Islamic & Commercial Banking Systems A Theoretical Comparison

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**Abstract**

This paper discusses Conventional and Islamic banking systems and shows that, even though they share the same basics and the same goals, they depart from each other at the ethical sources and the application phases. It starts by defining both systems and describing their general stances. It describes some of the procedures carried out in both Islamic based and conventional/commercial banks. Next, the paper illustrates the origins and principles of Islamic Finance, and subsequently, the development of modern Islamic banking. In the following section, the Islamic banking movement worldwide is discussed followed by a brief comparison between the Islamic banking models in the gulf region (as one of the main parts of the world applying Islamic Banking) and its counterpart outside of the gulf region. At the end of the paper, Islamic and commercial finance (mainly insurance) outside the banking arena is touched upon.

**Keywords:** Islamic Banking, Islamic Economics, Islamic Finance, Banking in the Gulf Area.

**Introduction**

The Commercial or conventional style of banking, and Islamic banking, both, have fundamental similarities and differences, and share the same overall objective which is the provision of an efficient system of money management, as well as the facilitation of finance for business. They do, however, use fundamentally different practices in order to achieve this common goal.
Banking systems

**Commercial Banking**

Investopedia (2010) defines a commercial bank as:

*“An institution that provides financial services such as accepting deposits and giving loans”*

Traditionally, it is implicit in the understanding of the term ‘Commercial Banking,’ which is frequently referred to as ‘retail banking,’ that the bank pays a rate of interest to depositors, and charges a rate of interest to debtors (Khambata, 1996). For this reason, it could be said that the payment of interest on credit deposits and the charging of interest on debt (be it in the form of an overdraft, loan, credit card account or other debt arrangement) is inherent or assumed in the provision of commercial or ‘western’ style banking (Haydon and Hicks 1966).

Traditionally, the assets of commercial banks are derived from the savings and other deposits of savers and deposit account customers. These customers deposit money for two key reasons. Firstly, to receive interest on their savings and, in the case of deposit or checking account customers, to hold their money in a safe place and manage it, taking advantage of the bank’s facilities in terms of electronic payments such as standing orders and direct debits, check amenities and similar money management tools (Haydon and Hicks 1966). According to Obaidullah (2005), because these deposits cost the bank nothing to receive, but provide them with the funds necessary to profit from lending and investing them, banks compete for these funds by providing individual customers with so-called ‘free’ services or services priced at less than it would otherwise cost the bank to provide them. These services include preparation of banker’s drafts, safekeeping of funds, accounting, and the provision of traveler's checks. Obaidullah (2005) asserts that such benefits are effectively interest payments to the depositors and, as such, would be prohibited in Shari’-a-compliant banking.

Investment capital is generated via deposits placed with the bank either for investment purposes, safekeeping, or a combination, by savers. These savings are used to invest in debt finance in the form of commercial and consumer loans and mortgages.

Commercial banks make their profits from a range of sources, which include returns on investments, interest charged on borrowing and the banking fees that they charge their customers (either in the form of penalties for unauthorized borrowing or late payment, or as monthly or annual fees for services, such as credit cards or premium bank accounts), as well as the sale of additional products such as insurance and foreign currency exchange. They also charge a range of fees to businesses for standard banking services such as processing customer payments, depositing checks and cash, and providing coins to use as change or floats. They also make significant profits from ‘arrangement fees’ on products such as loans and mortgages, and similar levies (Johansen, 2010).

**Islamic Banking**

Like conventional banks, an Islamic bank is an intermediary and trustee of other people’s money with the difference that it shares profit and loss with its depositors. This difference introduces an element of mutuality in Islamic banking, making its
depositors as customers with *some* ownership rights in it (Humayon A. Dar; Presley J. 2001)

*Investopedia* (2010) defines Islamic banking as:

“A banking system that is based on the principles of Islamic law (also known as Shari’a), and guided by Islamic economics. There exist two basic principles behind Islamic banking; the sharing of profit and loss and, significantly, the prohibition of the collection and payment of interest. Collecting interest is not permitted under Islamic law.”

As oversimplified as it might appear to be, the most fundamental difference between the two systems is the payment and levying of interest. On the surface, this would raise the question of how an Islamic banking system could possibly be commercially sustainable, given the fact that traditional forms of commercial or retail banking rely on interest as their primary source of revenue, with a commercial or retail bank profiting from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges on its lending activities (debit and credit interests). This is because, while different rates of interest are used for different activities or products (for example, savers would normally expect better rates of interest in exchange for tying their money in for a longer deposit period, using instruments such as term deposits or bonds, and borrowers would expect to pay a lower percentage rate of interest on large secured loans than they would on small unsecured loans or credit card balances), a lower rate of interest is always paid to savers than is charged to borrowers (Karkal, 2010).

As explained previously, one of the basic principles of Islamic banking is the prohibition of “Riba” (usury or interest). Up until as late as the 1980s in some Muslim schools of thought and traditions, Riba was used to define usury only, but it is now an accepted definition of all forms of interest by the majority of scholars (Hasan, 1994).

