property by the banks from their clients with buy-back agreement or otherwise,
- **(iv)** leasing,
- **(v)** hire-purchase,
- **(vi)** financing for development of property on the basis of a development charge.

Investment modes of financing included the following:

- **(i)** *Musharakah*,
- **(ii)** Equity participation and purchase of shares,

(iii) Purchase of participation term certificates and *mudarabah* certificates,
(iv) Rent sharing.

The central bank of the country was authorized to fix the minimum annual rate of profit which banks should keep in view while considering proposals for provision of finance, and the maximum rate of profit they were allowed to earn. These rates were to be changed from time to time. It was also laid down that should losses occur, these must be shared by all the financiers in proportion to the respective finances provided by them.

A gesture towards introducing the *mudarabah* technique of financing was made in June 1980 when a law was promulgated under which companies, banks and other financial institutions could register themselves as *mudarabah* companies and mobilize funds through the issuance of *mudarabah* certificates. Funds obtained through a *mudarabah* could only be used in such businesses as were permitted under the *Shari'a*, and needed prior clearance from a Religious Board established by the government specifically for the purpose. Though a number of steps were taken for the elimination of interest from the financial sector in Pakistan, the process of Islamisation was slow and selective. Nothing was done to eliminate interest from government transactions.

Iran

A new banking law, the Law for Usury-Free Banking Operations, was enacted in Iran in August 1983 to replace interest-based banking by interest-free banking. The law required the banks to convert their deposits to an interest-free basis within one year (and their other operations within three years) from the date of the passage of the law, and specified the types of transactions that must constitute the basis for asset and liability acquisition by banks. The law also specified the responsibilities of the central bank under the new system and the mechanics of the central bank's control over the banking system.

The law allows the banks to accept three types of deposits: *qard al-hasanah* deposits, general term investment deposits and project-specific investment deposits. The *qard al-hasanah* deposits comprise current as well as savings accounts which differ in their operational rules. The holders of current and savings accounts are guaranteed the safety of their principal amounts and are not entitled to any contractual return. However, banks are permitted to provide incentives to depositors through:

(i) Grant of prizes in cash or kind,
(ii) Reductions in or exemptions from service charges or agents' fees payable to banks,
(iii) According priority in the use of banking finances.

Holders of term investment deposits are entitled to receive a variable return, depending on the profitability of a bank's investments. The central bank fixes the minimum and maximum rates permissible. At the beginning of the year, 'expected' rates of profit are declared. However, the banks are required to calculate the 'actual' rates of return from their operations periodically and the difference between the 'actual' and 'expected' return is adjusted. The law allows the banks to undertake and/or ensure the repayment of the principal amounts of term investment deposits.

The third type of deposit accounts are project-specific, in which banks mobilize savings for specific investment projects. In this type of account, the rate of return is calculated at the end of the project. The bank charges only an administrative fee for its intermediation between savers and investors. The rest of the profit received by the bank is distributed among the deposit holders.
On the asset side, the law provides thirteen different modes of contract, through which finance can be provided. These are:

(i) *Qard-al hasanah*,
(ii) *Mudarabah*,
(iii) Civil partnership (*musharaka tmadani*),
(iv) Legal partnership (*musharaka thaqooqi*),
(v) Direct investment
(vi) Instalment sales,
(vii) Hire purchase, (
(viii) Forward deals (*salaf*),
(ix) *Jujalah*
(x) *Muzarajah*,
(xi) *Musaqah*
(xii) Debt purchase
(xiii) Guarantee notes.

However, in practice, instalment sales, civil partnerships and *mudarabah* in trade activities are the most dominant modes of finance used.
One important feature of Islamic banking in Iran is that banks are obliged to earmark a portion of their resources for grants of *qard al-hasanah* to help achieve the socio-economic objectives set out in the constitution of the country. In addition to banks a number of charity organizations have also been established under government patronage to grant *qard al-hasanah*. Besides *qard al-hasanah*, banks are authorized to extend financial assistance for productive ventures on a profit/loss sharing basis in accordance with the principles of *mudarabah* and *musharakah*. Banks are allowed to provide part of the capital of a new joint stock company and also to purchase shares of existing joint stock companies. Banks are authorized to provide working capital financing to productive units by purchasing raw materials, spare parts and other items on request for sale on the basis of deferred payment by instalments. Purchase of machinery and equipment for sale to their clients on a deferred payment basis is also allowed. Another mode is called *salaf* which is the same as *baysalam*, and is used for meeting working capital requirements through advance purchase of output. Banks can engage in lease-purchase transactions. They can also provide finance on the basis of *jujalah*(commission for working as agent), *muzarajah* (financing of agricultural production on a profit-sharing basis), or *musaqat* (financing of orchard production on a profit-sharing basis). In addition to these modes of financing, banks are permitted to purchase debt instruments of less than one year's maturity if these debts are issued against real assets.

