UPDATE AND INTERNATIONALIZATION OF THE ISLAMIC BANKING ACTIVITY

Mariana NEGRUŞ, Prof. Ph.D.
Faculty of Marketing and International Affaires
Spiru Haret University

Abstract

The context of the financial crisis started has triggered a flow of funds towards the Islamic financial market, which has turned itself into an alternative to the traditional banking structures. The paper herein includes: stages in the evolution of the Islamic banks; the Islamic principles and how they referred to the international banking standards; the impact of the informational technology on the funds segregation and diversification of the Islamic financial products for non-Muslim customers.

Key-words: *sharia-compliant assets, Islamic banking system, interest, profit distribution, Islamic bank.*

JEL Classification: G_{15}, G_{21}, O_{53}

Introduction

The Islamic banking systems are quite new, compared to the traditional banking systems – they emerged in the second half of the 20th century. During the years following the WWII (1939-1945), they enjoyed a spectacular evolution, labelled by gaining independence from the colonial powers (the 60's), the oil crisis and the surge in the price of black gold (1974-1978) and, last but not least, the financial crisis that started out in USA (2007), that had made waves worldwide.

The Islamic banking and financial activity is different from the traditional one in the fact that the entire business must fully comply with the Islamic religion **sharia**, which forbids the interest – **riba,** and where certain **principles** are set up and must be implemented in any transaction and in any bank activity or financial institution. Based on this practice, the 'sharia-compliant' sintagm has been created, in also the assessment of the banks activity, sharia-compliant assets'[1].

The compliance with the Islamic law is severe and firm. To this purpose, each bank has a person employed – **shariah**, or, in dependence with the bank size, a **shariah board**, made up of sharia scholars, juridical consultants of the Islamic religion who follow-up on the ‚compliance with sharia' at the respective institution.

Among the factors that have postponed the emergence of the Islamic banking systems, there are: economic and social under-development, late independence and the specific of the financial-banking operations due to the Islamic bank.

[1] In the international statistics regarding the activity of the Islamic banks, they are hierachized in reelation to the ‚sharia-compliant assets' – SCA.

In general, the Islamic banks have evolved from entities with a simple balance-sheet structure to banking groups with networks and branches at a regional level – in other countries of Muslim religion – and also international, in countries that have conventional banking systems.

Literature review

Shelagh Hefferman-Modern Banking in Theory and Practices, Edit. John Wiley, New York, 1996. The paper includes the changes that have put their print on the banking activity, from the organizational issues to the analysis of the essential factors in the banking bankruptcies. In this context, the authors have done the presentation and the analysis ‚Banking Structures around the World', where a chapter is dedicated to the ‚Islamic Banking', with all the specifics of the Islamic banks balance-sheet structures.

Catherine Eagleton, Jonathan Williams, Money. A History, The British Museum Press, London, 2007. The authors have carried out the analysis of the coin institution, from its beginnings to the modern era. In the chapter ‚The Islamic Lands', the Islamic coin history intertwines with the presentation of the banking practices in the caliphates of the Arabian Empire or the banking structures that emerged during the colonization of these territories by the great colonial powers.

Stages in evolution

When talking about their emergence and evolution, there are more stages: (1) the appearance of the first banks, (2) the building of the national banking systems, (3) the updating and internationalization of the Islamic banking activities.

(1). The **first Islamic banks** emerged during the inter-war interval of the 20th century (1920-1940). Most of the regions with Muslim population found themselves under the domination of various colonial powers. Thus, the banking activity in Iraq, Jordan and all the countries in the Persian Gulf were dominated by several English banks[2], and that zone belonged to the **Sterling Area**. The Northern Africa, Syria and Lebanon belonged to the **French Franc Area**, and the presence of the French banks was prevalent. Even in the midst of this geo-political context, four Islamic banks were created: in Egypt (1920), Lebanon (1929), Jerusalem (1930) and Iraq (1940).

Besides these countries and until the WWII, the banking systems in other regions and territories (Asia – Pacific), mostly Muslim, used to include the branches of the foreign banks that had the nationality of the representative power, colonial or under occupation.

