DEVELOPMENT OF THE ISLAMIC BANKING AND FINANCE IN THE MUSLIM AND NON-MUSLIM WORLD

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Background of the Article

The emergence of Islamic banking in the modern times is related to the revival of Islam and the desire of Muslims to live all aspects of their lives in accordance with Shariah. Renewed interest in Islam in general and Shariah in particular during the last three decades of the last century further accelerated the demand for establishing Islamic banks and financial institutions, which would be free from interest. There has always been a demand among Muslims for financial products and services that conform to Shariah.[1]

In Islamic countries, many of them poor and not highly developed, large segments of the Muslim population do not have access to adequate banking services—often because devout Muslims are unwilling to put their savings into a traditional financial system that runs counter to their religious principles. Islamic banks seek to provide financial services in a way that is compatible with Islamic teaching, and if Islamic banks can tap that potential Muslim clientele, that could hasten economic development in these countries.

It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom and Japan. Similarly, countries such as India, the Kyrgyz Republic, and Syria have recently granted, or are considering granting, licenses for Islamic banking activities.

In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles.

[1]Salahuddin Ahmed, *Islamic Banking Finance and Insurance: A Global Overview* (Kuala Lumpur: A.S.Noordeen, 2006), 42

And, over the past decade, the Islamic banking industry has experienced growth rates of 10-15 percent per year—a trend that is expected to continue.

There is convincing evidence of a close correlation between financial sector development and growth. Countries with larger financial systems tend, all else being equal, to grow faster [2] because banks perform a fundamental economic role as financial intermediaries and as facilitators of payments. They help stimulate savings and allocate resources efficiently. Banks also allow for diversification of risk, monitor managers, and exert control[3] . Moreover, even in a world of apparent capital mobility, the evidence suggests that domestic savings and investment rates are highly correlated[4], which makes domestic saving and financial development a major driver of economic growth

Globally, the assets of Islamic banks have been expanding at double-digit rates for a decade, and Islamic banking is an increasingly visible alternative to conventional banks in Islamic countries and countries with many Muslims. My study identifies the sources of Islamic banking expansion and ways to stimulate its continued growth. Knowing what drives the development of Islamic banking will help developing countries in Africa, Asia, and the Middle East catch up.

Introduction

The rise, the development and the spread, although these three word share a same close meaning in language but in economics they have a different meaning, definition and causes. You, as a reader may confuse, but if you deeply consider you will recognize that there are difference, and I summarized in some paragraph to explain them, as follows.

[2]King, R.G., Levine, R. "Finance And Growth: Schumpeter Might be Right". Quarterly Journal of Economics 108, 717–738, (1993a).

[3]Levine, R. "Financial development and economic growth: Views and agenda". Journal of Economic Literature 35, 688–726. (1997).

[4] The so called ―Feldstein-Horioka paradox, *see* Feldstein M. and Horioka C., 'Domestic Saving and International Capital Flows', The Economic Journal , 90, 314-329. (1980)

The rise of Islamic banking

Four decades ago, Islamic banking emerged on a modest scale to fill a gap in a banking system not attuned to the needs of the devout. Two events were crucial to its development. First, the early 1960s appearance in rural Egyptian villages of micro lending institutions following Islamic banking principles demonstrated the feasibility of Islamic banking. These experiments thrived and spread to Indonesia, Malaysia, and sub-saharan Africa.

Second, top-down support following the 1975 establishment of the Islamic Development Bank in Jeddah, Saudi Arabia, further spurred diffusion of Islamic banking by centralizing expertise. In its infancy, Islamic banking required much interpretation of Shariah law by Islamic scholars. In the first few years, basic implementation tools—such as legislation allowing such banks to be set up and the training of staff—were key ingredients for the spread of Islamic banking. And the past few years have seen rapid innovation, most recently improved regulation of liquidity management and accounting.

Similarly, the development of sukuk (Islamic bonds) has revolutionized Islamic finance in recent years: Islam prohibits conventional fixed income interest-bearing bonds. Harnessing sophisticated financial engineering techniques, sukuk are now a multibillion-dollar industry.

Rising oil prices since 2000 were also a catalyst, leading to a massive transfer of resources toward the large oil-producing countries, which have been more inclined to adopt Islamic banking. During the past decade, Islamic banking industry assets grew at an average 15 percent annually and more than 300 Islamic institutions claim total assets of several hundred billion dollars. Two-thirds of Islamic banks are in the Middle East and North Africa, with the rest mainly in Southeast Asia and sub-Saharan Africa. But even in countries with many Islamic banks, they are overshadowed by conventional banks. In the Gulf region, Islamic banks—in terms of their assets—account for one-quarter of the industry. Elsewhere, their share is in the single digits.

Islamic banking and development

The rise of Islamic banking has contributed to economic development in two main ways. One key benefit is increased financial intermediation. In Islamic countries and regions, large segments of the population do not use banks. The Islamic world, as a whole, has a lower level of financial development than other regions—in part because conventional banks do not satisfy the needs of devout Muslims. This “under banking” means savings are not used as efficiently as they could be.