Sudan

The process of the economy-wide Islamisation of the banking system in Sudan has not been smooth and steady. The first attempt to Islamize the entire banking system was made in 1984 when a presidential decree was issued directing all commercial banks to stop interest-based dealings with immediate effect and to negotiate the conversion of their then existing interest-bearing deposits and advances into Islamically acceptable forms.

Foreign transactions were allowed to be continued on the basis of interest temporarily. It is reported that this sudden change forced the banks to adopt the nearest Islamic alternative available, *murabahah*, which soon constituted 90 per cent of their financial operations. It is also reported that the banks applied Islamic financing techniques only formally in their ledger books and in the reports submitted to the Central Bank of the country.

Policy makers in the Central Bank were also discontented with the procedure **of** transforming the banking system. They considered it as a mere political decision imposed by the government which had not been prepared for adequately by detailed studies. This experiment with economy-wide Islamization of the banking system came to an end in 1985 with the change in government. The government revived the process in May 1990 by reactivating an existing Islamic banking law. It issued a more comprehensive law in 1992 which envisioned an economy-wide Islamization of the financial system including the government sector. Reports indicate that the effort is much more earnest and much better organized this time. Now all banks are using Islamic modes of finance. An important development worth mentioning is the attempt being made to eliminate interest from the government sector, too. Other countries have found this a hard nut to crack. The government of Sudan has launched two funds based on the principle of *musharakah*to mobilize resources for the public sector. The first is the Government *Musharakah* Certificate (GMC). It is an instrument that enables the government to raise funds through issuing securities that promise the investor a negotiable return linked to developments in government revenue in return for their investment in the provision of general government services. The other is the Central Bank *Musharakah* Certificate (CMC). This is an equity-based instrument that is issued against the government (or Central Bank) ownership in commercial banks. Under CMC, the Central Bank becomes a partner with the investors in profits of the underlying assets. The distribution of profit between the Central Bank and the investors is negotiable and the Certificate can be sold on the secondary market to another bank or the Central Bank. While GMC is still operating, CMC has been temporarily discontinued.

Bahrain

The Kingdom of Bahrain was amongst the first to recognize the importance of the concept of Islamic banking and finance and, as a consequence, has been both supportive of the development of the industry in general and welcoming to the new institutions in particular. As a result, Bahrain has gathered a concentration of specialist Islamic institutions on its shores. The first Islamic bank in Bahrain was established in 1979, when the Bahrain Islamic

Bank was licensed. Since then, the sector has grown considerably. Now Bahrain has the largest number of Islamic financial institutions not only in the Gulf but anywhere in the world. The Kingdom is playing host to 26 Islamic banks and financial institutions, five industry-support organizations, six Islamic insurance companies and 34 Islamic mutual funds. A comprehensive prudential set of regulations for Islamic banks was introduced in early 2000 by the Bahrain Monetary Agency (BMA). This is referred to as the Prudential Information and Regulations for Islamic Banks (PIRI) framework. The framework covers areas such as capital adequacy, asset quality, management of investment accounts, corporate governance and liquidity management.

Within such an environment, the Islamic financial industry in Bahrain will be able to enjoy sustainable growth based upon strong investor and customer confidence, attractive product design and expanding markets. Much is already in place. The Bahrain Monetary Agency’s statutory responsibility as the sole regulator for the financial sector and the sector’s adherence to the PIRI framework ensures that Islamic institutions will continue to operate according to standards comparable to those of the conventional financial sector.

Product innovation continues apace. The *ijarah* and *salam sukuk* are now firmly established and the Agency is fully committed to a rolling programme of further issues as an integral part of the development of Bahrain as an international Islamic bond market. These initiatives have been matched on their part by the private sector. The introduction of an Islamic credit card, and research into *takaful*, are two outstanding examples of the degree of innovative thinking coming from the industry that is driving forward the parameters of Islamic banking and finance.