(2) The **shaping of the Islamic banking systems** has gradually taken place, after the WWII, while the countries were freeing themselves (the 60's and sometimes later). Even though the structuring of the Islamic banking systems in

---

[2] British Bank of Middle East, Eastern Bank, Barklays Bank and Ottoman Bank.

various countries has not followed the same path, for its large majority incorporates the following features:

– the stoppage of the privileges in terms of currency emission granted to the foreign banks;

– the creation of a mainstream bank or the appointment of a national authority with the right of currency emission;

– the regulation of performing the banking profession and creation of certain institutional entities that will provide the control upon the banking activity;

– the opening of specialized Islamic banks;

– the building of payment reimbursement systems at a national level, and for some countries, of centres of banking risk.

At the beginning of the banking systems, the **savings banks** and a certain type of banks were prevalent, which were developing operations of a **strong social nature**, called ‚social welfare banks'.

Besides them, **specialized banks** were opened, for various fields (agriculture, foreign trade, industry) and they were concentrating on financing the development or supporting different sectors, according to the **economic development strategy** of the country, and to the solving social issues, as profitability took the second place.

Later, the first Islamic **trade banks** were created, which will rely on **commercial and profitability bases**.

(3) The **update and the internationalization of the Islamic banking activity.** The massive money input for the oil-exporting countries between 1974 and 1978 and the small size of the internal markets had two effects: (1) the orientation of the banks towards developing operations abroad and opening companies of financial investments and (2) deregulation of the monetary, currency and banking-operational restrictions.

Shortly after independence, there were severe discrepancies compared to the foreign banks; later on, the same authorities lessened the control upon the regulations and their attitude towards it. Thus, the economic liberalization emerged, certain seized goods were returned, the activity in the private sector restarted, the regulations in the field of currency exchange rates were changed - to better reflect the real value, in dependence with the market offer and demand; some countries have deregulated the circulation of foreign currency on their territories (free come and go), the opening of imports credits – now, imports were possible without the need to prove the source of money, etc.

Thus, at the onset of the 21st century, the worldwide Islamic-type banking systems were found in 47 countries, falling into three groups:

– **GCC member countries** (Gulf Co-operation Council). The Islamic banks are members of the **GCC**, they hold the largest percentage in the world in terms of sharia-compliant assets (41.2%);

– **GCC non-member countries or MENA countries** (**M**iddle **E**ast and **N**orth **A**frica) where predominantly Muslim states are included; Iran is a top state in this category (sharia-compliant assets 38.9%);

– **non MENA countries**, for other countries in the world where either Islamic banks were opened or the traditional banks created departments or branches that perform Islamic-type banking operations – the first places are occupied by Malaysia, United Kingdom, Turkey (19.9%) (Table 1).

Table 1

The geographical distribution of the *sharia*-compliant assets, reported by the Islamic banks

The Gulf Cooperation Council (GCC) (41.2%)		Countries in the Middle East and Northern Africa – MENA (non-members GCC) (38.9%)	
Saudi Arabia	35%	Iran	94.8%
Kuwait	24%	Egypt	2.3%
The United Arabian Emirates	18.7%	Jordan	1.3%
Bahrain	14.2%	Yemen	0.5%
Qatar	8%	Tunisia	0.3%
Oman (not available data)		Algeria	0.3%
		Lebanon	0.1%
		The Palestinian territories	0.1%

Other countries (non MENA) (~20% – 19.9%)	
Countries	
Malaysia	52.7%
United Kingdom	13.7%
Turkey	12.4%
Pakistan	5%
Bangladesh	4.5%
Sudan	4.2%
Indonesia	2.7%
Brunei	2.1%
Switzerland	0.7%

Other countries (non MENA) (~20% – 19.9%)	
Countries	
Thailand	0.7%
South Africa	0.2%
Bosnia and Herzegovina	0.1%
United States of America	0.03%
Australia	0.02%
Gambia	0.01%
India	0.01%
Senegal	0.01%

Note: The percentages presented for the categories of countries refer to the ‚sharia-compliant assets’ worldwide reported for 2008, a year when they amounted to USD **638.3 billion**. The statistics was drafted upon consulting the data provided by the Islamic banks; as a note, not all these banks have reported or provided data.

• **Malaysia** is one of the countries with the **largest Muslim population** in the world – 55% of the total of 21 mil. inhabitants (not in the Near East).

• **United Kingdom** is a country with a traditional banking system, which had a **larger opening** for promoting **Islamic banking activities**, while many countries of Muslim religion used to belong to the **British Colonial Empire**.