Moreover, because Islamic banking requires borrowers and lenders to share the risk of failure, it provides a shock absorbing mechanism that is essential in developing economies. These economies—whether in the Middle East, Africa, or east Asia—are often large, undiversified commodity producers (mainly of oil) subject to boom-bust cycles and the vagaries of export and import price changes. In addition, most tend to have fixed or highly managed exchange rates, so the exchange rate is less able to absorb shocks. A mechanism that allows the sharing of business risk in return for a stake in the profits encourages investment in such an uncertain environment and satisfies Islam’s core tenet of social justice.

How Islamic Banking Spreads?

Islamic banking is likely to continue to grow, because many of the world’s 1.6 billion Muslims are under banked; understanding how Islamic banking spreads will help guide the formulation of policy recommendations. To that end, it is estimated the factors behind the diffusion of Islamic banking around the world using a sample of 117 countries during 1992–2006. We also tested for whether it substitutes for—or complements—conventional banking. It was found, unsurprisingly, that the probability of increased Islamic banking in a given country rises with the share of Muslims in the population, income per capita, the price of oil, and macroeconomic stability. Proximity to Malaysia and Bahrain (the two main Islamic financial centers) and trade integration with Middle Eastern countries also make diffusion more likely.

Interest rates negatively affect the diffusion of Islamic banking, reflecting the implicit benchmark they pose for Islamic banks. Although pious individuals may have accounts only with Islamic banks, other consumers allocate their savings based on interest rates set by conventional banks. High interest rates hinder the diffusion of Islamic banking by raising the opportunity cost for the less pious (and individuals from other denominations who are increasingly attracted to Islamic banking) to put their savings in Islamic banks.

Some results, however, were unanticipated. First, Islamic banks spread more rapidly in countries with established banking systems. Islamic banks offer products not delivered by conventional banks and thus complement rather than substitute for conventional banks. Second, it is found that the quality of a country's institutions, such as the rule of law or the quality of the bureaucracy was not statistically significant in explaining the diffusion of Islamic banking. This is not true for conventional banking. Because Islamic banking is guided by Shariah, it is largely immune to weak institutions: disputes can be settled within Islamic jurisprudence. Third, the September 11, 2001, attacks on the United States were not an important factor in the diffusion of Islamic banking. These events simply coincided with rising oil prices, which appear to be the actual driver of Islamic banking.

Policy Implications

During the past decade, Islamic banking has grown from a niche market into a mainstream industry, and has likely helped drive growth in the Islamic world by drawing under banked populations into the financial system and allowing risk sharing in regions subject to large shocks.

Even though some findings suggest little need for institutional reform, policy change scan still boost the spread of Islamic banking. Encouraging regional integration through free-trade agreements, maintaining a stable macroeconomic environment that helps keep interest rates low, and raising per capita income through structural reforms will lead to further expansion. The spread of Islamic banking is not, however, a panacea—it is merely one of many elements needed to sustain growth and development.

Studies assessing the impact of banking development on growth have, however, looked at ―conventional rather than Islamic banks because the importance of the latter has grown only in the last two decades. Islamic banking is now expanding out of its niche, becoming a market that could rival the conventional sector in many countries. It is an increasingly visible alternative to conventional banks in Islamic countries and in countries with large Muslim populations, such as the UK. Globally, the assets of these institutions have grown at double digit rates for a decade, and some conventional banks have opened Islamic windows, with Shariah-compliant financial assets reaching an estimated $509 billion at end-2007.[5] The International Organization of Securities Commissions predicts that as much as half of the savings of the world's estimated 1.2-1.6 billion Muslims will be in Islamic financial institutions by 2015. Despite the rapid growth of Islamic banking in recent years, what drives its diffusion is still poorly understood.[6] .

As I am the author of this article, I agree that there is very significant growth of Islamic banks that is approximately double digit of growth. But I don’t agree that the causes and what drives its diffusion is still poorly understood. Absolutely it is clear and fully understood what caused and drives the diffusion of Islamic banking and finance system, those are the responsibility, accountability, transparency, fairness and the basic of Islamic economy which is common and mutual interest and social welfare. Nevertheless, those above mentioned drive and cause the diffusion of Islamic banking and finance.

In this article, I took different studies in a different countries around the world based on area. Most of the data I took from news papers in the Middle East. I compare Indonesia, Sudan, Europe and United States.

[5] Moody’s Investor Service, 2008

[6] Patrick Imam and Kangni Kpodar, “Islamic Banking: How Has it Diffused?” *IMF Working Paper*, African Department (August, 2010)

Indonesia

Indonesia is the world's largest Muslim nation and about 87 per cent of its 212 million people are Muslims. Indonesia has implemented some of the economics reforms its promised under an aid program backed by the international monetary fund. Currently there are some 40 million small enterprises, 54000 medium enterprises and some 2000 big enterprises in Indonesia. Indonesia had 4.8 percent growth in 2004 and the economy may expand 5.5 per cent in 2005.

Government and National Efforts in Promoting Islamic Banking and Finance in Indonesia

In 1994, the government launched the *Bait al-maal wa attamwil* (BMT) as a national movement, which has since grown *nation-wide.* Its not a bank but a NGO, which operates like co-operative bank. As the smallest financial institution, its focuses its target market on petty traders and hawkers. There 898 BMTs, spread throughout the country. The Union of Muslims Indonesian Intellectuals (ICMI) established a managerial project, PT Manajeman Musyarakah Indonesia (MMI) that aims at providing an institutional liaison between small enterprises and investors, who are eager to assist the development of small scale Muslim enterprise. Its goal is to create an alliance between affluent investors and poor Muslim entrepreneurs. The MMI plans to create "people's *Shariah* Credit Banks" which will set up savings and credit arrangements using a variety of profit-sharing arrangements. Most Indonesian companies do not have assets to back up loan applications.

