Outline of an Economic Sociology of Islamic Banking

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Abstract

This article offers the outline of a sociological framework for the analysis of Islamic banking. The proposed theoretical approach consists of three analytical levels. First it presents the key features that characterise Islamic conception of economy. In the next step, the article demonstrate how a specific institutional order derives from this fundamental conception. Finally it is shown how this institutional arrangement provides the rules and principles required for organising economic interactions, including financial practices. The article ends with a short chronological review of the actual course of establishment and expansion of the Islamic financial institutions during the last few decades, embracing a number of countries in which Islamic banking has been of a certain degree of significance.

Keywords: Economic Theory, Finance, Development, Islamic identity, Religion

Introduction

Islamic Banking refers to a system of banking or banking activity that is consistent with the principles of Islamic law (*Sharia*) and its practical application through the development of Islamic economics (Khorshid 2009; Mahlknecht 2009; Rosly 2006). In its modern shape, Islamic banking has been in existence for a few decades only, yet in this short period of time we have witnessed an extremely impressive growth of financial institutions and instruments designed in accordance with the principles of Islamic law and tradition – a growth which has been joined with a remarkably wide popularity across the Muslim world. Not restricted to Islamic societies, there are now more than a hundred financial institutions practising some form of Islamic banking and finance in about forty-five countries (Al-Omar and Abdel-Haq 1996); and though due to the lack of sufficient research no accurate figures concerning the actual size of the funds under Islamic management are yet available, according to some undocumented estimates among the people involved in the industry the current annual turnover of the market is between 30-70 billion USD, which is to be compared with a mere five billion in 1985 (Al-Omar and Abdel-Haq 1996 ; Iqbal 1997). Having grown rapidly and taken hold firmly, these institutions are "undoubtedly here to say" (Wilson 1990a: 3) and constitute an increasingly significant feature in the development of an important part of the contemporary world; and they do so in spite of the numerous challenges and substantial difficulties which – as we shall see below – they have had, and still will have, to cope with.

What follows however is an attempt to introduce this recent and rather unfamiliar phenomenon, and this is done in three stages: First there will be a general and brief presentation of the main features of the Islamic conception of economy and of the specific kind of economic order which is acceptable and desirable within this world-view. This conceptual presentation is meant to provide us with a background, which seems necessary for the understanding of the underlying constituent values and principles governing the Islamic view of economic issues. It then will be followed by an introduction of the main institutional arrangements providing the rules and principles of organising economic interactions, especially those that are decisive for the specific character of the practice of Islamic banking. Lastly, there will be a short chronological review of the actual course of establishment and expansion of the Islamic financial institutions during the last few decades, embracing a number of countries in which Islamic banking has been of a certain degree of significance.

The Theoretical Framework

Although the purpose of this paper is primarily to provide the reader with an introduction to the subject, the choice of the particular disposition mentioned above has been motivated by a certain theoretical approach to economic issues – an approach which due to its sensitivity to the contextually variable nature of economy seeks to attain a better understanding than the one the mainstream economics is capable of offering. Founded upon a coherent set of relatively few assumptions accompanied by a pertinent methodological outlook, mainstream economics has proven to a theoretical framework of considerable analytical strength; hence its establishment as the principal approach to the understanding of explanation of economic life.

Yet, it has also been subjected to a prolonged and severe criticism which, launched from outside as well as from the within the discipline, has been of most varying nature; and despite the great number of these critical evaluations, it seems possible to discern a common denominator shared by most of them, namely a critique of the mainstream economics for its strong tendency of universalism and its subsequent failure to pay due attention to the contextually determined character of an specific economic system.

To make a long history short, this failure originates in the deductive nature of neo-classical perspective which, drawing upon a certain ideal of science, finds a solid foundation and a reliable point of departure in an supposedly universal and invariant nature of man- By fixing the human nature pre-socially, that is by treating it as if it were moulded independently from the impact of the particular, historically variable socio-cultural settings, and by reducing it to the simple, naturally in-built and universal function of utility mainstream economics finds the 'given' premises from which everything else can be logically inferred through deduction. As a consequence of this epistemological bias, within the mainstream perspective all major components of any economic system, irrespective of their concrete context, are conceptualised in accordance with a set of assumptions taken to be universally valid, and receive undifferentiated theoretical treatment; hence the supposed universality of the assumptions of scarcity as the main problem of economy, of unbridled pursuit of self-interest as the chief driving force of economic processes, of *homo economicous* as the typical actor and instrumental rationality as the principal logic of economic behaviour, of the production of material wealth, prosperity and growth as the overall aim economic activity, and finally the assumptions of self-interested exchange as the paramount principle of organising economic interactions and self-regulating markets as the most efficient economic institution.

The obvious inadequacy of such a theoretical framework, especially when applied outside the context of modern industrial-market economies of the West, calls for a different and sociologically inspired approach in which these assumptions are considered as merely socio-cultural variables the existence, prevalence and force of which in any particular case are to be empirically verified. Within such an alternative approach it would in other words remain to be empirically examined in every given context how economy and its relation to wider society is conceived, what significance it is ascribed to, which ends are recognised as its legitimate goals, which incentives are admitted to pursue, what the approved modes of interaction are, how sacrifices and rewards are perceived, which principles and criteria these are to be distributed by, and so forth.