Table 2

The geographical worldwide distribution of the *sharia*-compliant assets in 2008 (%)

Geographical area	% of the worldwide total
GCC member countries	42.2
MENA (non GCC)	38.9
Sub-Saharian Africa	1
Asia	13.5
Australia/Europe/America	5.4

Source: Global Sharia market chalks up 25% growth, Geographical Distribution, „The Banker", November, 2008, p. 22-25.

The Islamic principles and the international banking principles

The concern of the Islamic bank to open branches or other entities on the **international financial market** and become active participants in the competition with the international trade banks, has triggered the issue of drafting and adopting certain norms that will comply with the requirements set at the international level, following the Basel Agreements (Basel I and Basel II).

In this larger context, an entity called **The Islamic Financial Services Board** (TFSB) was created in 2003 – it has issued prudential standards, which different Islamic authorities of regulation and monitoring must adopt for them for the Islamic financial operations under their jurisdiction.

The standards concern the requirements related to the risk management, capital adjustment and the corporatists governance that have become guidelines both for the Islamic regulators and the agents on the Islamic financial market – banks and financial institutions.

Ever since the early beginning of Islam (7th century AC), there has been a concern to achieve an agreement between the Kur'an concepts (as god's criteria) and the daily realities, where both reflect the Islam attitude towards wealth, interest and money.

In Kur'an, there are repeated warnings about the passing nature of wealth and the money that distracts the attention from the true faith; it is forbidden to ask for interest on the loan money: 'god has allowed the sale, but not the interest', etc.

As a result of the money ability to distract the attention from faith and the prohibition on the interest, the Islamic religious authorities themselves have aimed to regulate the **unwanted effects of the money** and to set up a frame where a Muslim has money but, at the same time, to be correct from the Islamic ethics point of view.

The compliance with **sharia** is a target for all the bank operations, via five **fundamental principles**:

• Prohibition of **riba** – interest, irrespective of the interest size or the operation type;

• Application of **Al Bay**, a trade principle implemented in all the transactions: one is allowed to sell or buy, to distribute the profit/loss;

• Avoidance of **Gharar** in contracts, namely the non-inclusion of certain clauses, terms, elements of a great degree of uncertainty or deceit;

• Prohibition of **Maisir** – gambling-like, high risk or speculative;

• **Disengagement from financial transactions** that are based on products, actions or merchandise prohibited in Kur'an (pork meat, alcoholic drinks, prostitution, slavery, etc.)

These principles are to be found, directly or indirectly, in the contracts underlying the banking activity in the relation with customers or other counterparties. The contracts are drafted by attorney consultants of the Islamic religion (the four schools).

At the level of the Islamic banking community, an entity has been created with the purpose to provide a unitary frame of implementing the compliance with sharia.

Thus, the Auditing Organization for Islamic Financial Institutions (AAOIFI) has **encoded these principles** into a sharia set and issued the **accounting standards** that were adopted by the Islamic banks worldwide.

These standards should be considered by the manufacturers of the informational technology that is specific to the Islamic banking activity, which developed their IT options for segments of the international financial and banking market.

In order to provide and follow up on how sharia is being complied on within such companies, there is an Islamic legal adviser for the Islamic financial market.

One of the main distinctive elements of the Islamic banking activity is the absence of the interest, both on the deposits (banking liabilities) and on credits (banking assets). According to the Kur'an, the interest is prohibited, irrespective of its size. This restriction does not mean that free transactions are being performed in either direction. The Islamic banks have created systems of trading the banking products and services that allow them to pay or earn an **income** similar to the interest, which are based on the Islamic principles (from the religious ideology), as they are **Islamic interest replacements**.

The **paid or earned income** by an Islamic bank is, mainly, in the shape of:

– The distribution of profit/loss;
– The price accrued or the trade allowance;
– The allowance for the sale of services.

Most often, the paid or earned income is set in a percentage form and it is generically called the ‚income rate'.