The government of Indonesia announced in September 2003 that it would soon issue a law on Islamic banks. The government is hopeful that Islamic banks would be in a position to give access for more small and medium enterprises (SMEs), so that they could contribute in reducing poverty. Islamic banks would give guidance and also share responsibility for taking risks of business. Eleven conventional banks with operations in

Aceh province are studying the conversation of their branches in the northern Sumatra territory.

Until 1991 the banking regulations in Indonesia did not allow depositing money in banks without payment of interest. Bank Negara Indonesia (BNI), the central bank of Indonesia issued regulations to monitor *Shariah* institutions and help them managing liquidity. Indonesia has responded to the growing demand for Islamic banking by changing its producers to allow Islamic banks to make interbank transactions, and make deposits with the central bank, in accordance with Islamic rules. Bank Indonesia has decided to accept deposits from Islamic banks and it will pay interest calculated as the average of the return on capital received by all Islamic banks in Indonesia. In December 2003, the Indonesian *Ulimas* Council issued a *fatwa*[7] at its national convention declaring that the receiving of interest from any financial institution "*forbidden*", though its conditional on the availability of an Islamic alternative.[8] it called on the country's Muslims to use only Islamic financial products and abandon standard banks, insurance companies and investments in the stock market. The Central Bank Act No.10/1998 adopted the *Shariah* principles as one of the Indonesian banking system.

Position of Islamic Banking and Financial services in Indonesia

The Islamic banks follow the standards very similar to those issued by the AAOIFI, although they modify AAOIFI standards to suit their needs. The National Shariah Board appointed by the government requires the Islamic banks of the country to follow its guidelines. It was reported in September 2003 that Bank Negara Indonesia (BNI) was seeking financial backing from HSBC Ammanah Syariah of Dubai to finance the Islamic banking unit of the state owned bank.[9]

[7] It said "dealing with financial institution which uses an interest rate system in a region which already has Shariah { Islamic Law} financial institution is not allowed, but region which does not have a shariah financial institution, the use of conventional financial institutions, based on emergency principles, is still allowed".

[8] Financial Times, December 17, 2003.

[9] Asia Pulse Via COMTEX, September 25, 2003

During the 1997 Asian economic crises, Indonesian interest rates skyrocketed. But the crises has much less effect on Islamic banks like multi-trans,[10] a privately held company, which actually earned US$500,000 on revenues of US$4.5 million. The number of Islamic rural banks increased from 22 in December 1993 to 78 in 1999. The total financing of Islamic rural banks at the end of March 1996 was US$16.46 million and the total deposits amounted to US$14.36 million.

The asset of the Islamic banks amounted to US$140 million in 1999, 90 per cent more than in 1997. The assets grew sharply by 60 per cent to 5 trillion rupiah (some US$588.2 million) in the first 5 months of 2003 when compared same period last year.[11] Islamic banking assets accounted for about 1 per cent of total Indonesian banking assets in 2004, compared with 0.7 percent in 2003. Such assets totaled Rp.14 trillion at end of last year, from Rp.7.85 trillion at a year earlier. Islamic banking assets will probably reach Rp24 trillion (US$2.6 billion) in 2005, or 1.8 per cent of total assets.[12] Bank Indonesia issued “blueprint” for Islamic banking in September 2002, forecasting growth for the sector to reach 5 percent of total banking assets by 2011. In a report released that the Islamic banking industry of the country is poised to expand more than two-thirds this year.[13]

Foreign banks like ABN Amro and Standard Chartered Bank developed Shariah units, the Shariah unit of Standard Chartered Bank is called Saadiq. It has been reported that with a view to encouraging foreign banks to establish Syariah banking units in Indonesia, the Bank Indonesia would simplify the procedures of granting licence for establishing such banks.[14] With the introduction of this simplification, it is expected that the Syariah banks would attain five per cent market share by 2010 from the current 0.5 per cent share. Syariah banks recorded a loan-to-deposit ration (LDR) of

[10] The success was due to the financial relationship of multitrans with Bank Muamalat. Instead of changing interest on loans, Bank Muamalat gets a share of the revenues from the multitrans project it funds like a partnership. A Director of Bank Muamalat, Mr. Suhaji Lestiadi, said it was operating with excess liquidity and had a capital adequacy ratio of 16 per cent. This at a time when the rest of the Indonesian banking system is operating with capital adequacy in negative territory.

[11] Xinhua News Agency, September 8, 2003

[12] Bloomberg.com March 22, 2005.

[13] Bloomberg, News March 3, 2005.

[14] Currently, it takes 60 days to process the establishment of syariah banking units, both for foreign and domestic banks, which will be reduced to only 30 days. Asia pulse via COMTEX, September 24, 2003.

