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### The Determinants of Islamic Financial Development and The Constraints On Its Growth

Lecture by **Professor Rodney Wilson** | *Director*  
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# **The Determinants of Islamic Financial Development and the Constraints on its Growth**

*Professor Rodney Wilson*

The aggregate figures for *Sharī'ah*-compliant assets are impressive, exceeding US\$1 trillion, with annual growth exceeding 10%, even during the financial crisis of 2008. Disaggregation, however, reveals numerous weaknesses and challenges, not least overdependence of Islamic banking and finance on a limited range of markets and its relative underdevelopment in the markets of the more populous Muslim countries. Although much has been achieved in Islamic banking during the last four decades, it remains on the margins of the international financial system. There has been an understandable disappointment, and to some extent frustration, for many of the advocates of Islamic finance.

The aim here is to examine the constraints facing the development of Islamic banking in a systematic manner. To facilitate this examination a number of concepts are introduced: first, the notion of financial deepening and whether this can be applied to the measurement of *Sharī'ah*-compliant bank deposits. Second, macro-level constraints are examined, notably political factors that may result in an unsupportive legal and regulatory system which favours conventional over Islamic banks. Third, at the micro level the decisions by Islamic banks concerning their product offerings are examined. Islamic banks are often accused of merely replicating conventional financing facilities, with the *Sharī'ah* compliance involving form rather than substance. This can result in potential clients, including the majority of Muslims, believing that the case is unconvincing for using the Islamic banking services on offer. Finally, there is the reality, especially among the poorer populations of the Muslim world, that most people do not use banks,

either conventional or Islamic. This raises the issues of financial widening and financial exclusion. Should existing Islamic banks, or perhaps more realistically specialist institutions, be offering *Shari'ah*-compliant microfinance? At present, Islamic microfinance remains in its infancy, but perhaps this is more relevant for those who have no collateral to offer and lack regular employment.

### ***Shari'ah*-compliant financial deepening**

Financial deepening is usually defined as the proportion of bank deposits to gross domestic product (GDP), the premise being that with economic development the proportion rises.<sup>1</sup> Whether a rise in the proportion of bank deposits to GDP facilitates development or merely results from development has been the subject of much debate in the literature on economic development, but there is no consensus over the causation between the development of financial intermediation and economic growth.

As bank deposits account for most of the money supply in the majority of economies, the first rationale for believing that more financial intermediation will facilitate growth is that bank deposits represent liquidity which provides the means for transactions. Efficiency in transactions in turn facilitates exchange and specialisation, the building blocks on which wealth creation is based. The second argument for believing that the development of banks can contribute to economic growth is that they provide efficient intermediation by ensuring an optimal allocation of surplus funds. The business of banks is to assess and manage risk, and without such institutions modern economies cannot function.

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<sup>1</sup> Maxwell J. Fry, "Money and Capital or Financial Deepening in Economic Development?", *Journal of Money, Credit and Banking*, Vol. 10, No. 4, November 1978, pp. 464–475.

One of the arguments in favour of Islamic banks is that they can harness funds that will not be deposited in conventional banks, as Muslims associate the latter with *riba*. In so far as Islamic banks can attract additional funds, they arguably facilitate economic development.<sup>2</sup> If, however, they are merely seen as an alternative to the conventional banks which Muslim clients would use anyway, then Islamic banks would only contribute to economic development if they provide superior intermediation and are better at appraising risks than their conventional counterparts. This might be the case, but it can only be proven by empirical data which at present are unavailable. Islamic banks do not seem to be, on average, any more or less profitable than their conventional counterparts and there is no evidence that their returns on assets or returns on equity are any higher.<sup>3</sup>

Unfortunately, in addition to the conceptual issues regarding whether Islamic banks have contributed to economic development or not, there are also measurement issues. Islamic economists have challenged measures of development based on the valuation of material goods, arguing that the mere supply of consumer goods should not be equated with development.<sup>4</sup> Even secular economists are dissatisfied with material output measures, arguing that human well-being indices are a better measure of satisfaction and that social factors are at least as important as individual consumption.<sup>5</sup>

Actually measuring the amount of Islamic bank deposits and financing facilities is also problematic. In Iran, where all banks are Islamic, the total figure for bank deposits and financing is by definition the same as that for

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<sup>2</sup> Shahid Saleem, "Role of Islamic Banks in Economic Development", *MPRA Working Paper*, No. 6449, University of Munich, February 2008, pp. 1–77.