Generally speaking the present paper starts out from the assumption that a more adequate approach to the understanding of economic issues is the one that is capable of expanding its scope of inquiry to the extent that it can also embrace both the institutional environment as well as the more underlying cultural values and conceptions prevalent in any context in time and space. More specifically, what is required is a *three-folded* mode of analysis which is able to open up the possibility of 1) venturing into the spirit, universal meaning, general cultural orientation or underlying symbolic structure of any given context, 2) identifying the institutional matrix into which this spirit, universe of meaning etc. is incorporated, preserved and objectified and thereby provides the valid set of rules of the game; and 3) understanding and explaining the more tangible economic behaviours and interactions of actual individual and organisations as actions and relations which are designed in compatibility with the spirit in question and structured in accordance with the pertinent institutional regulation. Seen in this light, the phenomena and categories of economic life, economic behaviours included, can be conceived as culturally and socially conditioned, if not determined; and in consequence we will have the analytical apparatus which enables us to regard them as the outcomes of specific societal circumstances prevalent in any given context rather than as expressions of some inherent, naturally-given and never-changing human capacities and faculties.

It is however with such an approach in mind that the present description and presentation of Islamic banking is organised in this paper. In this sense, this paper represents an attempt to apply the more general mode of analysis described above upon a specific case of study. In other words, it represents an attempt to unearth the underlying conceptions and, so to speak, capture the specific spirit incorporated in the practice of Islamic banking, and to identify the particular institutional arrangements and the modes of interaction in use. Consequently, the focal point of this paper is to present the phenomenon as such, that is to say to try to understand the nature and the significance of Islamic banking taken in a more general view rather than to seek to provide a detailed empirical description of the actual implementation, performance and/or outcome of the specifically Islamic principles and modes of financial conduct. Given this purpose, the present article becomes primarily a descriptive one seeking to explore the unfamiliar field of study and to capture the key aspects of Islamic banking as seen by those who practice it.

The Cultural Context

According to its very fundamental tenets, Islam is an all-encompassing value system providing universal guidelines for all aspects of life, including the economic ones. There is a consensus among the Islamic scholars that within the economic perspective of this faith the general point of departure consists of a positive attitude towards material prosperity and well-being of all human beings in their worldly life. Rather than seen man as being eternally condemned for some original sin, within Islamic philosophical outlook man is considered to be the vice-gerent of God for whom everything on the face of the earth has been created. Therefore. According to the widely prevalent conception of it, Islam is by and large a non-ascetic faith, and as such it does not seek to deprive man from the bounties of the world, which God has in fact primarily intended and designed for his delight and happiness (see for instance Chapra 1979). With this outset, Islam not only approves material wealth and encourages its production and pursuit, but also even regards wealth to be a necessary precondition for the progress of the faith. Moreover, within the most prevalent conceptions of Islam there is no virtue is ascribed to poverty which itself is seen as rather a serious deficiency of failure of the Islamic society. Indeed, whenever compelled poverty is regarded as being prone to fostering disbelief or weakening or even undermining the faith of the believers (Al-Omar and Abdel-Haq 1996), and an economically weak Islamic society is seen as politically vulnerable, and – unable to sustain its autonomy – liable to being manipulated or dominated by others (Amara 1996; Motahari 1993).

This approval of wealth however is not entirely without further qualifications. Although the well-being of all human beings is a principal goal in Islam, it is based upon an "unshakable foundation of spiritual values" (Chapra 1979: 21). Setting moral boundaries, this well-being is considered in a dual fashion in the sense that it is regarded to be attainable and sustainable only by means of a balanced pursuit or realisation of both the material and spiritual needs of man. Another way of putting it is to say that in Islam the dualism of the choice between the worldly and the spiritual is replaced by a duality, that is by a simultaneous and necessarily interwoven stress on both. Seeking to strike a delicate balance, the spiritual and the material are seen as firmly dovetailed with each other, rendering one the necessary precondition and the inevitable source of strength of the other – neither by itself alone being capable of underpinning true human welfare. Mentioned in more than seventy verses of the Quran, Islam takes material well-beings into consideration from different angles, and pays considerable attentions to its various aspects. A recurrent feature however concerns the conditioned nature of this approval, that finds its expression in the spiritual orientation inseparably attached to material well-being and economic wealth, subjecting their pursuit to a whole fabric of severe moral regulations. Consequently, unless the desire for acquisition and accumulation of wealth is "accompanied by [moral] efforts directed to ensure spiritual health at the inner core of human consciousness, it is considered as an illegitimate goal of the individual Muslim as well as the Islamic society (Al-Omar and Abdel-Haq 1996: 3; see also Chapra 1979 and 1993 as well as Beheshti and Bahonar 1990 for similar statements).

This duality however is to be observed in the treatment of a number of economic issues. For instance, though there seems to be no consensual conception of social justice among Islamic scholars, it is nonetheless conceived as a superior virtue and indeed a major, if not decisive, criterion according to which judgements about any other economic issue are to be made. Therefore, whereas Islam shows an undoubtedly deep respect for freedom of enterprise and for property rights, the legitimacy of both is put in relation to social justice, and in evaluating their outcomes and effects justice is never out of sight. Yet, the one expression of this dual approach to wealth that is of more direct relevance to the purpose of this article concerns the moral constraints, which in the Islamic view are attached to the source s of wealth and on its uses. To take the latter first, Islam has a clear and rather restrictive view upon consumption: whereas some objects are totally illegitimate and thus made prohibited, there is a whole set of rules regulating the consumption of the legitimate objects. These rules are in general designed to discourage individuals and societies alike to seek to expand their needs, and instead to contain them at a disciplined level, condemning any immoderate and/or wasteful use of wealth especially the superfluous and conspicuous consumption serving nothing but one's sense of vanity or need of displaying splendour (Beheshti and Bahonar 1990). More important are the rules determining the legitimate modes of wealth acquisition however. Distinguishing between productive and non-productive work or between 'true' and 'false' work, it is only the former that is considered as useful and value-creating economic activity and thus a legitimate source of wealth. 'True' work is the kind of economic activity which by providing for 'true' human needs kept at a disciplined level facilitates life and makes it more pleasant.