109 per cent, compared with conventional banks' LDR of 55 per cent. According to the central bank figures, the assets held by the Islamic banks in Indonesia grew from Rp1,790 billion (US$211 million) or 0.2 percent of total assets in 2000 to Rp6,500 billion or 0.5 per cent of total assets in October 2003.[15] Many Indonesian banks opened Islamic banking units and other banks are planning to open Islamic banking units after the MUI edict.[16]

Bank Niaga is Indonesia's ninth largest bank, in which Malaysia's Commerce Asset-holding Bhd (CAHB) has a majority stake of over 51 per cent. The bank launched its Syariah operation in September 2004.[17] The Syariah carried out in five of Niaga Bank branches in Jakarta in 2004 before expanding to its other branches in several cities throughout the country. The bank had the vision to become the fifth biggest bank in the country by 2007 and one of the biggest financial institutions in the region. Bank Pertama opened an Islamic banking unit. Many provincial banks opened Islamic banking units in the last 6 years in Aceh, North Sumatera, Jakarta, South Sumatera, Riau, South and West Kalimantan.

Islamic Banks and Financial Institutions in Indonesia

Bank Muamalat (BMI), the first Islamic bank of Indonesia was established in 2002 with US$50 million.[18] The BNI has a 40 per cent stake in the BMI. Bank Muamalat conducted rights issue on June 1998, which increased the paid-up capital to Rp165 billion. The main contributors to the rights issue were Islamic Development Bank and Hajj Pilgrimage Funds. In the May 2004 the bank planned to raise approximately Indonesia Rp200 billion, by offering shares to Saudis. The purpose of the new share offering is to allow BMI to increase its paid-up capital in order to maintain a

[15] Financial Times, December 17, 2003.
[16] AFX Asia (focus); December 23, 2003.
[17] The Star, September 28, 2004.
[18] Two cooperatives, Teknosa Cooperative and Ridho Gusti Cooperative were established, one after another to make experiment with the principles of Islamic banking. In its national congress, the Council of Muslim Indonesian Scholars (Majelis Ulama Indonesia) endorsed the idea of setting up of an Islamic bank. A financial support for the Islamic bank project came from Yayasan Amal Bhakti Muslim Pancasila, a foundation established by Suhrato to support dakwa and mosque building. The Union of Muslim Indonesian Intellectuals (ICMI) was instrument in supporting to establishment of such a bank.

capital adequacy ratio above 12 per cent. Total shareholders equity reached 312 billion rupiah at the end of 2003, BMI was planning to increase it to 600 billion rupiah by the end of 2006.

The bank has Shariah Supervisory Board, which supervises the products of the bank with a view of conforming to Shariah. The BMI has been working to reach low-income groups in major cities as well as in villages by opening branches in cities and playing a leading role in establishing rural banks and village credit cooperatives. The bank is designed to support middle and small-scale enterprises. The minimum amount of capital the BMI would provide is US$5000, which is beyond the reach of the mass of small-scale entrepreneurs. The maximum amount of capital is US$1 million. The account holders are not depositors but investors who get a share of the banks revenue (and thus always get a return even if the bank were to post a loss). The bank requires the borrower to deposit all revenues in Muamalat accounts. The borrower must be prepared for regular and close scrutiny of the operations of his business. He is not locked into paying a set of amount representing interest on the loans of regardless of the business results. At that time the bank had 200,000 depositors and 20,000 loan customers. On December 31 2003, MBI’s net profit was Rp352 billion. So far the profit of the bank has increased at an average annual rate of 31.7 per cent. During the severe of economic crises in Indonesia when many conventional banks collapsed or even faced liquidation, Bank Muamalat remained solid and did not incur high losses caused by negative spread. The Bank Muamalat’s total assets have passed Rp1 trillion. The introduction of ATM bersama and ATM BCA, enables customers to have access to more than 2000 ATMs. BMI established muamalat institute, an Islamic banking training organization. In 1994 the bank received a foreign exchange license to become a foreign exchange bank.

Established in 1999, Bank Mandiri Syariah, the state owned Islamic bank, had seven offices in 2005. It is Indonesia’s largest Islamic bank by assets. Bank IFI, a conventional bank established in 1999, has established Syariah branches. In October 2003, HSBC Syariah opened a special branch that offers banking services based on Syariah.[19] The opening makes HSBC the first among foreign banks in Indonesia

[19] Xinhua News Agency, October 20, 2003.

providing such service. The new until will follow HSBC's similar units in Malaysia, United Arab Emirates, Saudi Arabia and the United Kingdom. It is targeting the inflow of capital from campanies in the Middle East that the domestic Syariah banks are unable to accommodate. Islamic banking has become an important business link for HSBC, involving a combined fund of some US$1 billion and 115,000 customers worldwide.[20] there were also two local banks those fully offer Syariah-based services.

The Syariah division of Bank Rakyat Indonesia (BRI) recorded a 20 per cent increase annually in turnover to round Rp133.5 billion in 2003. Finance offered by Islamic banking division of Bank Rakyat Indonesia (BRI) shot up 30 per cent year-on-year to Rp99.2 billion (US$11 million) in the first quarter of 2004. The bank has planned to open more Syariah outlets. Bank Syariah Indonesia, formerly known as Bank Tugu, planned to launch its operations in May 2004 as an Islamic bank. PT Bank Niaga has 181 outlets in Indonesia, comprising main and supporting branches, cash offices and payment points. Bank Niaga has projected to achieve a 28 per cent rise in loan growth in 2004 compared with 30 per cent previously. Bank Niaga aims to achieve both loan and asset growth of between 30 per cent and 50 per cent per annum. The bank will look at the possibility of growing through mergers and acquisitions.