The Islamic scriptures which are the basis of this banking system, taken from the Qur’an as a primary source of Shari’a, are explicit in their forbidding of the charging of interest:

“O believers, devour not usury, doubled and redoubled, and fear your God; happily so you will prosper” (Qur’an 3:130)

“God has permitted trafficking, and forbidden usury” (Qur’an 2:275)

The central concept in Islamic banking and finance, as with many aspects of Islamic society, culture and legislation, is justice. In this instance, justice is achieved predominantly through the sharing of risk (International Monetary Fund, 2010). In terms of the methods by which Islamic banks generate revenue, deposits are made by investors and then invested in a manner similar to a commercial investment bank. Those who have deposited their savings then share the profits or losses resulting from the investment. While outright speculation is not permitted within Shari’a law, this type of co-operative venture capitalism is seen as enabling enterprise and, as such, is permissible (Prenzlin 2009).

Mortgages are a prime example of one of the most common lending scenarios within contemporary retail banking practice from a consumer perspective. In such an instance, the risks are shared between the bank and the borrower in Islamic banking,
frequently under a diminishing Musharaka, or partnership contract (Prenzlin 2009). The applicant and the bank form an effective partnership, with the bank providing the bulk of the equity and the borrower a percentage which in a commercial banking scenario would be classed as a deposit. The borrower then buys out the bank’s share of the partnership over a pre-defined period, through profits made on rental income for the property, although the borrower is usually the rental customer. In most cases, the borrower is effectively paying rent to him or herself, and then paying a proportion of that rent back to the bank in accordance with the bank’s percentage capital share of the partnership at the time (Prenzlin 2009).

The bank (and therefore the depositors who have entrusted their money to the bank, and who are effectively partners in the purchase of the house) makes gains through the profit from the rent, which is usually effectively paid by the borrower, as they normally live in the home they are purchasing through the bank. Should the borrower default on either the agreed rent or the principal partnership agreement itself, then the bank may elect to provide the borrower with an interest-free loan to enable him or her to continue making the agreed payments on the understanding that they will pay in full when they are able to do so (Prenzlin 2009). This does not mean that Islamic banks do not assess credit risk – in fact, they are usually more risk-averse than many commercial banks when making lending decisions (Prenzlin 2009) (Labib 1969).

Prenzlin (2009) simplified the definition of Islamic banking as, effectively, “a system of banking without interest”, is elaborated-on in what is arguably the most widely quoted paper on the subject, Professor Siddiqi’s ‘Banking Without Interest’. Originally published in 1963 in his native language (Urdu), the paper has been translated into a number of languages, the most recent and most peer-reviewed edition being released in 1983 in English.

Siddiqi outlined the first model of an interest-free economy which is one of very few models that comprehensively addressed the micro and macroeconomic functioning of a system of economics based on profit and loss sharing (PLS) in place of interest within the institutional framework of a market economy. Within this model, the market economy is comprised of private entrepreneurs and private PLS banks and has no public sector/government interference into and planning of the capital formation and allocation (Siddiqi 1963) (Iqbal and Llewellyn 2002).

### Islamic and Conventional Economics

Conventional and Islamic systems of economics have slightly different foundations. Contemporary conventional economic practice is a banking-based system, whereas a Shari’a-compliant system of economics is based on a more traditional ‘market-based’ system of the trade of goods and services, augmented by Qardh Hassan (benevolent loan). The financing needs of businesses are met through trade contracts of various types. These included sale contracts involving deferred payment options or the provision of advance payments, in order to enable businesses to supply their customers without credit on which interest was payable. This could be considered a more ‘middle ages’ approach, but it is a method of meeting financing needs through the market without the need for interest-bearing loans (Khan 1987).
The overriding feature of the Islamic economic system is that it has ethical practice as its cornerstone (Obaidullah 2005). The Shari’a system seeks to fulfill the purpose of a system of economics from the point of view of facilitating the transfer of funds from points of savings surplus to points of savings deficit within the economy, whilst avoiding the use of economic instruments which are contrary to the Islamic faith.

Economic policy outside of the Islamic World has been dominated by two seemingly mutually-exclusive philosophies – those of capitalism and socialism. Socialism is based on the principle of “from each according to his ability, to each accord to his need”, as promoted by Marx in his 1875 ‘Critique of the Gotha Program’ (Marx 1970). Communism is a variation on the same economic concept of socialism, the movement towards an economic structure founded within a classless society based on common ownership of most property. Conceptually, Marx upheld communism as a final stage in the evolution of society into what he championed as a classless and egalitarian utopia (Marx 1970). Whilst attempts have been made in several countries to operate such a regime, including the former Soviet Union, Cuba and most of Eastern Europe, these attempts never culminated in what Marx described as a ‘pure communist society’, instead usually devolving into totalitarian regimes (Keegan 1992).