Malaysia

In Malaysia, separate Islamic legislation and conventional banking regulations exist side by side. The Islamic financial system that has developed in Malaysia over the last two decades is emerging as a comprehensive Islamic financial system that operates in parallel with, and is able to compete on an even keel with, the more entrenched conventional financial system. The development of Islamic finance as an important niche activity in Malaysia’s International Offshore Financial Centre in Labuan also complements the development of the domestic Islamic financial market.

The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA) that came into effect on 7 April 1983. The IBA provides Bank Negara Malaysia (BNM) with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue Government Investment Certificates (GIC), which are government securities issued based on *Shari’a* principles. As the GIC are regarded as liquid assets, Islamic banks can invest in GIC to meet the prescribed liquidity requirements as well as to invest their surplus funds.The first Islamic bank established in the country was Bank Islam Malaysia Berhad (BIMB), which commenced operations on 1 July 1983. After about two decades of operations, BIMB has proved to be a viable banking institution with its activity expanding rapidly throughout the country via a network of 80 branches and 1,200 employees. The bank was listed on the Main Board of the Kuala Lumpur Stock Exchange on 17 January 1992. On 1 October 1999, a second Islamic bank, Bank Muamalat Malaysia Berhad (BMMB), commenced operations. The establishment of BMMB was the effect of the spin-off following the merger between Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce (Malaysia) Berhad (BOCB). Under the merger arrangement, the Islamic banking assets and liabilities of BBMB, BOCB and BBMB Kewangan Berhad (BBMBK) were transferred to

BBMB, while the conventional operations of BBMB, BOCB and BBMBK were transferred to the BOCB. In addition, BMMB was given 40 branches of BBMB and BBMBK in various locations throughout Malaysia. Recognizing that, like any banking system, an Islamic banking system requires three vital elements to qualify as a viable system (i.e., a large number of players, a broad variety of instruments, and an Islamic money market), BNM has adopted a step-by-step approach to achieve the above objectives. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nation-wide basis, with as many players as possible so as to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Following from the above, on 4 March 1993 BNM introduced a scheme known as Skim Perbankan Tanpa Faedah (Interest-free Banking Scheme), or SPTF. More than 20 banks are now offering Islamic banking services. In addition, there are more than 50 Islamic investment funds. The Malaysian Financial Sector Master Plan launched in 2001 is the blueprint for the development of the financial sector over a 10-year period in Malaysia. The plan places importance on the development of Islamic banking and the *takaful* sector as an important component in the financial system.

To ensure the sound and stable development of the Islamic financial industry, it needs to be supported by a strong regulatory and supervisory framework. To fulfil this requirement, the Islamic Financial Services Board (IFSB) was established in 2002. The IFSB is an international body hosted by Malaysia. It has the important mandate of developing the prudential standards in accordance with the unique features of the Islamic financial institutions.

Islamic Banks and Financial Institutions working in mixed Environments

Islamic Banks

There are around 70 Islamic banks working in the private sector, excluding those in Iran and Sudan, which have declared their intention to convert their entire banking sector to Islamic banking. These institutions are spread across a number of countries and continents. The figures show that the largest number of Islamic banks is in the GCC countries, followed by South-East Asian countries and then by other Middle Eastern countries. The share of the Arab world in the number of Islamic banks is about 60 per cent.

It can be seen that the bulk of the Islamic banking activity is concentrated in the Middle East, especially GCC countries. This region accounts for 85 per cent of the total assets of Islamic banks. In addition, two major international holding companies – the Dar al-Mal al-Islami and the Al-Baraka Group, each of which control about a dozen Islamic banks and finance companies, some of which operate outside the Middle East – are both controlled by Middle Eastern owners. Thus the real importance of the region in the Islamic banking industry is even higher.

Saudi Arabia is the largest market for Islamic finance in terms of size. The largest Islamic bank in the world, Al-Rajhi Banking and Investment Corporation, is based in Saudi Arabia. The bank had $15.8 billion in assets at the end of 2002. In addition, almost all other banks operating in Saudi Arabia are offering Islamic products besides their conventional operations. Saudi Arabia is also home to the largest concentration of Islamic funds. The most important Islamic banking institution, the IDB, is also headquartered in Saudi Arabia.

Several other countries in the Arab world have a significant presence in Islamic finance. Kuwait is host to the second largest Islamic commercial bank, the Kuwait Finance House. In addition, there are 10 Islamic investment banks and finance companies working in Kuwait and Qatar, while Jordan and Yemen also have some Islamic banks and finance companies.