Sudan: Position of Islamic Banking and Financial Services

In 1999, the economy of Sudan grew by 6 per cent during the year. Sudan is believed to have large reserves of oil. The year 2002 marked a significant period for the Sudanese banking industry in terms of performance. The industry registered encouraging growth over the past years, in both deposits and profits. The banks of Sudan were nationalized in 1970. In order to strengthen and development the regulatory framework of banking system, the central bank enhanced the corporate governance regulations in all the Sudanese banks.

The entire Sudanese banking industry is an Islamic one, supported by the government and central bank, encouraging its growth and development. It has enjoyed

20 Xinhua News Agency, October 20, 2003.

this status since 1992. According to Machakos Protocol, signed on july 20 2002, the people of southern Sudan will have the right to vote for secession at the end of a six-year interim period during which Shariah will apply in the north and Islamic banking system shall operate there.[21] Most of Islamic banking have been established in cooperation with foreign capital. Sudanese authorities have enforced the requirement for base1 principles, implemented AAOIFI disclosure standards, and revised the on-side inspection manual. It appears that the courts will not enforce the terms of agreements, which provide for the payment of interest.[22] In September 1984, the whole banking system was Islamised. In a regulation of February 1984, the Bank of Sudan (the central bank) ordered the banks to stop paying interest on commercial accounts holding foreign currency. In 1984 the Sudanese Court of Appeal held that the charging of interest is subject to criminal prosecution.[23] Since 1992, the banking sector in Sudan is totally Shariah based.

Tadamon Islamic Bank was established in 1981 with a paid-up capital SD4.974 million. It has 22 branches in Sudan. Its total assets grew by 275 per cent from SD30.3 billion in 1998 to SD83.5 billion at the end of 1999. In 1999, the executed investment operations amounted to SD1.4 billion, comprising Musharaka SD 551 million, Murabaha SD740 million, and others SD96 million. Saleh Abdullah Camel was one of three founding members of Al Shamal Islamic Bank in 1983, along with a Sudanese company, Al Shamal for Investment and Development and the government of northern state. Faysal Islamic Bank Sudan was established in 1977 under a special decree when US$10 million was deposited on the first day of its operation. Sudanese Islamic Bank was established in 1982, with a paid-up capital of 2,320 million Sudanese Pounds. It has 45 branches. The other Islamic banks in Sudan are Al Baraka Bank Sudan, Islamic Cooperative Development Bank (owned by the cooperative union) and El Gharb Islamic Bank and Islamic Bank of Western Sudan.

[21] Reuters, December 31, 2004

[22] The civil producer act, 1993,s 110 provides: “the court shall under no circumstance whatsoever make a degree ordering payment of interest on the principle sum adjudged.”

[23] Carey N. Gordon, ‘The Islamic Legal Revolution: The Case of Sudan’, 19 The International Lawyer (1985), 813.

Al Salam Bank, the new private banking venture to enter Sudanese Shariah-based system announced the launch of a US$18.75 million IPO to raise 25 per cent of its capital in October, 2004.[24] Omdurman Bank will lead arrange the IPO in Sudan, while Amlak will arrange the offering outside the country. The bank's capital has been set at US$75 million. The founders covered 75 per cent of capital equivalent to US$56.25 million from their own resources. The intension that the Al Salam Bank will help to stimulate the investment environment in Sudan.

As soon as the offering ends, the bank's stock will be listed on the Khartoum and Dubai financial markets. Once Al Salam Bank established it will have the largest capital of any bank operating in Sudan. The bank's list of founders include the Investment Office of Dubai, Amlak Finance, Lebanese Canadian Bank, Khartoum and the National Fund for Social Security.

The central bank of Sudan gave its approval for the fully Islamic US$200 million Emirates and Sudan Bank to be set up in Khartoum.[25] The bank has a paid-up capital of US$100 million and declared capital of US$200 million. Backed by a number of Islamic financial institutions, it has begin its operations in 2005. It plans to expand from it is Khartoum headquarters and create a network of branches throughout the country. All its operations services and products are fully shariah-compliant. The bank would offer a full range of Shariah-compliant services and products to meet the needs and requirements of all sections of Sudanese community, both business and retail.

Europe: Position of Islamic Banking and Financial Services

The Muslims population in Europe, outside of turkey an UK, is estimated 13.8 million. France and Germany, with Muslims population of 5.9 million and 3 million respectively provide ready markets for Islamic financial services.[26] ANZ International merchant Bank has Islamic finance division. Bosnia Bank International is the largest bank in Bosnia, which started operations April 2001. The bank has a US$60 million

[24] The Daily Star, October 6, 2004.
[25] Gulf News, December 29, 2004.
[26] The Banker; January 1, 2004.