While much as the Western world has upheld communism as a ‘failed social experiment’ (Keegan 1992), capitalism as practiced in most of the Western developed World cannot be said to be without inherent difficulty. Capitalism is a system of economics which is controlled by private and corporate ownership, and a mixture of government regulation and free market economics with its associated rules such as the law of supply and demand (Williamson 1998). There are multiple variants of the capitalist ideology, from the low-tax, low-regulation style of Anglo-Saxon capitalism, favored in the USA and UK, the high-tax, high public spending format of Nordic capitalism (Rachman n.d.).

If communism is seen as an extreme by many societies, if only from a political perspective, then capitalism could also be said to have its own extremes. The Anglo-Saxon brand of capitalist culture is fond of the maxim ‘the market will regulate itself’. The concept behind the theory the market will effectively police itself is that people will effectively ‘vote with their feet’; that when a free market economy is in operation, people will make the choices which are best for them, and the businesses which provide what their customers want and do so in the most efficient way will thrive. In the same manner, when there is a free and open labor market, individuals will select the employer who provides the best pay and conditions. By the same token, it is also assumed that investors will select the companies that are sufficiently capable to provide them with the best returns on a long term basis (Titmuss 1974).

‘A free market economy’ is to capitalism what communism is to the socialist movement: the absolute in capitalism, with no government R&D or agricultural subsidies, regulation or import/export tariffs; and no welfare state. In addition, such a market does not take into account any other factor, such as the use of natural resources or the effects of pollution.

Schumpeter (1943) made a case for the failure of socialism clearly, postulating that the concept of socialism, whilst ideologically attractive, is contrary to the natural self-interest ingrained in humanity. And suggesting that the existence of a large and far-
reaching welfare state encourages wastage in government, and acts as a disincentive to work hard and act responsibly. He also considered it to be detrimental to entrepreneurship and innovation. Almost 70 years after first publication, his word is still considered to be a required reading in the field of social economics, and his proposals certainly seem to be borne out in actuality if you consider those economies which have espoused communism previously, including the former Soviet Union, much of Eastern Europe, African nations such as Ethiopia, Congo and Somalia, and Totalitarian regimes (current and previous) such as North Korea, Burma and Kampuchea/Cambodia (Aneki.com).

Whilst capitalism has historically led to negative elements and exploitative practices such as child labor, long working hours and other forms of worker exploitation, and even the slave trade; the more contemporary negative elements of capitalism have become more visible in recent times. These include market instabilities, short-selling, the boom and bust economic cycle, unemployment and perceived inequities (Posner 2009). These have been further highlighted by the ‘Occupy’ Global movement throughout 2011 and onwards (Thompson 2011).

In practice, all modern systems (excluding the few remaining totalitarian states) involve elements of capitalism and socialism to varying degrees, in what is known as ‘social market economies’. These are a form of economic liberalism characterized by fair competition in private industry, the maintenance of low levels of unemployment, good working conditions and social welfare for all, alongside substantial public services. All of these are provided through government intervention, as espoused by Waelde and Gunderson (1994).

The Islamic economic system is distinct from both of the conventional philosophies, although it has often been referred to as ‘socially responsible capitalism’ (Sairally 2007). Whilst communism and capitalism in their pure forms are absolutes, Shari’a finance is upheld by Obaidullah (2005) as a ‘middle way’ – an option without extremes, where the individual choice and freedom of capitalism are tempered with moral regulations which prevent the more exploitative elements of capitalism without recourse to legislation, whilst providing the impetus to succeed not seen with socialist regimes.

The key guiding principle in the Islamic system of economics is Falah, which describes a state of both happiness and prosperity both in this life and the hereafter. Shari’a finance accepts the capitalist principles of supply and demand, and also acknowledges the right of the individual to own personal property and to make a profit, but these rights are tempered with certain conditions.

These conditions are governed by ensuring that the business dealings of the individual are in agreement with Islamic law, such as ensuring that the individual is not involved in businesses which trade in products and services contradictory to Islam (such as alcoholic drinks, pornography, tobacco, pork products or armaments). They are also linked to the core Islamic belief that mankind has sufficient resources to fulfill his needs, and therefore it can only be through either a lack of effort or through greed that everyone will not have enough (Institute of Islamic Banking and Insurance 2011) (Khan 2008).

Dr Fahim Kham, President of the Islamic society for Institutional Economics, produced a paper as a response to the Global banking crisis, in which he argued that
the crisis demonstrated the need for a system of -or similar to- a Shari’a compliant system of Global economics. His argument centers around the concept that the market itself is the place best suited to generate and maintain a financial system to suit its own needs. He provides the example of retail and wholesale businesses which provide their customers with non-interest bearing finance in the form of accounts. He also proffers the concept of the ‘forward sale’, or Bai’ Salam, as a model of a non-speculative economic instrument (Khan 2008).

