EMERGENCE OF ISLAMIC FINANCIAL INSTITUTIONS

THE NEED FOR A FINANCIAL SYSTEM

✧ The main function of financial intermediaries in the financial markets is to transfer funds from savers to investors.

✧ Financial intermediation enhances economic efficiency by eliminating the mismatches inherent in the requirements and availability of financial resources of savers and entrepreneurs in an economy. Some of the mismatches include:

1. Savers are often small households who save relatively small amounts and entrepreneurs are firms who often need relatively large amounts of cash. Financial intermediaries remove this mismatch of size of money by collecting small amounts of savings and packaging them to suit the needs of entrepreneurs.

2. Entrepreneurs may require funds for periods relatively longer than would suit individual savers. Intermediaries resolve this mismatch of maturity and liquidity preferences again by pooling small funds.

3. The risk preferences of savers and entrepreneurs are also different. It is often considered that small savers are risk averse and prefer safer placements whereas entrepreneurs deploy funds in risky projects. Financial intermediaries can substantially reduce their own risks through different techniques of proper risk management.

4. Small savers cannot efficiently gather information about opportunities to place their funds. Financial intermediaries are in a much better position to collect such information, which is crucial for making a successful placement of funds.

✧ The role and functions of financial institutions in general and banks in particular outlined above are indeed highly useful and socially desirable.

✧ However, since conventional banks’ transactions are based on interest, there is
reluctance among Muslims to deposit their money in conventional banks and financial institutions that deals with interest, or invest in companies engaged in unethical and socially harmful activities.

Therefore, Islamic banking and finance has emerged in order to create an alternative financial system to conventional banking for Muslims and has succeeded in achieving general acceptance.

THE NEED FOR ISLAMIC FINANCIAL SYSTEM

- Muslims, as everyone else, need banking services for all normal purposes, to finance new business ventures, to buy a car, to facilitate capital investment, to undertake trading activities, to provide a safe place for saving, etc.

- Islamic banks appeared on the world scene as active players over three decades ago. The basic principle of Islamic banking is the prohibition of *riba* (usury or interest). Allocating financial resources on a production basis is more efficient than their allocation on a purely lending basis.

- The impact of commercial banking on economic development would be below potential because conventional commercial banks largely finance short-term trade, business, and personal loans. This type of financing cannot satisfy the financial requirements of venture capital.

- Islamic banking, on the other hand, provides finance with greater involvement in the production process. Its financing targets both the equity as well as the working capital needs of enterprises. It is expected that its impact on economic development will be more pronounced.

- There is a definite desire amongst Muslim savers to invest their savings in ways that are permitted by the Shari’a. Nevertheless, they must be provided with halal returns on their investments. Islamic scholars and practical bankers took up that challenge and have made commendable progress in the last three decades in providing a number of such instruments. However, the concepts of Islamic banking and finance are still in their early stages of development and Islamic banking is an evolving reality for continuously testing and refining those concepts.
Islamic financial sector has grown considerably satisfying a growing desire by customers who are seeking to conduct their financial affairs in accordance with Islamic Shari’a. Islamic banking and financial institutions have now spread across several Muslim countries. Some non-Muslim countries and/or institutions are also keen to experiment with Islamic financial techniques. Various components of the Islamic financial system are now available in different parts of the world in varying depth and quality. A detailed and integrated system of Islamic banking and finance is gradually evolving.

Today, Islamic financial institutions are estimated to be managing funds around US$ 400 - $500 billion. The average growth rate of deposits in Islamic banks over the past twenty years has been over ten percent per annum, and expected to grow annually by more than 15 percent. Its clientele are not confined to Muslim countries but are spread over Europe, United States of America and the Far East. Today, more than two hundred and fifty Islamic financial institutions are operating world-wide. The success of Islamic financial institutions encourages many conventional banks and other financial institutions to start using Islamic finance techniques in the conduct of their business, particularly in dealing either with Muslim clients or in predominantly Muslim regions.

HISTORY OF ISLAMIC FINANCIAL INSTITUTIONS

All types of trading-based transactions were common in pre-Islam Arabic financial and economic system. Those transactions include: bay’ al-musawama (bargaining), bay’ al-muzayada (auctioning), bay’ al-amana (trust sale), al-murabaha (resale with profit). Barter trade and al-sarf (money exchange) were also common. Riba, gharar and maysir were widespread and acceptable practices.