issued capital and US$22 million paid up capital. The IDB has a US$ 10 million equity in this bank, while Abu Dhabai Islamic Bank (ADIB) has US$6 million equity and Dubai Islamic Bank (DIB) hasUS$6 million equity.[27] after 2 years in business, its making important progress. It made significant gains through real estate investments in Bosnia. Islamic Bank International of Denmark Copenhagen was established in 1993. BNP Paribas[28] has been actively promoting Islamic banking over the last few years. It has plans of further expanding its Islamic banking services. It provides *Sheriah* – compliant services along with conventional ones.[29]

In Germany, Commerzbank provides *Sheriah*-compliant services along with conventional ones.[30] Deutsche bank ranks second in topmost banks in the whole world. It has Islamic banking subsidiary. It was one of the sponsors of the ninth world Islamic Banking Conference (WIBC) held in Bahrain in November 2002. In Holland, ABN Amro is one the largest banks in the world.[31] this Dutch bank has established an Islamic banking division in its offshore unit in Bahrain. Its Islamic Banking unit is known as Global Islamic Financial Services. It has a large number of clients, which include over 3000 clients worldwide making it the world's leading bank in the international diamond and jewellery industry. It has set up a dedicated Diamond and jewellery business unit at its Dubai office in 2002 in order to service the banking requirements of several of its Global diamond clients who have set up operations in Dubai to cater to the UAE and middle east jewellery markets as well as conduct their international business from Dubai. In addition, the bank's diamond and Jewellery unit in Dubai also services the requirements of the UAE based gold & jewellery clients. In Luxembourg, the financial institution, which offer Islamic financial services, are Faysal holding, Islamic Finance House Universal holding SA (established in1979). Established in 1998, Samba Capital Management International ltd (SCMI), (Luxembourg) is a wholly owned Saudi American Bank financial institution. Its assets under management are US$4 billion (balance in mutual funds in Luxembourg and Saudi Arabia). Badr Bank (Moscow) was established in 1998

[27] Gulf News April 12, 2003.
[28] The 27th largest Bank in the world with Capital US$12,824 million.
[29] Time International, December 16, 2002.
[30] Time International, December 16, 2002.
[31] The 15th largest Bank in the world with capital US$17,471 million.

In Switzerland, a few financial institutions offer Islamic banking services. Dar Al Maal Al Islami trust (DMI) (Nassau, Bahamas) was established in 1981 with paid up capital of US$320 million. It is administered from Geneva, Switzerland. Dar Al Maal AL Islami (DMI) was established in 1981 through participation of ten Muslims countries, with major patronage of Saudi Arabia. It is pan-Islamic organization with over 25 financial and business companies represented in 15 companies of the world. It is one of the 3 largest Islamic banking group in the world with its headquarters in Geneva. It has ten banks, 7 investments companies, 7 business companies and 3 *Takaful* companies operating in 15 countries of the world it manages fiduciary funds of over US$3.6 billion. The commitments of DMI are in excess of US$700 million. It consists of 21 subsidiaries, which include 6 commercial banks, 3 investment banks, 4 investment companies and 4 business companies. These financial institutions are located in many Muslim countries besides Luxembourg. The group includes the various Faisal Islamic banks. Islamic banking is exercised in difficult forms: fund management and financial services in Switzerland and Morocco, investment banking in Pakistan, commercial and retail banking in Gulf region and other parts of the world. Islamic investment companies are located in Bahrain, Egypt, Pakistan, Qatar and UAE. DMI established Islamic Investment Company on the Gulf as its wholly owned subsidiary at Nassu in 1978.

Union Bank of Switzerland (UBS) is largest banking group in Switzerland. It opened its wholly owned subsidiary Noriba in Bahrain in May 2002, which was scheduled to start operations in June for providing banking services in accordance with Shariah principles.[32] It obtained license from the BMA to establish its subsidiary Noriba Bank BSC to provide traditional investment and merchant banking activities in accordance with Shariah principles.[33] Faysal Finance Switzerland (FFS) was established in 1990 (part of Dar Al Maal Al Islami Trust Oasis). Shamil Bank of Bahrain acquired a 51 per cent shareholding in FFS through its fully owned subsidiary Shamil Finance Luxembourg (SFL). Islamic Investment Company (Geneva) was established in 1984. Pan Islamic Consultancy Services was established in 1991. Swiss Banking Corporation offers Islamic financial products.

[32] Arab News, 5 August 2002.
[33] It was incorporated in Bahrain in May 2002. Arab News 5 August 2002.

United States: Position of Islamic Banking and Financial Services

Estimates on the size of the Muslim population in the United States range done in 2005 that from 6 million to 12 million people. It is said that by 2010, Islam will become America's second largest faith after Christianity. The average per capita income of Muslims in the United States was US$35,000 to US$45,000, which is well over the national average of US$24,000 to US$27,000.[34] 50 percent of the Muslims are immigrant, and another 40 percent are African-Americans, and they cut cross various cultures, and ethnic communities.

In September 2003, the US Secretary Snow invited the General Council of Islam banks and Financial Institutions (GCIBFI) to organize seminars inside the US to educate regulators and treasury officials on Islamic finance. He promised to work so that American regulation would not unnecessarily hamper the growth of Islamic banking in America.[35] There are growing interests and opportunities for investing in Shariah-compliant high-tech projects in the US. Freddie Mac and Warburg Dillion Read took initiative in development of Islamic structures for US investments. Wafra, owned by the public institution for Social Security of Kuwait, invests for Arab institutions and wealthy individuals in the US real estate, leasing operations and equity markets. In ten years, its asset under management grew to US$3.3 billion from US$150 million. More than two-thirds of the money is invested in securities. Kuwait Finance House (KFH), Gulf Investment House (GIH) of Kuwait have pioneered the development of Islamic structures for US investments, working closely with US banks and financial institutions, US law firms, and developers, construction contractors and other companies.