Only when entirely earned through thin kind of work, wealth is legitimate and its accumulation should not be subjected to interventions that hamper free enterprise or that violate property rights of the individual (Motahari 1993). 'Superfluous and fruitless' activities on the other hand that perform no genuine function and play no inherent role in the economic system can have no place in an Islamic society and cannot constitute a legitimate source of wealth (Beheshti and Bahonar 1990). In sum, the spirit of the Islamic economic thinking can be caught as follows: Islam's ambition of purifying life without being ascetic is sought through moderation (Motahari 1993), that is through articulation of a harmonious duality of the material and the spiritual. Thus, although it emphasises the trifling nature of this world and its possessions, it not only permits but also encourages material well-being, pursuit of self-interest, free enterprise, wealth accumulation and private ownership. Yet, within this world-view the well being of man is conceived to be a multifarious matter, and although seen as a necessary means, economic welfare constitutes only one dimension of this more comprehensive conception. In consequence, the Islamic conception of the economic issues is always embedded within a wider value context, leading one to regard them as always submerged in and subordinated to higher spiritual objectives and moral evaluations. allowing them to receive only a conditional recognition. Their free sway is endorsed only to the extent that it does not violate the goals and ideals which constitute the very characteristics of that context. Their free play is admitted, in other words, only to the extent that both their ends and means can be appraised as legitimate (Naqvi 1981) and only in so far as they can be pursued, acquired and sustained "without sacrificing spiritual ideals" (Chapra 1979: 9).

The Institutional Matrix

Given the specific conceptual foundation of the Islamic economic system, it can be expected that the dual nature of this foundation is permitted to permeate through the institutional order the concrete outfit of which is designed to materialise the underlying objectives and ideals of the system; and these objectives and ideals being different from those prevalent in other cultural environments, the concrete configuration of the institutional framework of the Islamic economy is necessarily expected to be different. Hardly surprising thus this institutional framework is tailored to serve the creation and maintenance of an economic order characterised by spiritual orientations and moderate outcomes descried above. The extreme inequalities generated by the market mechanisms for instance are to be flattened and alleviated by *zakat*, that is a religious tax levied on all wealth above a certain exemption level that, unlike fiscal measures of secular governments is paid voluntarily out of individual's sense of moral duty an that is often collected by religious authorities and re-distributed preferably locally among the needy (Al-Omar and Abdel-Haq 1996). More relevant here however is another economic measure initially designed for the same purpose, namely the prohibition against *riba* ('interest'), the unequivocal condemnation of which appears in several places in the Quran (Al-Omar and Abdel-Haq 1996). Literally meaning addition, excess, expansion or increase, *riba* is a religious-legal term the widest interpretation of which covers both interest and usury and indeed "any unjustifiable increase of capital whether in loans or sales" (Iqbal 1997: 43).

As far as sales on credit are concerned the prohibition is considered as a measure to forestall *riba* from creeping into the economy through the back door, and includes any exchange of commodities without giving an equivalent counter-value in return to the other party, whether this is arranged through variations in the amount of commodities being exchange or through exchange of commodities of equal value but with differences in time of delivery. Furthermore, with its obvious significance for the moulding of the Islamic financial system, this prohibition refers to any increment gained through lending money. More technically, it covers any cost levied on the principal of a loan to be paid to the borrower along with the principal amount at a pre-determined rate tied to the maturity and the amount of the principal as a condition for the loan or for its extension on its maturity. Excluding any possibility of distinguishing interest from usury in order to make room for the approval of the former, it is widely believed that "it makes no difference whether the return [of the principal loan to the borrower] is a fixed or variable percentage of the principal, an absolute amount to be paid in advance or on maturity, or a gift or service to be received as a condition for the loan" (Al-Omar and Abdel-Haq 1996: 8-9). Yet to meet the economic necessity of loan and credit several financial instruments are at hand. The first one, *qardh al-hassan* ('the good loan') concerns the provision for smaller, pure, interest-free loan for private purposes, provided either by the pious better-off individuals or especial agencies in the local community of ten organised as societies in associations with the local mosque. The loans available thus are of course advanced without interest but there may be some minor service charges to meet the current administrative expenses of these societies whose annual statements of account should not display any profit (Al-Omar and Abdel-Haq 1996; Beheshti and Bahonar 1990).

The more critical issue however is that of business loans and the institution providing them, that is the modern bank. In the Islamic economic thought the prohibition of usury and condemnation of all interest-bearing transactions as void is by no means equivalent to the abolishment of the whole system of banking. Banks as such are not regarded as bearing within themselves some "inherent harmful effects" (Beheshti and Bahonar 1990: 447). On the contrary, they are admitted because of their useful functions connected with effective transactions (drafts, payment orders, cheques, etc.), money exchanges and secure savings (current accounts and interest-free saving accounts). Moreover, banks are recognised as modern institutions performing the vital function of financial intermediation without which the necessary alteration of saving deposits into investment funds would hardly be possible.