<sup>3</sup> Data on profits and returns on assets for Islamic banks are compiled annually by *The Banker*, *Top 500 Islamic Financial Institutions*, London; most recent, November 2010.

<sup>4</sup> M. Umer Chapra, *Islam and the Economic Challenge*, Islamic Foundation, Leicester, 1992, pp. 147–196.

<sup>5</sup> Mark McGillivray, *Human Wellbeing: Concepts and Measurement*, Palgrave Macmillan, 2006. Chapter 1 focuses on issues, concepts and measures.



*Sharī'ah*-compliant bank deposits and financing. Elsewhere the situation is more complex, and central bank data do not indicate the extent of *Sharī'ah*-compliant bank deposits. In Saudi Arabia, the United Arab Emirates (UAE), Kuwait and Malaysia, there is timely financial reporting by most Islamic banks, and it is possible to calculate the percentage of bank deposits and financing with wholly Islamic banks in relation to total bank deposits. What cannot usually be calculated is the amount of *Sharī'ah*-compliant deposits and Islamic financing by conventional banks offering these facilities, as the amounts are usually not disclosed. There are exceptions, such as Maybank Islamic in Malaysia which functions as a separate bank from its parent and provides detailed breakdowns of its deposits and financing activity.<sup>6</sup> Unfortunately, similar data are unavailable from most banks in the Gulf Cooperation Council (GCC) countries with the notable exception of Emirates NBD in the UAE, which provides details of Islamic financing and deposits.<sup>7</sup> Hopefully, such good practices will spread, but until this happens accurate measurement of the amount of *Sharī'ah*-compliant deposits and Islamic finance is not possible.

For detailed analysis of Islamic bank deposits, data on demand and investment *Mudarabah* deposits are necessary, with maturity dates or notice periods reported for the latter. When Islamic banks offer a wide range of deposit facilities tailored to the needs of different groups of clients, this can contribute to financial deepening. Demand or current account deposits are classified as narrow money, in many respects a substitute for notes and coins. Such deposits at the retail level are typically subject to a monthly cycle, as depositors get their

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<sup>6</sup> Maybank Islamic Berhad, *Condensed Financial Statements*, Kuala Lumpur, Quarter ended 30 September 2010:

[http://maybankislamic.com.my/download/mibfirstquarter\\_sept10.pdf](http://maybankislamic.com.my/download/mibfirstquarter_sept10.pdf).

<sup>7</sup> Emirates NBD Group, *Consolidated Financial Statements*, Dubai, 31 December 2010, pp. 2, 31 and 44:

[http://www.emiratesnbd.com/uploads/quarterlyReports/2010/ENBD%202010%20Financial%20Statements\\_Q4\\_111\\_4.pdf](http://www.emiratesnbd.com/uploads/quarterlyReports/2010/ENBD%202010%20Financial%20Statements_Q4_111_4.pdf).

salaries deposited and then pay for their regular outgoings.

Less liquid investment *Mudarabah* deposits are usually classified as quasi-money or broad money, as they have a lower velocity of circulation being regarded as long-term savings.<sup>8</sup> Islamic banks with a greater proportion of investment *Mudarabah* deposits have a higher cost of funding, but on the other hand they can also make funding available for longer periods, thus earning higher returns.

### **Macro constraints**

The stance of governments on Islamic finance varies enormously both inside and outside the Muslim world. Some view Islamic banking and Islamic finance more generally as a business opportunity and are very supportive of the industry. The governments of Malaysia and Bahrain are in this category, as they have been very pro-active in promoting Islamic finance and in making the case for their respective jurisdictions to become important international centres in this field. In the West the UK government has been much more receptive to Islamic banking than other governments in Europe and elsewhere, largely because it was seen as expanding the breadth of the services offered by the City of London into new areas.<sup>9</sup> Governments taking a pro-active approach have seen the benefits of Islamic finance in terms of job creation, especially as many of the jobs are attractive and well paid and widen the skill set of those involved in financial services, not least in *Shari'ah*-compliant asset management, a major growth area.<sup>10</sup>

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<sup>8</sup> Rodney Wilson and Remali Yusoff, "An Econometric Analysis of Conventional and Islamic Bank Deposits in Malaysia", *Review of Islamic Economics*, Vol. 9, No. 1, 2005, pp. 31–49.