Fist Islamic Investment Bank (FIIB)[36] (based in Bahrain) has developed Islamically acceptable structures for financing US company acquisitions. The fist transaction occurred in the late 1990s and involved the acquisition of a water sports equipment company and a computer software company. Since then, FIIB has made acquisitions of a road paving machinery company and two portfolio of multi-family real

[34] The average per capita household income for US Muslims ranges as high as US$20,000 above the national average.

[35] Khaleej Time 26 September 2003.

[36] The bank's paid up capital has been increased to US$112.5 million.

estate projects. FIIB has completed the acquisition of US-based BR Lee Industries. It contributed US$23.3 million for 84 per cent of Lee Industries'[37] equity, and US$8.4 million in registered notes.[38] FIIB entered into an agreement of the acquisition of a majority equity stake in the US Caribou Coffee Company.[39] The total deal is understood to be worth in excess of US$80 million. FIIB has bought leading US companies in the sectors of canoes, paving equipment and infrared obstacle detectors. It has been involved in seven major acquisitions worth in excess of US$500 million. The most high profile, direct equity investment form only part of FIIB's activities. It wholly owned subsidiary, Crescent Capital Investments, occupied the 24th floor of Atlanta's Four Seasons Hotel Complex.[40] In June 1999, it took a US$50 million two-year facility arranged by ABC Islamic Bank.

Two real estate funds were launched—the First and Second Multifamily properties. Both were established through join ventures with the US Archstone Communities Trust and they own 11 apartment complexes in the US. The deals worth US$107.3 million and US$143.7 million respectively, were structured along seminar lines, with FIIB holding 80 per cent of each, and senior Ijarah Facilities provided by the Freddie Mac (Federal Home Loan Mortgage Corporation) have been put in place to support both. The Ijarah Liquidity Program was launched at the end of 2000. Based on sukuk principle, and backed by a-1 related leasing assets structured by Societe Generale, the program is aimed at meeting the need for short-term, low-risk Islamic instrument. Primary subscribers contribute US$100 million to the fund and it grown rapidly since. FIIB contributed US$18.4 million for 72.7 per cent stake in Transportation Safety Technologies (TST). FIIB has also provided a one million Murabaha facility to support

[37] It is a manufacturer of commercial paving and road building products such as rollers and tack distributors. It has about a 40 per cent stake of the US market.

[38] The total value of transaction was US$79.6 million. The sellers provided a US$4o million Ijara facility and maintained a 16 per cent equity stake, worth US$4.4 million. This is the fourth private quity deal completed by FIIB in the US since its establishment in 1997.

[39] Caribou owns a chain of 143 coffee shops in the US and second in size only the Starbucks Corporation Network.

40 There are plans for extension of the operation of FIIB to the UK and the German markets. The sale of the 84 per cent stake held by the bank, and its co-investors, in Computer Generation Incorporation (CGI) to the UK's Intec Telecom Systems was agreed, in a US$248 million deal. The company has been acquired in a US$178 million.

TST's working capital needs. DVT Corporation:[41] the total deal size was US$63.9 million. FIIB underwrote 61.1 per cent equity stake priced at US$39.5 million. Computer Generation Incorporation (CGI):[42] the total transaction was worth US$178 million. FIIB underwrote the acquisition of US$73 million worth of equity and US$27 million worth of subordinated notes, which is sum of represents 84 per cent of the shares remaining after a redemption scheme. Bank of America provided a US$50 million Ijarab term facility, and FIIB provided a US$10 million junior Ijara facility, for the financing of the share redemption programme.[43] FIIB acquired 94 per cent of perception's common stock.[44] the total deal was worth US$40 million. FIIB provided US$24 million with the remaining US$16 million coming through a bridge facility, which was later replaced by an Ijara term facility provided by HSBC Securities Divestment. FIIB and its co-investors acquired the stake in computer Generation (CGI) in February 1999 for a US$177.5 million. The deal was partly financed through the establishment of a US$60 million Ijara facility.[45]

These construction finance, acquisition and fund programmes For US transactions illustrate the growing awareness of US banks and financial institution in developing and implementing Islamic structures. The US participants have shown willingness to substantially modify traditional US financing structures to comply with Islamic precepts. These transactions also illustrate the ability of US banks and financial institutions to accommodate Islamic precepts within the extensive bank regulatory environment in the US.

Maconda Park Project was the first financing Project using shariah-compliant structure. The transaction exemplifies the participation in a joint venture by the Middle

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[41] It provides systems that inspect products and control machines such as robots and packaging machinery. A blue-chip customer base includes General Motors, 3-M, IBM, Motorola, Smith Kline Beecham and Nabisco.

[42] The US' CGI provides telecommunication mediation systems that collect and process electronic transactions and data passed through switches. The solution provided by CGI involve the sale of software, hardware, and maintenance services.

[43] The remaining 16 per cent of GCI's equity and subordinate notes, worth US$18 million, continuous to be held by the original owners.