Yet, within a world-view here economic considerations are submerged in, and subordinated to higher moral values and economic institution like bank is subsequently never stripped of moral dimensions and constraints. Here too, as elsewhere, the dual character of the Islamic approach to economic issues finds itself a clear expression in the social responsibility attached to the working of the banks. Given the prohibition against interest based upon justifications mentioned above, it is apparent that Islamic banking practices differ from those of conventional banks characterised by the charge of interest on loans and payment of interest on deposits. Undoubtedly this prohibition is "the nucleus of [Islamic banking] system" (Iqbal 1997: 42) but, emphasising the socio-ethical dimensions attached to bank as an economic institution, many Islamic scholars and bankers maintain that describing Islamic financial system merely as interest-free gives only too narrow a picture (Al-Omar and Abdel-Haq 1996; Iqbal 1997). In other words, the Islamic prohibition against interest – though a defining feature in itself – is only one institutional arrangement which should be taken as an indicator of the more general orientation of Islamic economic order. This point, often overlooked by many Western observers, makes up the very essence of Islamic banking and is stipulated most clearly in the public statement of the International Association of Islamic Banks (IAIB) as follows:

> "The Islamic banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristics that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or developmental activities, the Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability – despite its importance and priority – in not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match both between the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking that cannot be dispensed with or neglected" (IAIB 1990, quoted in Al-Omar and Abdel-Haq 1996: 27).

Shouldering this social responsibility by Islamic banks however takes several concrete forms of which the prohibition against interest and the promotion of interest-free loans (see above) are only two expressions. Other ones concern the types of economic activity that Islamic banks through their advancement of business loans and credit should encourage as well as the kinds of depositor- investor relations that are considered admissible., but before proceeding any further some clarifications deem necessary.

Within the Islamic economic thought money is not regarded as a commodity but as a medium of exchange and of storage of value (Al-Omar and Abdel-Haq 1996). Whereas its circulation for the purpose of increasing the economic activity is recognised, its use as "an object of transaction" and as "an independent factor to earn profit" is rejected as a regrettable deviation from its original and appropriate function (Beheshti and Bahonar 1990: 441-2). Accordingly, it is seen as "potential" capital becoming actual "only when it joins hands with other recourses to undertake a productive activity" (Iqbal 1997: 43). Further, another guiding principle for Islamic finance is provided by the conception of legitimate acquisition of wealth and earning of profit through productive work within the approved fields of the economic activity which, as already mentioned, is conceived as the only acceptable source of creation of value. From these considerations it follows that within the Islamic economic thought money by itself can not be a morally approved source of generating wealth "unless an asset yields economic and social *added value*" (Siddiqi 1997a: 26). This means that money can, and should, be lent for charitable purposes without expectation of return above the amount of the principal; but when lent for business purposes, it remains a prominent source of wrongful or unjustified earning whenever, and in whatever form, the profit it yields is generated without giving a just encounter-value.

Nor is it allowed to be used for unlawful economic activities including speculative transactions which involve extreme uncertainties and risks (Iqbal 1997). It can therefore be lent only for purposes of doing approved kinds of business, yet never at a prefix rate of interest. In consequence, the only form that the use of business loan and credit is permitted to take is *partnership* moulded in accordance with the guidelines stipulated through what has been known as the *Profit and Loss Sharing principle* (PLS). This principle simply means that, instead of lending his money and becoming a creditor, the provider of financial capital joins the borrowing entrepreneur in the enterprise and, in return for the funds supplied, shares the profits as well as the risks of the business; hence becoming a partner of the enterprise. Drawing upon the classic Islamic scholars' view on *riba*, the core idea beneath this financial model concerns elimination of the injustice inherent in the conventional creditor-debtor relationship which is considered as violating the justice principles that are very basic to Islamic economics. The argument runs as follows. Business profits, when earned along Islamic principles, are results of the hard work and wise management of the entrepreneur. But in spite of his decisive contribution, the entrepreneur is never assured of any positive return. Business profits may or may not be realised and, when they do, they indicate successful entrepreneurship and creation of additional wealth which can be determined only *ex post*.

Yet, while the earning of profit is uncertain, in a conventional creditor-debtor relationship the payment of interest is predetermined and certain. Settled *ex ante*, interest is an income landing on the side of the creditor who thereby is assured a certain profit without doing any work or sharing in the risk, or at least, regardless of the performance of the investment and irrespective of the outcome of the business operations. There is, it is argued, no doubt "the payment of something definite in return for something uncertain inflicts a wrong" (Al-Omar and Abdel-Haq 1996: 9). Nor there is any reason justifying such a mode of acquisition and accumulation of wealth, especially when considering that loan in itself cannot be profitable because the lender leaves his right of property in the hands of the borrower and, for the duration of loan, what happens to that property is not legally his concern any more; and just as possible losses should not harm the borrower possible profits too should be irrelevant to him (Motahari 1995). Thus, either the loan should be interest-free or alternatively, the borrower and lender should "share rewards as well as losses in an equitable fashion" (iqbal 1997: 43); hence the PLS principle becoming the overriding organising principle of the Islamic finance, and the various forms of economic interactions derived from it.