Islamic Insurance Companies

Another segment of the Islamic financial industry relates to insurance. Unfortunately, due to juridical issues which have not been satisfactorily resolved, this segment has not shown enough growth. Due to the element of 'chance' in all insurance contracts, some Islamic scholars have likened the insurance business to gambling which is prohibited in Islam. Other scholars have pointed out that the element of 'chance' emerges from the nature of risk. They further point out that all risks that one faces in life are not of the same kind. They make a distinction between three types of risks.

First, there is the risk that can be termed 'entrepreneurial risk'. This risk is part of the normal course of business. Every economic activity involves uncertainty that generates risks. Some agents, called entrepreneurs, take those risks. An enterprising person makes a profit, as well as (on occasions) incurring losses. However, the fact that society has always had such enterprising people is testimony to the fact that, by and large, profit outweighs loss. Willingness to take such risks does not imply any moral evil; rather, it is a need that no society can do away with.

The second type of risk which is also part of life arises from the possibility of the occurrence of natural disasters and calamities. People throughout the history have sought ways and means to protect themselves from the occurrence of personal losses due to such calamities. This is the essence of insurance.

The third type of risk arises from uncertainties that are not part of everyday life. They arise from various types of 'games' that people create for themselves. These risks are unnecessary. They are unnecessary for the individual in the sense that if someone chooses not to participate in these 'games', he will face no such risk; they are also unnecessary for society in the sense that they do not add any economic value to the wealth of the community.

It is the third type of risk that is the essence of gambling which is prohibited by Islam. As to the other two types of risks, both are a natural part of everyday life and must be reckoned and dealt with. Once this is accepted, the concept of insurance becomes acceptable in principle. However, it must be noticed that there is an important difference between the first and second types of risk mentioned above. While the basic motivation for taking an entrepreneurial risk is 'profit', the basic motivation to seek protection against the second type of risk is 'fear'. The loss resulting from such calamities is often huge and may in many cases be beyond the capacity of the individuals who suffer them. By paying a small price, called a

premium, one can buy 'protection' against such happenings. Many Islamic scholars have pointed out that there is nothing wrong in seeking protection against suffering if one can manage to do that.
However, they have pointed out that nobody should make a profitable business out of the sufferings that naturally befall humanity. This has led to the development of Islamic insurance which is based on the concept of *takaful*, which means taking care of each other. Thus an Islamic insurance company, usually called *takaful*, has the following features:

1. The company is not the one who assumes risks; nor the one taking any profit. Instead, it is the participants, the policy holders, who cover each other.
2. All contributions (premiums) are accumulated into a fund. This fund is invested using Islamic modes of investment and the net profit resulting from these investments is credited back to the fund.
3. All claims are paid from this fund. The policy holders, as a group, are the owners of any net profit that remains after paying all the claims. They are also collectively responsible if the claims exceed the balance in the fund.
4. The company acts as a trustee on behalf of the participants to manage the operations of the *takaful* business. The relationship between the company and the policy holders is governed by the terms of *mudarabah* contract. Therefore, should there be a surplus from the operation, the company (*mudarib*) will share the surplus with the participants (*rabb al-mal*) according to a pre-agreed profit-sharing ratio.

In practice, there are about 50 Islamic insurance companies operating in the world outside Iran and Sudan which, as mentioned before, are both attempting to Islamize their entire economies. South and South-East Asian countries host the largest number of Islamic insurance companies. Within this region, Bangladesh has the largest number of Islamic insurance companies while Malaysia is the largest market for Islamic insurance in terms of size. In GCC countries, Saudi Arabia and Bahrain have the largest number of Islamic insurance companies.

Islamic Banking Practices by Conventional Banks

Another achievement of Islamic banking may be gauged from the fact that many conventional banks have also started using Islamic banking techniques in the conduct of their business, particularly in dealing either with Muslim clients or in dominantly Muslim regions. At present, the number of such conventional banks may not be very large, but the very fact that some important and large multinational banks have also resorted to Islamic banking is itself a pointer of much significance. A Western observer of Islamic banking has aptly remarked that 'it is an excellent reflection on the success of Islamic banking that many conventional commercial banks are now offering their clients Islamic financial services'.
The involvement of some Western conventional banks, particularly multinational banks, in Islamic banking started quite early, in the 1980s. In the early period of their establishment, Islamic banks were stuck with high liquidity which was the result of high deposit growth and very few investment opportunities. In such a situation, Islamic banks turned to Western institutions such as Citibank to find profitable avenues for the investment of their money. Most of the resources supplied by the Islamic banks went to commodity trade and trade finance deals. Since Islamic banks did not want any