<sup>9</sup> Elaine Housby, *Islamic Financial Services in the United Kingdom*, Edinburgh University Press, 2011, pp. 121–140 and 157–171.

<sup>10</sup> Natalie Schoon, *Islamic Asset Management: An Asset Class on its Own?*, Edinburgh University Press, 2011, pp. 49–90.

### **Uphill road for Islamic finance in North Africa**

In contrast, other governments have been suspicious of – or even hostile to – Islamic finance, seeing it in political terms, and associated with prohibited Islamist movements. The government of Egypt under former president Hosni Mubarak was an example of this negative attitude, as although some Islamic banking was permitted, it was confined to the fringes of the banking system. Despite there having been over three decades of Islamic banking experience in Egypt, the laws governing Islamic banking remained unsatisfactory. In particular, law number 88 of 2003, the most recent version of the Banking Law, contains no provision for Islamic finance. Some of the articles are unhelpful, including article 40 governing interest rates, article 56(e) on reserves which has no reference to *Shari'ah* compliance, article 59 which provides for interest penalties if banks fail to meet liquidity requirements, and article 87 providing for deposit protection. Investment *Mudarabah* accounts cannot, of course, be guaranteed; otherwise, the profit returns for risk sharing would be unjustified.<sup>11</sup>

The government of Muammar Gaddafi in Libya was even more hostile to Islamic banking, as none was allowed to operate despite surveys revealing a degree of popular support.<sup>12</sup> Nevertheless, two recent developments indicate that Islamic banking may emerge in Libya sooner rather than latter. First, in 2010 the Central Bank of Libya invited bids from foreign banks for joint ventures as part of moves to open up the Libyan banking system. The aim was to provide a wider range of banking services at more competitive prices to help the Libyan economy. Three European banks – Unicredito SpA, HSBC and Standard Chartered – were short listed, together with three Arab banks – Qatar Islamic Bank,

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<sup>11</sup> Rodney Wilson, *Islamic Banking and Finance in North Africa: Development and Potential*, African Development Bank, Tunis, forthcoming 2011.

<sup>12</sup> Amal Kumati, *Commercial Banking in Libya and the Potential for Islamic Banking*, PhD thesis, Durham University, United Kingdom, 2008; Alsadek Hesain Abdelsalam Gait, *Libyan Attitudes Towards Islamic Methods of Finance: An Empirical Analysis of Retail Consumers, Business Firms and Banks*, Griffith University, Australia, 2009.

Mashreq Bank and National Bank of Dubai.<sup>13</sup> All these institutions prepared licence bids by June 2010 and these are being evaluated by the Central Bank. If Qatar Islamic Bank receives an operating licence, this could be highly significant as the bank already has subsidiaries in London and owns Arab Finance House in Beirut and Asia Finance House in Kuala Lumpur, both dedicated Islamic banks with a focus on asset management.

The second initiative, in January 2011, was by Gumhouria Bank, the second-largest bank in Libya with assets worth US\$6.46 billion, 5,800 employees and 142 branches. It merged in 2008 with the Al Ummah Bank. Gumhouria Bank is planning to establish a subsidiary that will offer Islamic financial products, and convert seven of its branches to supply these products exclusively. Staff training will also be required, as well as a marketing campaign to attract customers, both those who already use the bank's conventional services and new clients, including those with other banks and young people opening their first bank account. Although these developments may be delayed by the disruption caused by the February 2011 popular uprising, the momentum has been established that should see Gumhouria Bank providing Islamic financial services, with possibly competition from the planned Libyan venture of Qatar Islamic Bank. Discussions have already taken place between the commercial banks and the Libyan central banks regarding the regulation of Islamic finance, and these are expected to continue once the situation in Libya improves.<sup>14</sup>

### **The supportive macro environment in South-East Asia and Pakistan**

Elsewhere there has been much more consistent government support for Islamic banking and finance,

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<sup>13</sup> Lamine Ghanmi, "Libya picks banks qualified for licence bids", *Reuters*, London, 19 April 2010.