The Forms of Financial Interaction

Besides *qardh al-hasan*, i.e. the interest-free loan of rather small size for private purposes, which has already been mentioned, Islamic banks have developed a variety of basic financial instruments which, all being based upon the PLS principle, are tailored to satisfy different needs of both the providers and users of the funds and serve as "the basic building blocks for developing a wide array of more complex financial instruments" (Iqbal 1997: 43). The most frequently used of these instruments are as follows. *Mudaraba* (profit-sharing) is a form of partnership between the bank and an entrepreneur. In this form of financial interaction the bank supplies the capital and receives a pre-arranged share of the borrowers eventual profits (Moore 1990) while the other part, acting as the entrepreneur, provides the expertise and management. In this essence it seems to be "identical to an investment fund in which managers handle a pool of funds" (Iqbal 1997: 44). Here, in this 'trust financing' the bank, or any other fund providing partner, entrusts capital to the entrepreneur for investment and trading purposes, thereby investing its capital, though by another body, rather than borrowing it (Motahari 1995).

Whereas eventual profits are divided on a pre-agreed basis and in a ratio specified in the original agreement, the losses are borne by the fund supplier alone, and the entrepreneur who is assumed to have sufficient incentives to perform well is exempted from burdening any losses unless these result from his obvious negligence (Siddiqi 1997a). While this financial instrument is mostly used to provide short to medium capital loans and is most suitable for trade activities (Iqbal 1997), another mode of financing adopted by Islamic banks, *musharaka*, has traditionally been used for financing fixed assets and working capital of medium- and long-term duration (Iqbal 1997). This financing technique is a fixable form of equity financing which is "the same as a [classical] joint venture or equity partnership, whereby both parties [the bank and the client] contract to provide capital" (Siddiqi 1997a: 28). Both the bank, or any other investor, and the entrepreneur contribute to the capital (assets, technical and managerial expertise, working capital, etc.) of the operation in varying degrees and the funds thus provided are mixed together in a single enterprise body where the bank holds equity shares and participates in its management but may be bought out by other partners' shares of subsequent profits (Moore 1990). Suitable for long-term project financing, *musharaka* is regarded as "the purest form of Islamic instrument, as it conforms to the principle of PLS" (Siddiqi 1997a: 28).

According to this mode of financing all providers of capital, including the bank, are entitled to participate in management but not necessarily required to do so. They, however, agree to share the returns (as well as the risks) in pre-agreed ratios while the losses are borne by each partner strictly in proportion to respective capital contributions or equity participation (Al-Omar and Abdel-Haq 1996). The next alternative is *murabaha* which one of the most widely used instruments for short-term financing and is based on the traditional notion of purchase finance. The term literally means a sale on profit and refers technically to a contract of sale in which the seller declares his cost and profits. This form of financial interaction involves a request by the client to the bank to purchase certain items for him. The bank, or any other investor which undertakes to supply, i.e., to buy the specific requested goods or commodities, does so in order to resell them to the client. For the latter this form means provision of needed trade capital and for the bank the transaction entails a definite profit which is settled in advance through the resale contract where a profit margin is negotiated and pre-agreed. This mode of 'cost-plus sale' or 'trade with mark-up' has been adopted by a number of Islamic banks and makes up for a considerable part of Islamic financial transactions (Iqbal 1997), despite the fact that many, because of its similarity with *riba*, have questioned its legality (Al-Omar and Abdel-Haq 1996).

Other forms of financial interactions are *ijara* (leasing or letting on sale) and two types of sale contracts used for conducting credit sales and purchases. *bay mu'ajil* (credit sale or deferred payment sale) and *bay salam* (forward sale or deffered delivery sale). *Ijara*, which is a popular instrument accounting for about 10 % of Islamic financial transactions, is an arrangement under which the Islamic bank leases machinery, equipment, buildings or other facilities to a client against an agreed rental. Different forms of leasing are permissible including leases where a portion of the instalment payment goes towards the final purchase with the transfer of ownership to the lessee. The rent however is so fixed that the bank gets back its original investment plus a profit on it. Another use of this instrument is for wages, agreeing upon a definite usufruct in exchange for definite reward, but it is also used for the leasing of land at a fixed rent payable in cash (Al-Omar and Abdel-Haq 1996; Iqbal 1997).

In a deferred-payment sale, the delivery of the product is done on the spot while the seller allows the buyer to pay the price of the commodity at a future date in a lump sum or in instalments, provided there is no extra charge for the delay. A deferred- delivery sale is similar to a forward sale contract where delivery of the product is in the future in exchange for payment on the spot. For this form of purchase with payment in advance no sale can be effected unless the goods traded are in existence at the time of the bargain or, at least, they are defined, and the date of delivery is fixed. Thus, except for gold or silver which are regarded as a means and not an object of transaction, almost everything which is capable of being definitely described as to quantity, quality and workmanship can be traded by use of this financial instrument (Al-Omar and Abdel-Haq 1996; Iqbal 1997).

The Emergence and Expansion: A Brief Historical Review

The very first attempt at introducing Islamic banking in recent time was the establishment of the *Mit Ghamr Local Savings Bank* in 1963 in Mit Ghamr, a small provincial rural centre in the Nile Delta in Egypt (see Wilson 1996a:7). This little experiment which lasted until 1967 is important not just because of its pioneering role and not primarily because it came to incorporate the spirit of Islamic banking in its purest sense in its operation. It thus can serve as a good example to illuminate the phenomenon and, therefore, is presented here at some length. This small local bank provided for five financial functions: deposit or saving accounts, loans, equity participations, direct investments, and social services. Deposit accounts were designed to develop the habit of saving among small savers rather than to bear any financial rewards. More, there were two main types of interest-free loans, non-investment and investment loans, available to help overcome personal financial problems (*qardh al-hasan*), and for investment purposes of financing small enterprises on the basis of PLS principle. Through equity participation (*musharaka*), the bank participated as a joint owner in the enterprise initiated and run by an entrepreneur, sharing both the profits and the losses in proportion to the amount of capital invested.

