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Islamic finance

Perhaps the "assertion of Islamic economics ... that interest is patently un-Islamic ... sanctifies opposition to global economic integration."[1] On the other hand, Islamic banks compete with conventional banks in the international banking system and thereby help to integrate parts of the Muslim public into the global order. As Timur Kuran observes in chapter 19, "the very fact that these banks have maintained profitability for so long and attracted vast deposits proves that they have been filling a need," namely for Muslims, perhaps the majority of them,[2] who perceive the interest paid on conventional bank deposits to be *riba*, which Islam forbids.

Islamic economics may have originated in the 1940s, as our colleague suggests, as part of the effort to justify an Islamic nation on the Indian subcontinent, but their prime institutional embodiment, the Islamic banks, originally took root in other contexts, after a short-lived effort in rural Pakistan in the late 1950s. The newly independent government of Malaysia sponsored a Pilgrims Saving Corporation in 1963 that served as a precedent for creating the country's first Islamic bank in 1983. In Egypt, also in 1963, Dr. Ahmad al-Najjar, who had studied in Germany, established a system of rural privately owned cooperatives based on the German *Sparkassen*. Although other Egyptians involved in these banks may have been associated with the Muslim Brotherhood, in part explaining the collapse of the experiment in 1967, Najjar does not seem to have been affiliated with any form of political Islam. Only in the loosest sense could Islamic banking be related to the theories of Sayyid Abul A'la Al-Mawdudi (1903-79), the Pakistani Islamist who had advocated "Islamising" economics along with other aspects of social life. The bankers were also attempting to liberate Islamic jurisprudence from the colonial closet of family law, albeit only in this very narrow, yet strategic domain of banking.

Their enduring financial experiments, moreover, marked an alliance of their private sector owners – princes, merchants, and financiers -- not with Islamist politicians but rather, at least in most countries except the Sudan, with the mainstream religious *'ulama* whom the Muslim Brothers and other more radical political Islamists usually opposed. Although the first of the banks to be established, the Dubai Islamic Bank in 1974, did not have a religious advisory board until 1999, those that followed proved their Islamic credentials by selecting recognized 'ulama to be members of their shari'a boards. As Moncer Kahf explains, Prince Mohammad Al-Faisal initiated the practice in Egypt in 1976. He forged an alliance with a former mufti of Egypt in order to gain President Anwar Sadat's favour and a special law to establish the Faisal Islamic Bank of Egypt. Salah Kamel, a Saudi businessman, took the prince's lead. He and the prince established competing (and cooperating) transnational networks of Islamic banks, the Al Baraka Group and Dar Al-Mal Al-Islami, respectively. As they developed their networks across the Muslim world, they sought out the 'ulama because "unlike other Muslim intellectuals, the *shari'a* scholars have close contacts with businessmen with small and medium-sized

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[1] Timur Kuran, *Islam and Mammon: the Economic Predicaments of Islamism* (Princeton 2004), ix

[2] Frank Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religiion, Risk, and Return* (The Hague, London, Boston: Kluer Law International, 1998), 25.

firms and middle-income earners from whom the clientele of Islamic banks is to be derived."[3]

As these private sector groups were forming, the Islamic Development Bank (IDB) also, almost by accident, developed into an "Islamic" bank. Founded as a consortium bank owned by the members of the Conference of Islamic States, it was to be a regional development bank like those of Africa, Asia, or Latin America. But an unlikely founding committee of Algeria, Saudi Arabia, and Somalia, none of whom would tolerate Islamic banks at home until the late 1980s, determined that the new bank should operate not just for Muslim states but, with some encouragement from Dr. al Najjar, by the rules of the *shari'a*. Like the Dubai Islamic Bank it consulted scholars on an ad hoc basis to gain some understanding of what these rules might be, and it worked closely with the Faisal and Baraka groups. The IDB finally acquired a board of *shari'a* scholars in 2003.[4]

Joined in 1979 by the Kuwait Finance House, which was 49 per cent owned by government ministries, the nucleus of Saudi-owned transnationals rapidly invested with other partners in much of the Muslim world, albeit not in Saudi Arabia (or Morocco, for that matter), where any new institution claiming an "Islamic" distinction might reflect adversely upon the ruler's legitimacy. In its core areas of strength, however, the movement faced hard times in the mid-1980s. The Kuwait Finance House, like the conventional banks, had to be rescued by the government in 1984, in the wake of the Souk al-Manakh crisis. In Egypt, so-called "Islamic" fund management companies devised pyramid schemes that collapsed with the devaluation of the Egyptian pound in 1987-88. Although the Faisal Islamic Bank was not associated with these schemes, it lost a quarter of its total assets with the collapse of the rogue Bank of Credit and Commerce International (BCCI) in 1991.

Evidently Islamic banks could attract funds as long as they could distribute profits to their "investor"-depositors that were competitive with interest rates offered by conventional banks. But Islamic banks did not have a sufficient array of investment instruments in these early years to generate the necessary revenues to fund their depositors, unless they engaged in risky commodity trading or parked their funds with other institutions such as the BCCI. Their principal instruments were the *murababa*, a contract whereby the bank purchases a good for the client and sells it to him on a deferred payment basis at cost plus profit, and *ijara*, or leasing, also for fixed returns. Some Islamic economists considered other instruments, such as *musharaka* and *mudaraba*, which were forms of equity financing akin to investment banking, to be more distinctively Islamic, but they were too risky to comprise more than 2 or 3 per cent of most Islamic banking portfolios. Profits stagnated by the late 1980s, and the market shares of these banks peaked at about 10 per cent in their strongholds, Egypt, Jordan, and the microstates of Bahrain and Kuwait. Only in Sudan, where they supported Hassan Turabi's rise to power (1989-1999), did they win a greater share of the deposits and total assets of a commercial banking system, all of which had been theoretically Islamized by decree in 1983.