Islam eradicated riba and gharar transactions and prohibited monopoly and fraud. Implementing Shari’a rules and principles resulted in the Islamization of many business transactions such as mudharabah, musharaka, salam, muzara’ah (sharecropping or partnership in agriculture), and musaqah.
(irrigation), and new organizations and institutions were introduced such as *Zakat, waqf* and *Baitul-mal*

- Islamic banking and finance (IBF) in its contemporary settings is relatively new compared to conventional banking and finance
- The early attempts to avoid interest existed in India in 1890s and 1920s as some Muslim communities initiated lending poor loans free of interest.
- The first attempt of establishing an Islamic financial institution was found in Malaysia in 1940 with the establishment of the first interest-free saving funds
- Pakistan in the 1950s. Loans were offered to clients without interest, but minimal charges were imposed to cover the operational expenses of the bank. The failure of this experience was unavoidable due to some operational reasons.
- The second attempt to establish an Islamic financial institution was undertaken in Egyptian town of Mit Ghamr in 1963 and 1967. The institution functioned essentially as saving investment institution based of profit-sharing rather than as a commercial bank. This experiment took place under cover to avoid providing a religious image to the public, which might have influenced its progress. Towards the end of this experiment in 1967, there were nine similar banks established in the country. These banks neither charged nor paid interest, and invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors.
- Around the same time in Malaysia in 1963, another Islamic financial institution was created, called the Muslim Pilgrims Savings Corporation. The function of this institution was to help people save for the Hajj (Pilgrimage) to Mekka and Madina. Six years later, this institution developed into what is now known as the Pilgrims Management and Fund Board, or the Tabung Haji. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shari’a. Although it is a non-bank financial institution with a limited role, the Pilgrims Management and Fund Board’s success helped pave the way for the Bank Islam Malaysia Berhad (BIMB), which is now the chief commercial Islamic bank in Malaysia.
In the 1970s, the political, cultural and social climate changed in many Muslim countries and Islamic awakening among the masses of Muslims resulted in the awareness of the necessity to find Islamic alternative to economic and financial transactions. In addition, oil boom in the 1970s triggered a rapid growth of Islamic financial institutions.

A number of Islamic banks, both in letter and spirit, came into existence in the Middle East.

The Islamic Development Bank (IDB) was created by the Organization of Islamic Countries (OIC) in 1974 to support the economic development of Muslim nations whilst complying with Islamic law. The IDB was primarily an intergovernmental bank aimed at providing funds for development projects in member countries. It provides fee based financial services and profit-sharing financial assistance to member countries. The IDB was the first international development assistance agency to provide loans on an interest-free basis.

The Dubai Islamic Bank was established in 1975. In 1977, the Faisal Islamic Bank of Sudan was created, as well as the Faisal Islamic Bank of Egypt. The Bahrain Islamic Bank was established in 1979.

In 1978 the first institution specialized in Islamic economics and finance was established in Jeddah, namely, the Centre for Research in Islamic Economics at King Abdul Aziz University.

It is worth noting that an Islamic financial institution was established in Philippine earlier than in many other Muslim countries. The Philippine Amanah Bank (PAB) was established in 1973 by Presidential Decree as a specialized banking institution without reference to its Islamic character in the bank's charter. The establishment of the PAB was a response by the Philippines Government to the Muslim rebellion in the south, designed to serve the special banking needs of the Muslim community. However, the primary task of the PAB was to assist rehabilitation and reconstruction in Mindanao, Sulu and Palawan in the south. The PAB has eight branches located in the major cities of the southern Muslim provinces. The PAB, however, is not strictly an Islamic bank, since interest-based operations continue to coexist with the Islamic modes.
of financing.

- The first attempt to establish an Islamic bank in the Western world also occurred in the 1970s: The Islamic Finance House was established in Luxembourg in 1978.

- The Islamic countries have different approaches regarding Islamic banking and finance. Some countries such as Sudan, Pakistan, and Iran at least officially claimed they converted their finance and banking systems to an interest-free basis. Other Islamic countries embrace Islamic banking as a national policy concurrently with conventional banking and finance (dual track banking); for example, Bahrain, Malaysia, Brunei, Kuwait, Indonesia, Turkey, and UAE. Other countries neither support nor oppose Islamic banking such as Egypt, and Yemen. Another group actively discourage separate Islamic banking presence such as Oman and Saudi Arabia.

- However, most of Islamic countries have established Islamic banks in conjunction with conventional banks. Even in countries where the legal system doesn’t allow the establishment of Islamic banks, such as India, Muslims have found alternative methods within the law to substitute interest-based financial institutions so as to carry out their financial needs while abiding by the Shari’a.

- Large Western multinational banks such as Citibank, HSBC, Barkley’s and Merrill Lynch have recently begun offering Islamic modes of financing through Islamic windows to diversify their large client base and attract more customers. This move of conventional banks implies that the Islamic banking system is becoming increasingly accepted and popular. This has also made the Islamic banking system much more challenging.