The segregation of funds and the diversification of the Islamic financial products

The Islamic banks have built **electronic processing platforms that provides the accounting segregation of the Islamic funds from other funds**. This concern has been triggered by three aspects:

– keeping and increasing the credibility of the bank as for the compliance with the Islamic law, in order to not only to attract the Islamic-type companies but also the Islamic religion population who has emigrated or worked in the countries where these banks have opened their branches;

– The Islamic law only mentions the principles that must lead the financial-banking transactions, and not the people who have access to them; as a result, most of the Islamic banks also develops transactions that are specific to the traditional banks for any entity of other religion or/and for the less-religious Arabian customers. This is how the Islamic banks have become direct competitors of the local traditional banks in a financial centre – this thing happened during the 2007 financial crisis when various investors worldwide have opted for placing their funds in the Arabian financial market.

– The Islamic law does not include the requirements that the **seller** of banking products or services be a Muslim or that the other services provided should be only **Islamic** – therefore, the Islamic banks have also developed transactions carrying interest.

But this last aspect has triggered the vice versa – the traditional banking groups have developed Islamic financial products within them. In all cases, they have constituted a separate entity – branch or department in the bank; thus, they provided the strict segregation of the Islamic funds from other money and have hired religious legal advisers or created boards of all such consultants to fully comply with the Islamic law of the products being offered, and accepted by the Islamic legal advisers, consultants of an intangible reputation[3].

In a nutshell, the plans used by the Islamic banks are commercial-banking stratagems meant to comply with certain religious principles but, in the end, they have to provide for the bank – as the interest does, for the traditional banking systems – the coverage of the bank expenses and profit making: otherwise, the banking activity could not develop whatsoever.

At the same time, the level of income brought by the deposits or the amount that has to be paid to finance a business or project, mainly in the international competition context, needs to be close enough to the interest fluctuations on the international market, so that the Islamic banks attract clientele and penetrate new markets.

Starting with 1995-2000, the process of maturation of the Islamic banking systems has been accompanied by the concern of capitalizing the experience of volatility being experienced by some conventional banking systems. The context of the financial crisis in 2007, previously warned by certain phenomena in 2005, has triggered a funds flow towards the Islamic financial market. In this context, the Islamic banks have registered significant growth, of mainly three dimensions:

– the volume of transactions has grown, at the level of the current Islamic banking institutions;
– the number of Islamic reporting banks has increased, as Islamic financial institutions that used not to be reporting;

– on the Islamic market, new participants/banks emerged, with new offers of Islamic banking and financial products and services at a global level.

This growth of the Islamic market, besides the flow of funds, was based on new approaches in terms of the new products and services, namely:

– the creation of new products and services, Islamic type, for foreigners (non-Muslim), similar with the products from the traditional banks (inventivity);
– the application of the ‚compliance-to-**sharia**' principle to various banking products, by adjusting to the customer lifestyle (innovation);
– the creation of more products, Islamic type, for more customers and more markets (the proliferation of the Islamic products).

As a result of an increase in the number of Muslim customers, and also non-Muslim, who have opted for the Islamic financial instruments (during the present crisis), the Islamic banks have been concerned with the inventivity, i.e. creation of new products.

This has led to two dimensions: (1) **new products** for the **current customers** and (2) new products as instruments to penetrate new **geographical markets** or **attract new customers** on certain target segments. In this sense, the major direction was to create and develop Islamic financial products that point to the corporations, as with the Islamic bonds – **sukuk**. For example, United Kingdom and other European countries have taken into consideration the possibility of issuing **sukuk** bonds; other countries has issued financial instruments, such as: Standard Chartered Bank-Malaysia (the SCB group branch in Malaysia) and CIMB Investment Bank; in 2007, the first **sukuk** issuance emerged for the Fresco Group company in Malaysia, in the amount of USD 210 mil. and for Toyota Motors Corp (Japan) for USD 311 mil.

The concept of ‚new customers, new markets' has taken into account countries where there is **no Islamic banking activity**, but with Muslim population – the aim was to build a relation with the local clientele. Thus, Express Bank in Russia introduced the Islamic payment card on the Russian market, in 2007, which very quickly witnessed a great audience among the Muslims in this country. Another target was the Muslim population in Australia, where the contact relation has been achieved by the Muslim Community Co-Operative Australia etc.

The new product, the **Islamic card,** has been introduced simultaneously on several Islamic markets (2007 and 2008). This card is similar to any debit or credit card, but the compliance with **sharia** must be considered.

The fundamental element in the development of the new products, Islamic-type, has been the implementation of the **sharia**-compliance principle for the non-Muslim customers who were turning to the Muslim-type products or services.