And through direct investments the bank started some minor enterprises on its own such as a brick factory, a private school, a macaroni factory, a mechanised irrigation project and a dairy. Finally the bank undertook some social service activities which resembled it to a re-distributive agency since it established a special *zakat* fund, pooling *zakat* revenues in order to redistribute it for the purposes of helping others socially and economically. *The Mit Ghamr Local Savings Bank* however was short-lived and in 1967, due to political reasons, was put under the direct control of governmental institutions and run on the basis of conventional financial policies, losing its operational autonomy as well as its Islamic character (El-Ashker 1990).

Yet, during its short life the performance of the bank was marked by a notable success, relying on the savings of small investors and managing to mobilise small savings of individuals of limited income. Further, it succeeded in improving the standard of livings of many in its area of operation. But above all, as a significant experiment for putting Islamic principles into practice, it "signalled to Muslims that the *Sharia* (the sacred law of Islam) was still applicable to economic issues in the modern world" (El-Ashker 1990: 61). This financial experiment, however, was studied by many Muslim countries as a pioneering and successful example (El-Ashker 1990) and functioned as a sort of kick-start for the establishment of the *Islamic Development Bank* (IsDB) in 1975 in Jeddah, Saudi Arabia, which marked the expansion of Islamic banking (Al-Omar and Abdel-Haq 1996). According to the charter of the bank this international financial institution, composed of 51 member states, is to be a practical expression of the unity and solidarity of the Islamic world community and to pursue development and welfare of this community as a whole and of its individual member states along the Islamic principles and ideals as outlined by the *Sharia*.

Although IsDB is an investment bank, commercial banks were quick to follow and the second half of the 1970s witnessed a significant expansion. The first commercial Islamic bank, the *Dubai Islamic Bank*, was launched in 1975 in Dubai, shortly after joined by the *Faisal Islamic Bank of Egypt* (FIBE) established in 1977 (Wilson 1990a). The latter performed financial functions similar to those of its forerunner the *Mit Ghamr Local Savings Bank* but none the less there were some difference. It was no longer local or small. Rather, it was a joint venture established by, and as a member of, the Saudi Prince Mohammed bin Faisal's *Islamic Financial House*, and with a much larger starting capital of 8 million US dollars which soon was to be increased to 40 million due the public demand for subscription of its shares. Further, FIBE came to have a Religious Supervisory Board established to keep watch over the activities of the bank itself and its financially independent *Zakat* Fund (El-Ashker 1990).

By the same financial group, the *Faisal Islamic Bank of Sudan* (FIBS) was launched in 1977, beginning its operation in May 1978. FIBS, too, established a separate department concerned with the collection of *zakat* and other donations, and the distribution of these funds to needy people. As in case of FIBE, the *Faisal Islamic Bank of Sudan* came alongside its conventional board of directors to have a *Sharia Supervisory Board* which, enjoying a high degree of independence from the directors' board, was to "give credibility to the operations of the bank by authenticating their legitimacy from the *Sharia* point of view" (Ahmed 1990: 79). The year 1977 saw also the foundation of *Kuwait Finance House* (KFH) which, set up as an Islamic investment bank operating under a special government decree, began its operation in the following year. The KFH, too, had a permanent *Sharia* supervisory board with the authority to make statements, included in each annual report, about the consistency of the bank's activities to the principles of Islam; hence becoming "the ultimate authority in the House" (Wilson 1990b: 131). In 1978 the Bahrain Islamic Bank too opened its doors to the public, to be followed by the *Jordan Islamic Bank for Finance and Investment*, also established in the same year with a *Sharia* control authority which was to play a relatively restricted advisory role (Shallah 1990; Wilson 1990a).

In all the cases mentioned above, the Islamic banks were established as institutions rather isolated or submerged within a larger context of conventional financial system. By the end of 1970s however political developments in Pakistan and Iran had led to governmental attempts at transforming these countries' whole financial system into an Islamic one. In December 1978 Pakistan witnessed the official announcement of the intention of the Government to Islamise the economy of the country and this was to be approached in two steps: the establishment of the traditional institution of *zakat* in order to meet the needs of social welfare, and the elimination of *riba*. Following the recommendations of the entrusted *Council of Islamic Ideology*, three major existing finance institutions of the country (*House Building Finance Corporation*, *Investment Corporation of Pakistan* and the *National Investment Trust*) started in 1979 a three-year plan to change all their transactions into the Islamic interest-free mode of finance.

In the same year also a fourth financial institution, *Bankers Equity Limited*, was established and began its operation along Islamic principles (Gieraths 1990). Short after the victory of the Islamic revolution in Iran, the *Revolutionary Council* nationalised in 1979 the country's whole financial system which, in addition to the public banks, embraced also 27 privately owned ones, 13 of them joint ventures with minority foreign share-holdings. The next step which was taken in 1981 was to Islamise the operation of the banking system through a complete and once-and-for-all transformation process, carried out as a piecemeal policy extended over a six-year period (Aryan 1990).