<sup>14</sup> Staff writer, "Islamic finance moves slowly into North Africa", *Tripoli Post*, 22 February 2011.

with Malaysia's Islamic Banking Law enacted as early as 1983<sup>15</sup> and a law governing Islamic *Takaful* insurance passed the following year.<sup>16</sup> More recently, the Central Bank of Malaysia Act of 2009 included specific provisions for Islamic financial business, with a chapter dealing with the responsibilities of the *Shari'ah* Advisory Council appointed to serve the Central Bank.<sup>17</sup> There is also provision for Malaysia to serve as an international centre for Islamic finance.<sup>18</sup> In Indonesia, where Islamic banking started much later (in 1991), official encouragement has steadily increased as its business merits have been recognised, along with its ability to build beneficial financial links with other Muslim countries. Bank Indonesia produced a plan for the development of Islamic banking in 2002,<sup>19</sup> which was followed by comprehensive legislation in 2008<sup>20</sup> and the formulation of an Islamic financial strategy in 2010.<sup>21</sup>

In Pakistan there is no comprehensive Islamic banking law, but at the regulatory level the State Bank of Pakistan has done much to promote Islamic banking. It established an Islamic Banking Department on 15 September 2003 which subsequently developed detailed guidelines on the following: *Shari'ah* compliance; fit and proper criteria for the appointment of *Shari'ah* advisors; risk management; establishment of stand alone branches for Islamic banking; Islamic finance for agriculture; and Islamic microfinance. The Department also drafted a *Strategic Plan for the Islamic Banking Industry of Pakistan*, which aims to increase the share of Islamic to total deposits from 4% in 2007 to 12% by 2012.<sup>22</sup> As five Islamic banks are already operating in Pakistan, the target seems attainable.

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<sup>15</sup> Laws of Malaysia, *Islamic Banking Act* (No. 276), Kuala Lumpur, 1983, amended 2002.

<sup>16</sup> Laws of Malaysia, *Takaful Act* (No. 312), Kuala Lumpur, 1984.

<sup>17</sup> Laws of Malaysia, *Central Bank Act* (No. 701), Kuala Lumpur, 2009, Part 7, Chapter 1.

<sup>18</sup> Laws of Malaysia, *Central Bank Act* (No. 701), Kuala Lumpur, 2009, Part 7, Chapter 2, Section 60.

<sup>19</sup> Bank Indonesia, *Blueprint for Islamic Banking Development in Indonesia*, Jakarta, 2002.

<sup>20</sup> Laws of Indonesia, *Shari'ahShari'ah Banking Act* (No. 21), Jakarta, 2008.

<sup>21</sup> Bank of Indonesia, *Grand Strategy of Islamic Banking Market Development*, Jakarta, 2010.

<sup>22</sup> Islamic Banking Department, *Strategic Plan for the Islamic Banking Industry of Pakistan*, State Bank of Pakistan, Karachi, 2008.

### **The varied government policies on Islamic banking in the Gulf Cooperation Council**

Islamic banking is more developed in the GCC than anywhere else, apart from Iran where, by law, all banking must be Islamic as already indicated. In the GCC, only the UAE has a comprehensive law on Islamic banking, although Kuwait has modified its conventional banking law to accommodate Islamic banks.

In the UAE there are four significant provisions in the Federal Law of 1985, one regarding the rights of Islamic banks, two dealing with consequential exemptions, and the final provision dealing with *Shari'ah* governance.<sup>23</sup> The first significant provision is under Article 3, which states that Islamic banks have the right to form companies, either on their own account or with partners, the latter presumably applying to *Mudarabah* and *Musharakah* partnership contracts, although these are not specifically mentioned.

Two exemptions are referred to under Article 4 of the Federal Law. The first is the exemption given to Islamic banks from Article 90, clause (a) of the earlier Union Law of 1980, which stipulates that banks should not trade in goods. As the *Murabahah* contracts offered by Dubai Islamic Bank involved the bank acquiring commodities and selling them to their clients at a mark-up, this exemption retrospectively legitimised these contracts. The second exemption was to Article 96, clause (e) of the Union Law, which provided for the boards of directors of banks to determine the interest rates paid to depositors and charged to lenders. As Dubai Islamic Bank did not apply interest to any of its operations, this stipulation was clearly redundant.

Provisions for *Shari'ah* governance are provided under Articles 5 and 6 of the Federal Law of 1985. Article 5, which provides for the establishment of a Higher

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<sup>23</sup> UAE Federal Law *Regarding Investment Banks, Financial Institutions and Investment Companies* (No. 6), Abu Dhabi, 1985.