A forward sale, also known as a forward contract or just a forward is a purchase/sale agreement where the price is set at the time of the agreement, but the effective sale is postponed to a specified point in the future (Hull 2006). As applied to Islamic economic practices, a purchaser would effectively promise to buy a commodity at an agreed point in the future, paying a price normally under the market value for the goods with the money changing hands at the time of the agreement, but the actual sale taking place at the time of delivery, which is deferred until a pre-agreed date in the future. In such a way, a grain merchant could agree to buy a farmer’s stock of grain once it is ready at a time before it is grown. A farmer could then use the money paid for the ‘forward sale’ to purchase seed and pay wages to grow the grain. The sale would then complete when the grain is delivered, and the merchant could then make their profit by selling the grain to a third party, such as a mill. This type of agreement is covered by Bay al-salam, or a Salam contract (Kreatoc n.d.)

The purpose behind the forward contract is that it removes the requirement for two key economic instruments which are forbidden under Shari’a law: the payment of interest and market speculation, as the payment for the goods in a forward sale is fixed at the time of the agreement, and no credit is granted, as no formal sale takes place until the goods are delivered (Khan 2008).

The Development of the Principles of Islamic Finance

The development of Islamic finance has been a long process, developed over many hundreds of years and, as with all processes by which people interact, it has developed in accordance with the needs of the people involved and the societies and civilizations in which it takes place. Of all the World religions, Islam is the only one whose laws require a specific banking and financial system. While some other religions have comparable ethical standards, including Christianity and Judaism, their religious laws do not prescribe a specific financial system. Historically, however, this was not always the case. ‘Usury’ was forbidden by law in many countries in the past. During the middle ages, Catholic ‘Canon’ law banned the charging of interest, but this only applied to Catholics. While the Torah (the Jewish holy book) also forbids the charging of interest, this is interpreted as a rule for transactions carried out between Jews, leaving Jewish people free to lend money to others outside their faith. This interpretation provided Jewish money lenders with the ability to effectively create their own market in Catholic countries (Algaoud and Lewis 2001), famously becoming western society’s moneylenders.

The Western style of commercial banking in the form in which it is recognized today was a product of the Industrial Revolution. This, combined with the publication of Adam Smith’s ‘The Wealth of Nations’ in 1776, was the impetus for the creation of a formal system of banking and financial services. Prior to this point, basic and local
financial services were provided by merchants, goldsmiths and the aforementioned moneylenders (Kohn 1999).

The Birth of Islam was the life of the Prophet Mohammad from 570 to 632 AD. After the Prophet's death in 632 AD, the leadership of the Muslim people passed to Abu Bakr, referred to as the first of the four 'rightfully guided' Caliphs. Over the course of the following five hundred years, Islam continued to expand and spread through the sub-Saharan African region, across and Asia Minor, and across the Mediterranean to Southern Spain (Hallaq 1997). Islam as a World Power reached its peak around the ninth century AD, and continued until around the thirteenth century. During this time, Islam represented "The greatest military power on earth – its armies were at the same time invading Europe, Africa, India and China. It was the foremost economic power in the world, and it had achieved the highest level so far in human history in the arts and sciences of civilizations (Lewis 2002)".

From around the mid 1500’s, the Islamic civilization’s learning and development began to be overtaken by that of the West. The fall of Constantinople to the Turks in 1453 led to the departure of many Byzantine scholars, most of whom relocated to Rome or other European cities (Runciman 1965). Armed with all the learning of ancient Greece from their own libraries, they were the catalyst for a European rebirth of learning which eventually led to the Renaissance. The fall of Constantinople was not the sole reason for the decline of the Islamic civilization, but rather a ‘last straw’ in a series of events over a period of time. The invasion of the Crusaders, and particularly the Mongols into Islamic territories from the 11th to the 13th centuries were key turning points in the course of Islamic civilization, also. When the Mongols invaded, they destroyed scores of Muslim libraries, hospitals, observatories and universities, until they reached and sacked Baghdad, which was at the time the Abbasid capital (Hodgson 1977).

International conflicts and resultant displacement notwithstanding, science and learning were already in decline in Iraq, Al-Andalus (modern-day Spain) and the western parts (North-West Africa – including present-day Tunisia, Morocco, Libya, Algeria and Mauritania) by the late 1300s, as conflicts between Sunni and Shi’a Muslims took precedence over ongoing education (Khalidun 1967). At the time of the decline of knowledge and innovation, the Islamic World also entered into a period of economic decline. This was fostered by a range of economic problems which would not be out of place in today’s economic world - corruption, greed, spiraling taxation, oppression, and nepotism (Khalidun 1967). Many observers from the Muslim World took an active interest in the developments of the European renaissance, principally in innovations in weaponry, new shipbuilding techniques and advances in medicine and medical practice. Despite this interest, they were unable to either realize the socioeconomic reforms or appreciate the elements responsible for the renaissance period, which prevented the Islamic World from replicating this period of development and advancement.

As with all World religions, Muslims are governed by a series of religious laws. Islamic law is known as Shari‘a, which translated literally is ‘the path that leads to the spring’, or figuratively ‘a clear path to be followed and observed’. Islamic law has a variety of sources, which can be categorized (in order of provenance or priority) as primary and secondary sources, and minor or subsidiary techniques.
The most important source of Shari’a by far is the Holy Qur'an (which means ‘The Recitation’), which is the Muslim holy book – a collection of revelations to the Prophet Mohammad. Approximately 500 rules or decrees are contained in the Qu’ran, of which 20 concern economic matters (Doi 1989). In addition to the Qu’ran, the Sunna or Hadith are also considered to be primary sources.