Although a number of Islamic countries such as Algeria, Iraq, Libya, South Yemen, Syria did not allow any private banking, whether conventional or Islamic, until 1990 (see Moore 1990:236-7), the process of expansion of the Islamic banking continued throughout the 1980s and 1990s, both reaching new countries and becoming strengthened where already introduced. In 1980 the *Islamic International Bank for Investment and Development Bank* (IBID) was established in Cairo through a ministerial decree and with a capital of 100 million US dollars (El-Ashker 1990). Three years later (1983) Sudan experienced something of an explosion and no less than three Islamic banks were established within a relatively brief period of time: *Tadamon Islamic Bank*, the *Sudanese Islamic Bank,* and the *Islamic Co-operative Development Bank*; joined in the following year by the *Islamic Bank of Western Sudan* and the *Al Baraka Bank.*

Like its forerunner and its major competitor the *Faisal's Islamic Finance House*, *Al Baraka* or more exactly *Al Baraka Investment and Development Company* is a multi-national finance group launched in early 1980s by Sheykh Saleh Kamel, a Saudi businessman. Since its establishment *Al Baraka* has initiated a number of Islamic institutions in a number of countries, Muslim and non-Muslim alike. *The Al Baraka Bank* (Sudan) has already been mentioned. Turkey was to be the host of the second one. In 1983 the secularised Turkey, presumably under "external influence and pressure" (Baldwin 1990: 37; see also Moore 1990), finally allowed Islamic banks to operate in the country though the authorities refused to recognise officially the Islamic character of these institutions and referred to them as 'special financial houses'. In that year however two banks, the *Al Baraka Turkish Special Finance House* and *Faisal Finance Institution* were launched, soon followed by another Gulf-based joint venture, the *Kuwait Turkish Evkaf Finance House* founded in 1988, and by an entirely Turkish one, *Anatolian Finance House* (Al-Omar and Abdel-Haq 1996; Moore 1990). Similar *Al Baraka* initiatives have been undertaken in other countries as well. In 1985 the *Al Baraka* group managed to penetrate into the Tunisian financial market as well where it founded another joint venture called *Bayt Ittamwil al-Saudi al Tunisi Bank* (BEST). It also managed to acquire control of the ailing Egyptian *Ahram Bank* and thereby to found Egypt's third Islamic bank in 1988 under the name the *Saudi-Egyptian Finance Bank* (Moore 1990). And finally, *Al Baraka* opened its way into Algeria where until then no private banking was allowed, and was granted the permission to set up a joint venture with the state banks (Moore 1990).

The general trend of expansion continued during the 1980s and reached Muslim countries far outside the core Islamic region of the Middle East. One of these new countries was Malaysia whose adoption of Islamic finance showed a unique pragmatic *dual* character. Its first Islamic institution, the *Bank Islam Malaysia Berhad* (BIMB) was established in 1982 and since then all conventional banks have been given the opportunity to practise Islamic banking, provided certain terms and conditions are met. The BIMB also proved to be innovative, creating new financial products such as *Islamically Accepted Bills*, and *Islamic Export Credit Refinancing*. The Malaysian expansion however has continued ever since. In 1993 three new banks – the *Malayan Banking Berhad* (May Bank), *Bank Bumiputra Malaysia Berhad* (BBMB) and the *United Malayan Banking Corporation* (UMBC) – were established and the development seems to have encouraged also the neighbouring countries, given the establishment of the first Islamic banks in Indonesia in 1992 and in Brunei Darussalam in the following year (Al-Omar and Abdel-Haq 1996). The expansion of Islamic financial institutions has found other expressions as well. One such regards the recognition they have received from other non-Islamic banks. According to Wilson (1990a), due to the educative efforts of the Islamic financial movement, the principles of Islamic finance are now widely understood and respected, both within the Muslim world itself and by many of the Western financial communities who have extensive dealings with Muslim clients.

This can be seen in the close relations which a good number of Western financial institutions such as *ANZ Grindlays*, *Citibank*, the *Union Bank of Switzerland*, *Credit Swiss First-Boston*, *Swiss Bank Corp*., *Kleinworth Benson* and many others have developed with their Islamic counterparts and even formed special *Islamic Banking Units*, which comply with the *Sharia* (Siddiqi 1997b). "Narrowing the distinction between commercial banks and fully fledged Islamic banks" (Iqbal 1997: 44), similar trend can be observed amongst the conventional Arab banks. Already in 1988 the non-Islamic banks in Egypt for instance had set up some 60 especial Islamic branches (Moore 1990) and now many major non-Islamic Arab banks such as the *Arab Banking Co-operation*, *Gulf International Bank*, *National Bank of Kuwait*, *Saudi International Bank*, and *Saudi British Bank* are strengthening their Islamic operations, providing Islamic trade and portfolio services (Al-Omar and Abdel-Haq 1996). Another sign of this expansion can be seen in the growth of an international institutional network facilitating co-operation among the Islamic banks themselves. The *International Association of Islamic Banks* (IAIB) for instance was founded in 1977 to promote and foster Islamic banking, and recognised as one of OIC's affiliate organs.

Another forum has been the *Accounting and Auditing Organisation for Islamic Financial Institutions* (AAOIFI) established in 1989 in Bahrain in order to cope with the difficulties which due to lack of accounting standards were met in matters of revenue recognition and profit-sharing (Al-Omar and Abdel-Haq 1996). Others worth mentioning are the *Islamic Banks' Portfolio* (IBP) established in 1987 within the IsDB and the *Islamic Inter-bank Money Market* (IIMM) established in 1994 in Malaysia.