[44] Water Mark is the holding company for two of the US's dominant kayak manufacturers, Perception and Dagger Canoe Company. Between them they have annual revenues in excess of US$30 million.

[45] Middle East Economic Digest, December 8, 2000,

East and US equity and US financiers, investors, developers and contractors. The financing structure of the Maconda Park has been replicated in a variety of construction financings in the US and elsewhere. The Maconda Park transactions is the first of its kind in the US. Its based on construction contract (Istisna) and lease (Ijara), both involving the bank affiliate, and related documents. The structure was developed from the principles under Shariah. With extensive structural and documentary review bt GIH's shariah committee. The structure complies with both US law-including bank regulatory requirements and tax laws and shariah.[46]

A key bank affiliate with relevant regulatory clearances became the project owner, for financing purposes. The bank affiliate entered into an Istisna or construction contract with a Fairfield affiliate. This contract is unique US financings given increased contractor risks, and the flexibility of Fairfield was critical to implementing the structure. The structure complied with a wide range of US laws, insuring that the project company remains the project owner for US tax and other purposes, insuring favourable tax treatment to GIH as foreign investor, all without causing a violation of shariah precepts. The Maconda Park Istisna-Ijara structure is now the basis for variety of construction financings in theUS and other jurisdictions.

FIIB has set up a joint venture with sunrise Assisted living[47] to acquire lease (Ijara) interests in 12 properties, comprising 940 residential units in united states. The total transactions value is nearly US$203.4 million. The properties in the assisted living sector are in Los Angeles, New York, Chicago, Detroit, Philadelphia and Virginia. FIIB and its co-investors hold 80 per cent in Sunrise First Assisted Living Holdings with its main office in Virginia. It will act as the asset manager. Fannie Mae (Federal National Mortgage Association), one of the largest provides of funds for home mortgage in the US., providedUS$138 million Islamic Ijara financing facility to leverage 11 of the properties in the portfolio. The First Islamic investment has been structured to generate a "stable" annual cash yield, which will be distributed an a monthly basis to the

[46] It allows the franchisers to comply with traditional US bank credit policies. One of the most significant aspects of the transaction relates the overcoming perceptions of, and restrictions on, the US participants in order to implement a joinder of Islamic and US/European financing concepts.

[47] Sunrise is the largest provider of assisted living services in the US. These facilities cater to the elderly in need of assistance, but who wish to live an independent as possible.

investors. First Islamic is projecting the investment to generate a blended internal rate of return of nearly 13 per cent over 5 years. This is inclusive of the projected annual cash yield of nearly 10 per cent. This will be distributed on a monthly basis.

Al Baraka Bancorp (California) Inc. was established in 1987. Al Baraka Bancorp Inc. Chicago, Illinois was established in 1989. Al Baraka Bancorp (Taxes) Inc. Houston was established in 1987. Al Manzil Islamic Financial Services, New York was established 1998. Lariba Bank is currently serving 13 states. It range Islamic financial products includes trade financing and financing for family homes, small businesses, fast food franchises, clinics and petrol stations. Chase Manhattan Corp[48] operates Islamic banking transactions. Goldman Sachs, which ranks third in the topmost banks of the world, has Islamic banking subsidiary. It has arranged Islamic lease financing of an oil refinery in Europe.[49] Muslim Credit Union received the permission of the regulatory authorities in Pennsylvania to establish a credit union in Philadelphia that would serve 100,000 Muslims of that area in conformity with Shariah. Samad Group is involved in establishing an Islamic banking under FDIC charter, under the name SAMAD American Bank Holding Group.

In June 2004, the US Treasury announced the appointment of an Arab economist as its first in-house expert to boost understanding of Islamic banking.[50] He would be the principal adviser on Islamic finance to senior Treasury officials and liaise with international groups seeking to monitor and create standards for Islamic finance. He would conduct workshops for US government agencies on Islamic finance, including overviews of the industry, prudent supervision and regulation, accounting standards, government practices and debt management.

US financial institutions are beginning to recognize the importance of the Islamic financial market. Two types of Islamic financing vehicles are commonly in use in the United States: Ijara and Murabaha. The Office of the comptroller of the Currency (the OCC) issued two key interpretive letters in 1997 and 1999 concerning products

[48] The first largest bank in the world with capital US$24,121 million.
[49] Buckmaster, *Overview of Islamic Banking and finance; Anthology of Islamic Banking*, London: Institute of Islamic Banking and Insurance, 1996
[50] Reuters; The Star September 22, 2004.

designed to be Shariah-complaint. In each case, the OCC looked beyond the form of transaction to its economic substance and concluded that the product was "functionally equivalent to or a logically outgrowth of secured lending and therefore permissible under existing banking law." The 1999 approval involved a proposal by the United Bank of Kuwait to offer Murabaha-based financial products. Ann Arbor's University Bank developed its Islamic banking division through a partnership with shape financial corp., a group of financial services and real estate professionals in West Falls Church, Va. The bank has about US$1.65 million in its Islamic deposit accounts, which allows Muslims to open accounts were any profits are shared rather than paid as interest. The Islamic Banking Division of the bank is looked upon as an "Islamic friendly lender".[51]

[51] Market Wire, February 8, 2005.

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