The first of the secondary sources is Ijamaa. This means ‘consensus’ which, in this context describes the informed consensus of the community of scholars. The application of consensus is designed not for application in fundamental matters of faith, as these are already agreed, but for decisions on the application of Shari’a in contemporary scenarios. This is of particular relevance concerning finance, as there is no reference to suitable models of Islamic banking in either the Qur’an or in the Hadith, the primary sources of Shari’a. For this reason, the development of the Islamic system of banking has mainly been developed through the consensus of modern Muslim scholars at both national and international levels.

The second of the secondary sources is Qyias, or analogical deduction. This is where scholars use analogies from existing law to make judgments. The third of the secondary sources is Ijtihad, which is individual interpretation. This is where individuals use their own reasoning and judgment to decide whether a particular course of action is in line with the spirit of the Holy Qur’an and the Hadith.

Finally, there are the subsidiary techniques, or minor sources:

- **Istihsan** - juristic preference. This refers to the exceptions that can be made to an otherwise strict or literal legal judgment. Istihsan can be applied to any method, and does not provide a single or definite response.

- **Istihlah** - Public interest. This means 'seeking the good' in literal terms (Ramadan 2004) or taking public interest into consideration.

- **Urf** – Custom. This refers to the recognition of customary practice (within reason). This is not accepted by all schools of thought and would only be used in practice in the absence of a more prestigious alternative, such as scripture.

- **Darura** – Necessity. This is a method of creating exceptions to the law in times or situations of absolute necessity. This is the mechanism by which an individual is permitted to carry out an action which would normally be against Shari’a, such as eating a forbidden food such as pork, or to carry out an otherwise impermissible action if it is the only way to preserve the individual’s life at the time. It would be for the individual to decide what would constitute a legitimate case of Darura.

The Qur’an and the Sunna are the primary sources of Islamic law – they are Shari’a in its most narrow sense, as they are considered to be the word and the will of God and, as such, to be both infallible and immutable. However, given the sheer length of time since these writings came into being, there are many contemporary issues which require judgment on which ancient law cannot be used, simply because the situation to which they refer did not exist at the time the law was prescribed. In addition, both
texts have elements of their phrasing which are open to interpretation. It is in these circumstances that secondary sources of law are used.

Imam al-Shafii (the founder of the renowned Shafii School of Law) cited in the early ninth century that human reason should be considered to be the final judge on matters not directly governed by the Qu’ran. He approved two secondary sources of law: *Ijma*, or consensus, and *Qiyas*, or analogy. In concert with the primary sources of the Qu’ran and Sunna, these form the four principal *usul al-fiqh* or the ‘Fundamentals of Jurisprudence’.

From very early in Islamic history, Muslims established the basis of a financial system without interest in order to manage resources to facilitate the financing of commercial activities and the fulfillment of consumers’ needs. The original pre-Industrial Revolution method of financing business transactions was generally based on profit and loss sharing. Versions of *mudarabah* (a passive partnership agreement) and *Musharaka* (an active partnership agreement) were used, in addition to deferred trading and *Qarad hassan* (a basic form of interest-free loan) were utilized to finance both business transactions and the purchases of end users.

The system was very successful over the course of Islamic civilization. These systems changed very little throughout several centuries. The initial Islamic financing models of *Mudarabah* and *Musharaka* proved sufficient to facilitate the needs of the entire Islamic civilization, from the financing of agriculture and manufacturing to long-distance trade agreements.

After the decline of the Muslim civilization as discussed previously, Western institutions replaced most of the existing Islamic arrangements, including the Islamic systems of rudimentary financial services provision. Given the point in history where Muslim civilization collapsed, it was the Western systems of financial management which were in place at the time of the Industrial Revolution, where the face of financial services changed irrevocably to service the growing trade and the swiftly developing industrial economies formed by the advances in technology and innovation of the age.

After the Industrial Revolution, global economic development continued from the point it was established, namely using the western systems created during the period of rapid industrial development. Despite this, there remained numerous independent Muslim states. The revival of Islam after the Second World War refocused the Muslim World on its desire to reinstate most of its lost institutions, of which an effective Shari’a-compliant financial system was a key priority.

**The Development of Modern Islamic Banking**

While the foundation for a Shari’a-compliant system of finance had been laid centuries in the past, as described above, the turning point for the establishment of a modern comprehensive system of Islamic finance and, more specifically, Islamic banking, came in the 1960s (Iqbal and Molyneux 2005). The first Islamic bank within this contemporary system was launched in Egypt in 1963. The *Mit Gharmr Savings Bank* was created by Dr Ahmad El Najjar, a leading Egyptian economist. The bank operated through a system of profit sharing, providing savers with an incentive to deposit funds without resorting to the payment of interest. This institution was
modeled on Sparkessen (or ‘Savings Bank’) in Germany, which used profit-sharing techniques in order to finance small, rural commercial enterprises.