- Recognizing the need for standards, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991 in Bahrain, as an international, autonomous, non-profit-making body, by Islamic financial institutions and other parties to set international accounting and auditing standards for Islamic financial institutions based on Shari’a rules and principles. It is the leading international standard setter for Islamic financial institutions, in the field of accounting, auditing, ethics, governance and transparency. AAOIFI
standards are increasingly being used by central banks around the world as standards of the Islamic financial system. AAOIFI has helped to standardize accounting practices of Islamic financial institutions, thereby making the financial information of these institutions comparable and transparent, thus allowing investors to make informed decisions. The growing acceptance and implementation of these standards, however, will require a high degree of cooperation between standard-setters and regulators.

✧ The Islamic Financial Services Board (IFSB) was established in 2002 in Kuala Lumpur, Malaysia. IFSB is an association of central banks, monetary agencies, and intergovernmental international organizations that have an explicit mandate for promoting Islamic finance. The IFSB sets and disseminates prudential and supervisory standards and core principles that are in compliance with Sahri’a rules and principles for the supervision and regulation of the Islamic financial institutions and services.

✧ Several other institutions were established to create, regulate and support the emerging Islamic financial system. These institutions include the International Islamic Financial Market (IIFM), the International Islamic Rating Agency (IIRA), the General Council of Islamic Banks and Financial Institutions (CIBAFI), and the Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI).

✧ Further progress was made in developing capital markets. Different structures of Islamic asset-backed certificates, Sukuk, were introduced successfully in Bahrain, Qatar, Pakistan, and Malaysia.

✧ In addition, Dow Jones has also introduced the Dow Jones Islamic Market index (DJIM) of 600 companies worldwide that comply with Shari’a law. The progress of the past few decades proves that Islamic finance is here to stay, and is not just a passing phenomenon.

✧ Islamic financial institutions have showed immense progress in a very short period of time, capturing a significant market share from their conventional rivals.

✧ Currently, Islamic Finance across the globe consists of $400 - $500 billion in
assets and 275 institutions that operate in about 75 countries.

- Currently, the Islamic financial system encompassed products such as: banking, mortgages, equity funds, fixed income, insurance, project finance, private equity, and even derivatives. However, the industry is too small compared to the potential market.
- In 8-10 years, the predicted market share that will be managed by Islamic financial institutions is expected to be 40-50% of the total savings of Muslims worldwide.

**DEVELOPMENT OF ISLAMIC FINANCIAL SYSTEM IN BAHRAIN**

- Since its establishment in 1973, Bahrain Monetary Agency (the successor of the Bahrain Currency Board) has been promoting the country as an international financial center and encouraging major international financial institutions to use Bahrain as their regional base. By marketing a number of the country’s competitive advantages (such as the strategic geographic location, the tax-free environment, the skilled workforce, the clearly-defined legal and administrative framework, the well-developed infrastructure, the liberal trade policy, and the absence of restrictions on foreign exchange), Bahrain has been successful in attracting Islamic financial investors and firms.
- Bahrain pursues a dual banking system, where Islamic banks operate side by side with their conventional counterparts. In fact, the emergence of Islamic banks in Bahrain drew on the same environment that led to the development of Bahrain as an international financial center. The BMA (now Central Bank of Bahrain) affords equal opportunities and treatment for conventional as for Islamic banks.
- The birth of Islamic banking services in Bahrain dates back to 1979 when Bahrain Islamic Bank was established to provide commercial banking services.
- Islamic banking in Bahrain gained momentum in the early 1980s, with the issue of four new licenses, one of which was an offshore banking unit license, while the rest were investment banking licenses. The creation of an Islamic offshore bank was the first of its kind, an illustration of the innovative approach to
regulation pioneered in Bahrain.

✧ In 1981 Dar-Almal, a holding company, was formed in Switzerland owning a group of banks in some Muslim Countries which they then established Shamil Bank in Bahrain in 1982 (formerly Faisal Islamic Bank).

✧ Al Baraka Islamic Bank followed the move in 1983 and Al Baraka Group was actively involved in establishing Islamic banks in many countries as well.

✧ The 1990s marked a turning point in the development of Islamic banks in Bahrain. The BMA, during the 1990's, issued a total of eight licenses to a diverse group of institutions to enable them to pursue Islamic banking services.

✧ Central Bank of Bahrain (CBB) (formerly Bahrain Monetary Agency (BMA)) was the first central bank to develop and issue prudential regulations for Islamic banks. Bahrain has highest concentration of Islamic financial institutions (Check the latest numbers of Islamic banks and takaful establishments in Bahrain). 2/3 of Islamic financial institutions operating in GCC countries are based in Bahrain.

✧ The CBB has Shari’a advisors to help with the auditing of the banks and a new regulatory system is being worked out to take into account the special characteristics of Islamic financial products.

✧ The CBB is also developing short-term financial instruments that would provide liquidity for Islamic Banks.

✧ All Islamic financial institutions licensed in Bahrain have to comply with AAOIFI standards.