involvement of these funds in *riba*-based transactions, the Western banks found themselves negotiating '*murabahah*' deals in which they arranged for a trader to buy goods on behalf of the Islamic bank and resell them at a mark-up. This prompted other Western commercial banks to follow suit.
Although it is difficult to know with certainty how many conventional commercial banks around the globe practise Islamic banking techniques, even a randomly selected short list may contain some of the giants of the international banking industry such as Chase Manhattan, Citibank, the HongKong and Shanghai Banking Corporation (HSBC), ANZ Grindlays, along with other banks such as the Union Bank of Switzerland, Deutsche Bank of Germany, ABC International, the National Bank of Kuwait, the Saudi British Bank, National Commercial Bank, Riyadh Bank of Saudi Arabia and Bank Misr of Egypt.

International Islamic Financial institutions

Some international financial institutions have also come on to the scene. Two major international holding companies, the Dar al-Mal al-Islami and the Al-Baraka Group, control more than a dozen Islamic banks and finance companies each; but perhaps the most important multinational institution is the Islamic Development Bank. In the following paragraphs, brief profiles of some institutions established within the Islamic financial industry are given.

Islamic Development Bank

The Islamic Development Bank is a multilateral development bank serving Muslim countries. Its present membership stands at 55 countries. Its purpose is to foster economic development and the social progress of member countries and Muslim communities, individually and collectively, in accordance with the principles of the *Shari'a*. In order to meet the growing and diverse needs of its member countries, the Bank has established a number of institutions and funds with distinct administrative arrangements and operational rules. These entities and funds, affiliated with the Bank, enable the IDB to mobilize supplementary financial resources in line with *Shari'a* principles, and to focus on those functions and activities which cannot be covered under its normal financing arrangements. With these affiliated entities and funds, the Bank has evolved over time into a group called the IDB Group.
In 1995 IDB established the Islamic Corporation for Insurance of Investment and Export Credit (ICIEC). The objective of ICIEC is to enlarge the scope of trade transactions and the flow of investments among member states. In fulfilment of this objective ICIEC provides *Shari'a*-compliant export credit insurance and reinsurance to cover the non-payment of export receivables resulting from commercial (buyer) or non-commercial (country) risks; and foreign investment insurance and reinsurance against country risks, mainly the risks of exchange transfer restrictions, expropriation, war and civil disturbance and breach of contract by the host government. The safety-net provided by ICIEC is also expected to contribute positively to the development of the industry in the future.
In 1999 IDB established the Islamic Corporation for the Development of the Private Sector (ICD). The focused objectives of the ICD are to identify opportunities in the private sector that could function as engines of growth; to provide a wide range of *Shari'a*-compatible financial products and services; and to expand access to Islamic capital markets by private companies in IDB member countries. In the coming

years, the operations of the ICD are expected to have a significant impact on the development of the member countries.

The Accounting and Auditing Organization for Islamic Financial Institutions

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and *Shari'a* standards for Islamic financial institutions. It was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 26 February 1990 in Algiers. It was registered in the Kingdom of Bahrain on 27 March 1991. The objectives of AAOIFI include:

- **(a)** develop accounting, auditing, governance and ethical ideas relating to the activities of Islamic financial institutions taking into consideration the international standards and practices which comply with Islamic *Shari'a* rules;
- **(b)** disseminate the accounting, auditing, governance and ethical ideas relating to the activities of Islamic financial institutions and their application through training seminars, publication of periodical newsletters, preparation of reports, research and through other means;
- **(c)** harmonize the accounting policies and procedures adopted by Islamic financial institutions through the preparation and issuance of accounting standards and the interpretations of the same to the said institutions;
- **(d)** improve the quality and uniformity of auditing and governance practices relating to Islamic financial institutions through the preparation and issuance of auditing and governance standards and the interpretation of the same to the said institutions;
- **(e)** promote good ethical practices relating to Islamic financial institutions through the preparation and issuance of codes of ethics to these institutions;
- **(f)** achieve conformity or similarity – to whatever extent possible – in concepts and applications among the *Shari'a* supervisory boards of Islamic financial institutions to avoid contradiction and inconsistency between the *fatwas* and the applications by these institutions, with a view to activating the role of the *Shari'a* supervisory boards of Islamic financial institutions and central banks through the preparation, issuance and interpretations of *Shari'a* standards and *Shari'a* rules for investment, financing and insurance;
- **(g)** approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the standards, as well as the statements and guidelines that are published by AAOIFI. The AAOIFI standards were introduced for the first time in 1993 for Islamic financial institutions. Islamic financial institutions are adopting these standards in increasing numbers.