By the end of 1976 the bank had expanded to include 9 branches throughout Egypt. These banks neither paid interest on savings nor charged interest on debts. Their business activities were generally limited to market sectors where they had direct investments, or where they had entered into partnerships with depositors.

For this reason, these early institutions were operating more as investment institutions, rather than as commercial or retail banks. In 1971, Nasser Social Bank became the first ‘high street’ bank in Egypt which operated according to Islamic financial principles. However, the institution’s charter made no reference to Shari’a principles.

The concept of an Islamic bank was then rationalized in the early 1970s, when the First International Conference on Islamic Economics, organized by King Abdul Aziz University in Makah, Saudi Arabia, was held. The first bank explicitly based on Shari’a principles was established soon after this conference by the Organization of Islamic countries (OIC) in 1974, known as the Islamic Development Bank (IDB). The bank’s primary role was with intergovernmental activities and provided the funds for development projects within OIC member countries. The business model for the bank was based on profit sharing financial assistance for projects, with profits generated through charging fees for financial services.

Shortly after this, the first ‘commercial’ Islamic Bank, the Dubai Islamic Bank (DIB), was launched in the UAE (Iqbal and Molyneux 2005). This was swiftly followed by the establishment of the Islamic Development Bank (IDB) in Jeddah, Saudi Arabia. The formation of these institutions coincided with the rise in the price of oil which was a key feature of the Middle Eastern economy in the 1970s; which led to the accumulation of oil revenues in several oil-rich Muslim countries, chiefly Saudi Arabia, the UAE and Kuwait, among others. This oil revenue, or ‘petro-dollars’, as it came to be known, provided a powerful incentive to create suitable investment opportunities for Muslims wishing to make money from investments, but also wishing to comply with Shari’a. The sudden wealth of a significant group of Muslims provided the incentive to take what was at the time merely the conceptual entity that was interest-free or Islamic banking, and turn it into a viable business model or, at the very least, a sufficiently powerful business case to warrant further market research and development.

After the initial pioneering work, many private and semi-private commercial Islamic banks were formed in Egypt, Sudan, Kuwait, Bahrain, and other Islamic countries. It was at this point that Islamic banking was recognized as a feasible and viable alternative to traditional commercial financial institutions (Hasan and Lewis 2007). Use of Islamic banking practices is no longer limited to Arabic and Muslim countries, but has furthered its reach:

“From East to West, all the way from Indonesia and Malaysia towards Europe and the Americas...Many conventional banks, including some major multinational western banks have also started using Islamic banking techniques” (Siddiqi, 1983)

Deregulation in the 1980s and 1990s across the Western economies of Europe and the USA provided a great opportunity for Islamic banking, fostering as it did the
development of a range of bespoke Shari’a-compliant products. Prior to this, Islamic banks’ product ranges were somewhat narrow. With the removal of the ‘red tape’ on the types of products that financial institutions were able to create, bankers were free to devise a vast array of financial products tailored to every customer need, both religious and secular.

Since Siddiqi’s (1983) observation, Islamic banking has continued to grow exponentially and is far from an anomaly, but has demonstrated its capability to not only present a realistic alternative to traditional forms of commercial banking (Ariff 1988); but has also established itself as a system which contains many unique principles which could benefit the stability of commercial banking if applied (Landen, 2009; Totaro, 2009).

The world of commercial banking appears to be acknowledging these developments, as many global commercial institutions have started to offer Sharia-compliant products. The assets of financial institutions offering these services have soared by almost 25 percent year-on-year over the past decade to about 300 billion USD today, and they are projected to reach 1 trillion US Dollars by 2013 (Infosys 2009). Part of this increase has been attributed to Islamic finance being viewed on the global stage by many (often non-Muslim) investors as a way of ensuring an ‘ethical’ banking solution (Brownlow 2009).

In more recent times, the Islamic banking sector’s growth has accelerated dramatically. There is a combination of factors behind this trend. The impact of continuously rising oil prices and the resultant boom in the economies of the Gulf region is the most immediately apparent factor, which is enhanced by levels of excess liquidity, which has increased the demand for a wider variety of financial products. These factors are coupled with a phenomenon which could be described by the ‘September 11th Effect’. This concept is a combination of growing nationalist and religious emotionalism which has been building as a result of the launch of the ‘war on terror’ by the USA. This increased religious fervor has heightened demand for Islamic financial products. In addition, the crackdown on many Islamic financial institutions and charities, and the freezing of the assets of many Middle Eastern individuals following the events of September 11th led to many Muslim investors removing a significant proportion of their liquid assets out of the United States.

This more recent oil boom differed from the oil boom of the 1970s in that more of the resultant revenues are remaining within the Islamic World, as opposed to being utilized to purchase imported goods. Furthermore, globalization has an impact on the World of Islamic banking, with the convergence between the Arab and Malaysian models of Islamic finance. This in turn has led to a rationalization and harmonization of the format of Islamic banking.