*Sharī'ah* Authority attached to the Ministry of Justice and Islamic Affairs, was never implemented. This provision was subject to cabinet approval, which was not given, possibly because of lobbying by supporters of Islamic banking who resisted centralised control. Instead, Article 6 was implemented, which provides for each Islamic bank to have its own *Sharī'ah* supervisory authority comprising at least three members. The Article provides that those nominated should be approved by the Higher *Sharī'ah* Authority, but as none exists, this has never happened.

An alternative approach would have been for the Central Bank of the UAE to have its own *Sharī'ah* board, as is the case in Malaysia.<sup>24</sup> This might have been more acceptable than having a federal ministry involved, especially one with little knowledge or capacity to deal with financial matters. Another explanation for the resistance to centralised control might have been that it was being exercised from Abu Dhabi, whereas Dubai Islamic Bank was (as its name suggests) based in Dubai, where financial institutions, whether Islamic or conventional, seek a high degree of autonomy. However, as Dubai Islamic Bank has branches in Abu Dhabi as well as other Emirates, this explanation does not stand up to scrutiny. Furthermore, when Abu Dhabi Islamic Bank was opened in 1997, it was subject to the same regulatory provision, demonstrating that there is a level playing field for Islamic finance throughout the UAE.

Kuwait is the only other country in the GCC to have specific legislation pertaining to Islamic banking, but in its case, there was a very long lag between when Islamic banking started in 1977 with the establishment of the Kuwait Finance House and the addition in 2003 of a new section on Islamic banking to the Banking Law of 1968.<sup>25</sup>

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<sup>24</sup> Rodney Wilson, *The Development of Islamic Finance in the GCC*, Kuwait Programme on Development, Governance and Globalisation in the Gulf States, London School of Economics, 2009, p. 65.

<sup>25</sup> Central Bank of Kuwait Law No. 32 of 1968: Section 10; *Islamic Banking*, Kuwait 2003.

The most significant provision relates to *Sharī'ah* governance. Under Article 93 of Section 10, each Islamic bank has to appoint an independent *Sharī'ah* board comprising at least three members. Where there are conflicts of opinion between *Sharī'ah* board members, these should be referred to the Fatwa Board of the Ministry of *Awqaf* and Islamic Affairs, which is empowered to provide the definitive ruling. In practice this has never happened and the Strategic Plan of the Ministry of *Awqaf* and Islamic Affairs covering the 2006–2011 period contains no reference to Islamic banking.

Qatar and Bahrain have no specific laws governing Islamic banks, but both countries have special regulations, details of which can be found in the Qatar Central Bank's *Instructions to Banks* and in the *Central Bank of Bahrain Rulebook*. In Qatar, Islamic banks have invested heavily in real estate for leasing through *Ijarah* contracts, which poses substantial risks, although the real estate sector in Doha has suffered less severe price declines than that of Dubai. Nevertheless, the *Instructions to Banks* specify that total investment by Islamic banks in real estate should not exceed 25 percent of the bank's capital and reserves, and that the investment period should not exceed five years.<sup>26</sup> The *Instructions to Banks* in Qatar cover many areas of Islamic finance, including the operations of Islamic subsidiaries of conventional banks, which had become the norm in Qatar, although these are now being closed down for unspecified reasons.<sup>27</sup> The *Instructions to Banks* in Qatar are not clearly presented and there is confusion over some issues, such as the number of *Sharī'ah* scholars to be appointed to each bank, with a minimum of two stipulated. However, the Accounting and Auditing Organization for Islamic Financial Institutions, whose standards are recognised in Qatar, stipulates a minimum of three scholars.

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<sup>26</sup> Qatar Central Bank, *Instructions to Banks*, Doha, 2008, p. 153.

<sup>27</sup> Hafsa Kara, "Rule Change Blow for Qatar Banks", *The Banker*, March 2011, pp. 51–52.