Some Conclusive Remarks

The Path of the expansion of Islamic banks, however, has not been one entirely free from problems; and once having witnessed a period of rapid breakthrough and initial growth they now seem to have embarked upon a much more sluggish process of maturation in which they have to cope with a number of substantial challenges. Some of these originates from the lack of a supportive environment. This is especially the case when Islamic banks operate in non-Muslim countries whose authorities, sometimes owing to the prevalent principles of deposit guarantee, do not recognise the Islamic character of these banks (for example the *Al Baraka International Bank* in London and the *Islamic Bank* in Durban, South Africa) (Al-Omar and Abdel-Haq 1996). But also in Muslim countries where not the entire financial system is Islamic there remain unsettled issues such as determining which jurisdiction, civil or religious, falls over the Islamic banks.

Other challenges, however, are rather inherent to the nature of Islamic banks themselves. Among these are the slow pace of innovation and lack of adequate and sound accounting procedures and standards, rendering these institutions to operate below their potentials (Iqbal 1997). In general, these problems arise from the infant stage of the Islamic banking and are therefore inevitable, at least at the primary pilot stages when old ideas and principles need to be adopted to meet the complex requirements of modern economic systems. This difficulty is reflected in the absence of a consensus on the guiding religious principles and in the lack of a uniform regulatory framework, leading to prevalence of different evaluations of practices, procedures and instruments in use. Yet, perhaps the more important challenges concern the performance of the banks themselves which, despite their remarkable success and popularity, have faced a rather persistent difficulty in placing the funds at their disposal in long-term investment projects. Too many of them have tended to advance short-term loans to finance import and commodity purchase which meets consumption needs but does little to encourage actual production, and in effect manufacturing as well as agriculture remain under-funded. Nor have they done enough to support exports or help adverse the balance-of-payments situation of their home-countries (Moore 1990; Wilson 1990a).

Islamic banks appear also to have fallen short of the required or at least expected levels concerning the performance of their social responsibility. Having turned mostly into large impersonal bureaucracies, they seem to have failed "in contributing positively to essential social needs such as poverty alleviation, granting credit to the poor, donating to charities, and helping to achieve redistribution in income" (Al-Omar and Abdel-Haq 1996). However, it should remembered that some of the problems which have hampered the better performance of the Islamic banks are of a more general character and are common to many developing countries. Some examples of these problems are the lack of profitable investment opportunities or the existence of institutional shortcomings necessary for long-term investments like established suitable legal frameworks and well-functioning secondary stock markets. Moreover, one should also keep in mind that, as historical experiences from elsewhere suggest, commerce can be a very effective means of accumulating the initial capital required for the subsequent large-scale, long-term industrial or agricultural investments in the hands of social groups most capable of undertaking such endeavours. It none the less remains to be empirically examined to what extent and how well these institutions are capable of performing the technical function of financial intermediation.

If successful, they can play a vital role in the economic development of Islamic countries by mobilising dormant savings that in many cases are being intentionally kept out of interest-based financial channels. Thus, by offering an Islamic alternative, they will "enable savers and borrowers to choose financial instruments compatible with their business needs, social values and religious beliefs" (Iqbal 1997: 45); and by doing so they will be able to make an important contribution to the harnessing of large potential resources which otherwise would not be activated by conventional banking but would remain merely hoarded as idle cash or held as precious metals (Wilson 1990a). As the history of Islam offers a number of fairly good examples indicating its capability of innovating and developing sophisticated financial instruments in the past, there seems to be no reason why we should assume that now it will not be able to improve the performance of the financial institutions designed along its principles. This too. However, remains an interesting empirical question of the future. But, irrespective of the degree of the forthcoming success of these institutions, one thing seems sure.

They are here to stay and there seems to be no going back, partly because the survival and relatively long existence of economic institutions is by no means solely an effect of their optimal economic efficiency. Furthermore, it is true that establishment of the most important Islamic financial institution, the *Islamic Development Bank* (IsDB) in 1975 did coincide with the radical rise of oil prices and the subsequent current account surpluses of oil-exporting Islamic countries throughout 1970s. But it would be a mistake to seek to explain the emergence of the phenomenon in these terms alone. As we have seen, the very first Islamic bank in modern time appeared in 1963, that is almost a decade before there was any significant increase in the oil-revenues, and it appeared in Egypt which is not an oil-exporting country. More, as mentioned before, Islamic banking did not appear in all Islamic member countries of OPEC. Whereas it was totally absent in pre-Revolutionary Iran, some other major oil-exporting countries such as Algeria, Iraq and Libya "did not allow any private-sector banking, whether conventional or Islamic, until 1990" (Moore 1990: 236-7). Indeed, as we have seen, the continued growth of the Islamic banking has taken place and shown a very rapid rate despite the eroding oil revenues of the last 15 years, and this has been the case in countries like Egypt, Turkey, Malaysia, and Pakistan which do not produce petroleum.

All these elementary observations suggest that, whereas the increased oil-revenues and the global integration of finance markets surely constitute parts of the explanation, any account for the strong emergence of Islamic banking should not be confines to purely economic factors alone. Nor should in estimating their significance, and even less their future development, we reduce our account to purely economic dimensions of these institutions, measured by purely technical yardsticks such as efficiency and profitability. Rather it appears that a more insightful evaluation of Islamic banking *as a phenomenon* should transcend the merely economic frameworks and try to embrace also its political dimensions, seeking to reveal the impact of factors which are only too obvious to be excluded, namely the reinforced desire for socio-political and economic systems based upon Islamic principles and with a stronger Islamic identity.

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