Meanwhile, state sponsored Islamic banking in Pakistan and Iran produced only cosmetic changes in the respective commercial banking systems until 2000, when Iran

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[3] Moncer Kahf, "The Rise of a New Power Alliance," in Clement M. Henry and Rodney Wilson, eds., *The Politics of Islamic Finance* (Edinburgh: Edinburgh University Press, 2004), 22, 23.
[4] *Ibid.*, 21-22.

permitted privately owned Islamic banks to compete with the public sector. Pakistan, obliged by law to reorganize its "Islamic" system, permitted its first privately owned Islamic bank in 2002: the Al-Meezan Bank rapidly gained market share, and other banks opened Islamic windows.[5] So also in Indonesia, General Suharto supported the founders of the Bank Muamalat Indonesia (BMI) in 1989-1992 to gain support from Islamists in his bid to stay in power in the early 1990s prepare for elections.[6] BMI and Bank Syariah Mega Indonesia, reinforced by new Islamic windows of conventional banks, were aiming for two per cent of the market in 2005, and there were plans to establish Jakarta as a leading Islamic finance center, competing with Kuala Lumpur, Malaysia, and Bahrain.[7] In Turkey five "special finance houses," defined by a law passed in 1983 that Turkut Özal's staff had negotiated with Saleh Kamel, were fully integrated into the country's commercial banking system in 1999, survived the financial crisis of 2001, and grew more rapidly than their conventional competitors to gain over 4 per cent of the market by 2005.[8]

With the new surge in oil prices and revenues (1999-) Islamic banking consolidated its presence in global markets.[9] Efforts since 1990 to standardize Islamic financial instruments were bearing fruit. With encouragement from the IMF an Islamic Financial Services Board was established in Kuala Lumpur, headed by the former director of the Accounting and Auditing Organization for Islamic Financial Institutions, which remained in Bahrain. The Bahrain Monetary Fund took the initiative in 2000 to launch Islamic finance's first bond issue, and it was rapidly followed by Malaysia, the Islamic Development Bank, Qatar, Kuwait, Dubai, and the German state of Saxony-Anhalt. Project finance also assumed Islamic as well as conventional components, and Islamic investors were acquiring an ever larger menu of choices, sponsored by Citigroup and Hong Kong Shanghei as well as Islamic banks. Teams of London and New York lawyers worked closely with *shari'a* scholars to devise new packages.[10] The driving force consisted of Muslim investors, principally located in Saudi Arabia and neighbouring microstates, who were steadily Islamising their portfolios, diversifying away from the standards accounts of conventional banks to their new "Islamic" windows, admitted in Saudi Arabia in the mid 1990s after being instituted in Egypt a decade earlier. Despite initial concern that Islamic finance might fall victim to measures against Islamic terrorism in the wake of the September 11, 2001, attacks, the threat of sanctions may have driven some Arab-owned funds from North America and Europe into some of the newer "Islamic" investment vehicles.

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[5] International Monetary Fund, Pakistan--Financial Sector Assessment Program--Technical Note--Condition of the Banking System (May 11, 2005): http://www.imf.org/external/pubs/ft/scr/2005/cr05157.pdf

[6] Robert Hefner, "Islamizing Capitalism: On the Founding of Indonesia's First Islamic Bank," in Arskul Salim and Azyumardi Azva, ed., *Shari'a and Politics in Modern Indonesia*, 2003, 152-156.

[7] Shanthy Nambiar, Bloomberg News, March 2, 2005 (www.wwrn.org/parse.php?idd=9518&c=82).

[8] Ji-Hyang Jang, Taming Political Islamists by Islamic Capital: The Passions and the Interests in Turkish Islamic Society (Ph.D. diss., University of Texas at Austin, 2005), 158-165

[9] Kristin Smith, Islamic Banking and the Politics of International Financial Harmonization, in in S. Nazim Ali, ed., *Islamic Finance Current Legal and Regulatory Issues* (Cambridge, MA: Islamic Finance Project, Harvard Law School, 2005).

[10] For an illustration see Michael J. T. McMillen, "Structuring a Securitized *Shari'a*-Compliant Real Estate Acquisition Financing: A South Korean Case Study," in Ali, *Islamic Finance*

The original alliance of *'ulama*, princes, and merchants has opened up to international banks and lawyers that are reducing the transaction costs of being "*shari'a*-compliant" to meet the needs of global markets. Some critics argue that Islamic finance is compromising its ethics by mimicking international financial practices too closely. Others, in the tradition of the late Ahmad al-Najjar, argue that Islamic banks have lost their developmental impetus to service small Muslim businesses, for indeed (like conventional banks in most developing countries) they cater principally to wealthy individuals who place their funds outside the region.[11]

As Islamic finance is integrated into the global financial system, however, more Muslims acquire a stake in the system and greater familiarity with the logic of savings and investments, expressed in a shared vocabulary across the Muslim world and reaching into Europe and North America. As the enterprise grows, it may also spread the realization that the distinctively Islamic modes of finance that involve a sharing of business risks between principal and agent presuppose a transparent business environment, good corporate governance, and government accountability.[12] These banks may serve as economic educators, but they cannot generate private capital accumulation within their respective countries if investment climates remain precarious and investors dependent on political cronies for protection.

[11] See the essays, for instance, by Mahmoud A. Al-Gamal and Walid Hegazy, in Ali, *Islamic Finance*.
[12] Tarik M. Youssef, "The *Murabaha* Syndrome in Islamic Finance:Laws, Institutions, and Politics," in Henry and Wilson, ed., *The Politics of Islamic Finance*, 63-80.