**Islam Based Banking**

**The Islamic Banking Movement Worldwide**

While the Key elements or markers of Islamic banking are similar across the World, particularly since the rationalization of the format, there are subtle differences across the Globe. Shari’a-compliant banking may have its root in nations which have a high percentage of Muslims within the population such as Egypt, Saudi Arabia and the
United Arab Emirates, but there are Muslims living in most countries around the World. In many countries, there is a sufficient Muslim population to make the introduction of Shari’a-compliant banking commercially viable, either through dedicated Islamic banks, Islamic products offered within standard commercial banks, or both.

**Banking Models in the Gulf Region**

The majority of commercial banks in the nations which comprise the Gulf Co-operation Council (GCC) are small to medium-sized domestic-branded banks, which have localized operations and high credit exposure in retail and corporate sectors (Pandey 2006), with several region-wide banks, of which around 40% are subsidiaries of Global institutions (IMF 2010). Banks in GCC countries have a relatively short history of reporting information on their core business. A cultural tendency throughout the Middle East towards corporate secrecy, coupled with a low level of existing infrastructure to facilitate the collection and analysis of such information collectively leads to a scarcity of risk data in the banking sector.

Throughout the nations of the GCC, Islamic banking is practiced in two ways; as dedicated Islamic banks operating within the private corporate sector and also with individual Islamic products offered by conventional commercial banks (Ahmed, Khan and Iqbal, 1998; Khan, 1987). There are 23 leading Islamic banks operating within the GCC. Between them, they account for total assets in excess of $125bn, which equates to 25% of global Islamic banking assets (Ameinfo 2008). 35% of all purely Islamic banks across the World are located within the GCC (Infosys 2009).

In addition to the considerable Islamic banking network, some existing commercial banks offer a separate ‘brand name’ under which they offer Islamic banking services, such as HSBC’s ‘Amanah’; whereas other conventional commercial banks provide branches which offer purely Islamic services, such as the ‘Samba Financial’ branches (formally known as the ‘Saudi American Bank) which are part of the Citibank group in Saudi Arabia (although it now has branches outside the Kingdom). Other institutions are entirely Shari’a-compliant, such as Sharjah Islamic Bank in Kuwait (Infosys 2009).

The highest proportion of Shari’a-compliant bank deposits of any country in the GCC is in Qatar, where 20% of total banking deposits are made into Shari’a-compliant accounts. Qatar recently enacted a law which banned commercial banks from offering Islamic products, which has been seen by many as a method of giving formal Government backing to Islamic banking, and promoting the use of Islamic banks within the nation (Saudi News Today 2011). In Saudi Arabia, deposits made into Islamic banks grew year-on-year with an annual growth rate of 17.4% from 2002 to 2005, compared against a rate of 12.9% for the banking sector as a whole across the Kingdom in the same time period. Of the GCC countries, Saudi Arabia has the highest Muslim population at 97%, compared to 95% in Kuwait, 87.7% in Oman, 81.2% in Bahrain, 77.5% in Qatar and 76.2% in the UAE (Pew Research Center 2009).

Given that the vast majority of the population of each of the Gulf nations is Muslim; this begs the question as to why Islamic banking does not represent a much higher ratio of overall banking either in terms of the asset held or the number of branches established, especially as Islamic banks are also open to non-Muslim customers. Hasan Al-Tamimi (2010) argues that, if one were to take the simplistic approach and
assume that all Muslims wish to adhere to Shari’a without exception, and that all Muslims will want to use Islamic banking facilities to facilitate this adherence, then (while the relative wealth of each individual cannot be assumed, and so no assumptions can be made concerning the level of deposits) it should be the case that the number of Islamic bank branches should be roughly equal in percentage terms to the percentage of Muslims living in the country in question.

Hasan Al-Tamimi (2010) uses this simplified illustration to raise two questions. Firstly, why are there not more Muslims, particularly in the GCC nations where Islam is the majority faith, using Islamic banking facilities? Secondly, if only on the basis of the potential customer base available, Islamic banks should have significant opportunities to expand their businesses, in all the Gulf States, attract a significant number of additional customers and subsequently open more branches throughout the region. (Hasan Al-Tamimi 2010). As he, so succinctly, queries, there must be a reason for the apparent reticence of many of the Islamic community in the GCC region to use Islamic banking facilities. It is the responsibility of the sector to isolate these reasons and deal with them, in order to strengthen its position and grow its market share closer to what could be considered to be expected levels.

Islamic Banking outside the Gulf Region

Just 40 years since its contemporary inception, Islamic banking is now a worldwide phenomenon, with Islamic banks in over 60 countries across the Globe (Akhtar 2007). The nation with the most involvement in Islamic banking outside the Gulf region is Malaysia. Islam is the most frequently practiced religion in Malaysia, and 61.4% of the population is Muslim (Pew Research Center 2009). The first instance of Islamic banking in Malaysia was in 1963, when the Perbadanan Wang Simpanan Bakal-Bakal Haji was formed as a savings organization to allow Muslims to save in order to take part in the Hajj (pilgrimage to Mecca). The full first Islamic bank was opened in Malaysia 1983. Ten years later, conventional commercial banks were first legally permitted to offer Islamic banking options to customers, on the proviso that funds accumulated through Islamic banking products and transactions are kept separately from those from the institution’s conventional banking activities to ensure that the two types of business are operated completely separately (Ahmad 1997).