General Council for Islamic Banks and Financial Institutions

Founded in May 2001, the General Council for Islamic Banks and Financial Institutions (GCIBFI) is a non-profit association based in Bahrain with members from around the world including Islamic commercial banks, Islamic windows, investment banks, Islamic funds, Islamic *takaful* (insurance) companies and so on. Membership of the GCIBFI is available to any registered Islamic bank or financial institution anywhere in the world that 'undertakes all activities in complete compliance with the tenets of Islam'. The GCIBFI represents Islamic banks and financial institutions on issues of international importance for these institutions and their customers. It also aims to increase understanding of Islamic banking and prevent misunderstandings that could inhibit its progress in the international banking sector. GCIBFI fulfils this role by hosting conferences in key centres around the world, and by finding ways to improve customer understanding of Islamic banking and finance. GCIBFI also acts as a resource for its members for employee training, technical assistance, conferences, and seminars.

International Islamic Financial Market

The Islamic financial services industry faces greater liquidity risk due to the absence of a secondary market for Islamic financial instruments. The non-existence of an inter-bank Islamic money market makes liquidity management a challenging task. The Islamic banks are thus under a constraint to maintain liquidity at higher levels than conventional banks. This adversely affects Islamic banks' competitiveness. The establishment of an International Islamic Financial Market (IIFM) in 2002 in Bahrain was thus an important building block for Islamic financial services infrastructure.

The IIFM is a non-profit international organization that aims to create an environment which will encourage cross-border trading of *Shari'a*-compatible instruments. The principal objectives of IIFM are to develop an active international financial market based on *Shari'a*rules and principles and to issue guidelines to market participants for the issuing of instruments and standardization of documentation for secondary market trading. The core product of IIFM is the *Shari'a* endorsement of existing and new Islamic financial products and instruments which are offered by Islamic financial institutions, conventional banks with Islamic banking subsidiaries, windows and so forth. Through *Shari'a* endorsement, the IIFM intends to accomplish uniformity in Islamic products and instruments in order to have global reach and acceptance.

The Islamic Financial Services Board

Proper regulation and supervision of banks and financial institutions is also important for financial efficiency and stability. Some of the risks faced by the Islamic financial industry are unique due to the *Shari'a* compliance requirements. Bank supervisors utilizing the traditional standards cannot assess such risks. The need for special guidelines for the regulation and supervision of Islamic banks has long been felt. Some regulatory authorities have already introduced guidelines for Islamic banking supervision in their respective jurisdictions. With the active involvement of the IMF, the IDB and support from the Bahrain Monetary Agency, Bank Negara Malaysia and other central banks, an Islamic Financial Services Board was established in Malaysia in November 2002 and has been in operation since March 2003.

The International Islamic Rating Agency

Market discipline is important for an efficient and stable financial system. In this regard, external rating systems and accounting standards play a vital role in improving the availability of information to depositors, bankers and regulators. Existing conventional rating systems are primarily concerned with the financial strength of counterparties and ignore compliance with the *Shari'a* requirements. Since non-compliance of even a financially sound Islamic bank with the *Shari'a* requirements can be a serious cause of systemic instability, the need for an Islamic rating agency has always been felt necessary. Keeping this need in mind, an International Islamic Rating Agency (IIRA) was incorporated in Bahrain in October 2002. The IIRA will also scrutinize *Shari'a* aspects of financial institutions and products, which will be of major importance to the Islamic financial industry bearing in mind the global character/appeal of the new international agency.

An internationally-recognized rating will give these institutions the credibility and the transparency they need to deal with the international market. As a specialized rating agency, the IIRA will be complementary to the existing agencies, adding value to the market. By assessing fiduciary relationships and the credit risk inherent in any instrument or issuer, the IIRA will help create a higher degree of confidence and acceptability of products among the players in the industry.

Further Reading:

- ✓ ***Islamic Banking: How to Manage Risk and Improve Profitability By Amr Mohamed El Tiby Ahmed***
- ✓ ***Current Issues in Islamic Banking and Finance: Resilience and Stability in By Angelo M. Venardos.***