The process has included two approaches: (1) **Islamic banks** that aimed to attract the Muslim population who had immigrated to other countries and/or who had known or had used the traditional banking products and (2) banks in the traditional banking systems that have opened branches/departments with Islamic banking products.

The Islamic products tender of the **new** Islamic banking **groups** includes **Islamic variants**: private banking, investment funds, leverage buyout (the first Islamic leverage buyout was in UK, 2007); the **murabaha** technique has been adjusted for the trade financing, buyer credit, accounts receivables based on future earnings; new types of structured finances have been created (**salam** and **wa'ad**) and solutions to finance the projects (**Ijara and istisna**) etc.; even though they are conventional financial products as origin, all of them have been redesigned to comply with **sharia**.

As a result of the financial transactions specific nature, the extension of the Islamic banking activity in other countries with traditional banking systems has been done with difficulty, mainly from the perspective of the banking regulating and the reporting duty to the central bank in the host country for certain indicators, with no equivalent in the Islamic banking practice.

United Kingdom has been one of the countries with a conventional banking system that, officially, started the authorization of functioning for the Islamic banks or allowed the opening of departments within their banks to offer Islamic products.

At the beginning of the financial crisis, it seemed that the Islamic banks were sidestepped by its effects and even proud to have changed into an alternative of placement. The relevant mass-media had articles where the Islamic financiers always underlined the value of the Islamic concept of the banking, where profit and risk are being divided – unlike for the western creditors -; the characteristic of profit and risk division has been highlighted, different from the systems of the interest-based trade banks, where the pressure is all exerting upon the borrower to reimburse the credit and interest, no matter of his success or failure in his business.[4].

Short time after the crisis and while the oil price went down, the Islamic banks have started confronting with various phenomena: the ones in Kuwait were affected by the negative evolution of credits granted for properties – the banks in Bahrain were having a surging liquidity crisis and the ones in the United Arabian Emirates reached an under-capital level and performed non-efficient activities.

In this context, the Islamic banks have taken into account the possibility of their strengthening (mergers and acquisitions) as a solution to overcome the tough financial situations and maintain their market positions.

The concerns of the Gulf countries to develop transactions that are specific to the financial market have not only limited to the creation of specialized entities but, in time, have looked at the possibility to open financial centres with an international resonance.

Such an example is **Dubai International Financial Centre** (DIFC), built in Dubai, the financiers have had the purpose to have a financial centre for operations and transactions of huge values and, when fully developed, to reach a status similar to the ones in New York, London and Hong Kong and to serve the large region located between Western Europe and Eastern Asia. Since it opened in 2004, it has been the financial centre with the fastest growth. In 2005, it opened a stock market of an international stature: NASDAQ Dubai (formerly known as Dubai International Financial Exchange or DIFX). Besides the financial effort (billions!) put into its building per se and the equipping with state-of-art IT, all the steps have been taken to give it a legal and normative frame, worldwide recognized – implicitly, by creating an independent entity of regulation and monitoring of the financial services, Dubai Financial Service Authority.

Conclusions

Currently, the mankind is going through extreme changes, new hierarchies emerge and so new participants on the international financial-banking market.

In this context, the Islamic banking industry is setting itself apart, by dynamism, inventivity and the un-doubtable desire to impose itself worldwide, not only for the Islamic population having emigrated to non-Islamic countries, but also for the non-Muslim customers.

The phenomenon of dissemination of the Islamic products is also seen at the traditional banks, banking groups that, on the international market, opened departments, branches where promote Islamic banking products.

Even though the activity of the Islamic banks is not always transparent, but traditionalist and unsophisticated (subject to the Islamic legal advisers), the Islamic banking system distinguishes itself as an active presence on the international financial market.

REFERENCES

- Shelagh Hefferman (1996), *Modern Banking in Theory and Practices*, Edit. John Wiley, New York.
- Catherine Eagleton (2007), Jonathan Williams, *Money*. *A History*, The British Museum Press, London.
- Stephen Timwell, Joseph Di Vanna (nov. 2008), *Islamic Financial Institutions*, The Banker.
- Nabeel Shoaib (2008), *The Case for Islamic Banking*, „The Banker", FT, Business, octomber, p. 16-17.
- Joseph Di Vanna (nov. 2008), *Investion, Innovation and Implementation*, „The Banker", p. 10-11.