At present, Malaysia is a venue which is foremost in the development of Islamic financial products. Islam in Malaysia is practiced largely according to the Shafi’i school, and practice of Shari’a-compliant finance in the Malaysia has some features which differ from other nations. It was in Malaysia that bay’ina transactions were first developed. Bay’ina literally means ‘double sales’, and is the name given to a transaction where an individual sells a product for cash and then buys it back from the same purchaser at a higher price in exchange for deferred payment. The net result of the transaction is very similar to the Western practice of pawn broking. This is permissible in some schools of Islamic thought, but others consider this type of transaction as hila (a ruse or legal artifice) to circumnavigate the prohibition of Riba, or interest (Warde 2007).

Another financial product presented to investors which is unique to Malaysia is bai al dayn. This is the name given to the trading of existing debt on the secondary market, under the auspices of sukuk al ijarah, otherwise known as ‘certificates of leasing’. This is limited to the trading of documents evidencing debt which has arisen from
bona fide commercial transactions. Outside of Malaysia, this financial instrument is generally considered to be non-compliant with Shari’a law (Warde 2007).

In direct contrast to the gradual process of the introduction of Islamic banking in Malaysia and the creative process of product development, Islamic banking in Pakistan had a very different style of introduction. Pakistan was created as a Muslim nation, and 96.4% of its population is Muslim (Pew Research Center 2009). Pakistan made an initial attempt to Islamize their banking system in the 1980s, through legislative means. From 1981 onwards, separate interest-free counters began to operate in all the nationalized commercial banks, while legislation began to be introduced prohibiting banks from certain types of interest-based activities.

Finally, a law to eliminate *Riba* from the banking system in its entirety was introduced in 1984, and all commercial banking in Pakistani Rupees was made interest free in July 1985. Following the implementation of this legislation, profit and loss sharing deposits grew from 9.2% of all deposits at the end of 1981 to 61.6% of all deposits by the end of 1985. However, the roll-out was not without difficulty. The suddenness and the totality of the requirements led to difficulties in making the change. Akhtar (2007), writing as the Governor of the State Bank of Pakistan, put forward the following advice for other nations seeking to take a similar path to Pakistan. Some key lessons emerge from Pakistan’s experience of 1980s. He recommended allowing businesses to take an evolutionary, rather than revolutionary approach, allowing them time to understand the changes and accept them. Being more flexible to the needs of a dynamic marketplace was also seen as a ‘lesson learned’. He also stated that ensuring public confidence was vital as part of the process, as ensuring that all stakeholders in the change are sufficiently prepared and equipped prior to the implementation of the changes (Akhtar 2007). This advice could be useful not just in a scenario akin to that of Pakistan, where an entire National system was changed by rule of law, but also where a Government wished to encourage changes within an open marketplace, as happened in Malaysia.

**Islamic and Commercial Finance Outside of the Banking Arena**

The main element of financial services outside of the banking system is the provision of insurance. From an Islamic standpoint, insurance is a method of risk-sharing and not a form of speculation. This is explained very clearly by Obaidullah (2005) who asserts that, as insurance facilitates transfer of pure risks and not speculative risks, it is permissible in Shari’a. Obaidullah (2005) notes the key difference between pure risks and speculative risks being that pure risks can only lead to an outcome of loss, whereas speculative risks provide the possibility for gain.

In addition, Obaidullah (2005) is emphatic in his insistence that the concept that using insurance policies is un-Islamic, owing to the belief that Muslims should live in a state of total dependence on God, known as *tawakkul*, leading to the idea that insurance has no place in Islam, as a misconception; putting forward the counterargument that holding insurance does not seek to change the will of God, and that seeking to minimize risk is entirely within Muslim culture, and merely based in common sense (Obaidullah 2005).

However, insuring for profit as the provider of insurance opens up the problem if speculation, which is forbidden in Shari’a. The point which makes insurance a problem in Shari’a, as defined by Obaidullah (2005), is where it is implemented as a
‘buy and sale’ contract between two parties – as it is with conventional insurance policies. The Shari’a-compliant alternative is Takaful ta’awuni, which is a cooperative arrangement involving a group of people in similar positions, whereby the members of the scheme agree to guarantee or protect each other from pre-agreed types of scenario through the creation of a fund created from their pooled resources.

**Conclusion**

Conventional and Islamic banking have numerous similarities, and also, have fundamental differences. This paper intended to highlight the origins of the two systems, and compare them.

A possible extension to this work is a research that would compare the two applications, not from a theoretical, but from a practical / applied point of view.

Also, a comparison of the performance of each system under different circumstances would shed more light on their advantages and disadvantages.

**References**