The *Central Bank of Bahrain Rulebook* contains the most comprehensive treatment of Islamic banking in the Gulf region, reflecting its status as an Islamic banking centre hosting 26 institutions with assets worth over US\$26 billion. There are rules governing the capital adequacy requirements, *Murabahah*, *Salam*, *Istisna*, *Musharakah*, *Mudarabah* and *Sukuk*, including the treatment of credit, market and operational risk.<sup>28</sup> Detailed rules are also provided for profit-sharing *Mudarabah* investment accounts, including the treatment of profit equalisation reserves that smooth the returns paid to time depositors, and investment risk reserves to mitigate possible losses. It is evident that there is much regulatory support for the Islamic banking sector in Bahrain, given its significance for the economy and employment in this small island nation. There is, of course, the question of whether effective regulation facilitates the growth of financial intermediation or is introduced in response to past financial crises. In the case of Bahrain's Islamic banking sector there has never been a crisis; hence, the former positive proposition probably applies.

Saudi Arabia's Banking Control Law was introduced in 1966, 20 years before Al Rajhi Bank, the first Islamic bank in the Kingdom, was awarded a licence. The law has never been revised to introduce provisions for Islamic banks, even though they have become of major significance, with Al Rajhi having more branches than any other bank, and ranking third in terms of assets and deposits in Saudi Arabia. Under Article 10 of the Law, bank involvement in wholesale or retail trade, including through imports or exports, is prohibited; yet, this is the basis of most *Murabahah* transactions by Islamic banks such as Al Rajhi.<sup>29</sup> Similarly, there are minimal regulations for Islamic banking in Saudi Arabia even though the Monetary Agency had run 374 courses on the supervision and marketing of Islamic financial products, attended by 6,300 people, over the period from

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<sup>28</sup> Central Bank of Bahrain, *Rulebook*, Manama, 2010: Section CA-3.

<sup>29</sup> Saudi Arabia Banking Law, Riyadh, 1966: Article 10.1.

2000 to 2007.<sup>30</sup> The only mention of Islamic finance is in the Regulations for Consumer Credit, where it is stated that Islamic products' documents for the purchase and sale of goods should conform to the requirements of the bank's *Shari'ah* committee, and that a profit rate rather than a borrowing rate applies to all credit extended under Islamic contracts.<sup>31</sup>

### **Micro-level decisions: Marketing Islamic banking products**

Islamic banking has been a bottom-up, rather than a top-down, phenomenon with its success largely resulting from popular support rather than government policy. In most jurisdictions, bank clients have a choice about whether to use the services of conventional versus Islamic banks, and in this context it is important for their success that Islamic banks provide attractive and convincing products.

There is an increasing literature on the marketing of Islamic banking and financial products following the pioneering work by Dale Shook and Salah Hassan which focused on religion, cultural priorities, lifestyles and buyer decision-making factors. In other words, much of the focus was on clients' preferences, and hence on the demand side.<sup>32</sup> More recent demand side studies have focused on brand loyalty and in particular the relationship between this and trust, commitment and effective communication, especially through the building of relationships between Islamic banks and their clients.<sup>33</sup> The strength of this approach is that it draws on

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<sup>30</sup> Governor of SAMA, *Speech*, Riyadh, 2007. Reported on the Saudi Arabia Monetary Agency website:

<http://www.sama.gov.sa/sites/samaen/SpeechWords/Governor/Pages/Home.aspx>.

<sup>31</sup> Saudi Arabia Monetary Agency, *Regulations on Consumer Credit*, Riyadh, 2008: Sections 2.3 and 5.3.

<sup>32</sup> Dale N. Shook and Salah S. Hassan, "Marketing Management in an Islamic Banking Environment: In Search of an Innovative Marketing Concept", *International Journal of Bank Marketing*, Vol. 6, No. 1, pp. 21–30.

<sup>33</sup> Maznah Wan Omar and Mohd Noor Mohd Ali, "Brand Loyalty and Relationship Marketing in Islamic Banking Systems", *Canadian Social Science*, Vol. 6, No. 1, 2010, pp. 25–32.

the well-established marketing literature with its many helpful concepts.

An alternative approach is to focus on the supply side, or in other words on what Islamic banks can do to promote their products and if appropriate try to change client perceptions rather than accepting these as given. Those who follow this approach often stress the importance of strategic marketing – in particular, drawing the clients' attention to the integrity of the *Shari'ah* supervision system and conveying trust and piety.<sup>34</sup> Kamal Nasser and Luis Moutinho view organisational change as part of the marketing strategy, as they see this as necessary if Islamic banks are to play an active role in their clients' business affairs.<sup>35</sup> Such a pro-active approach may be important in the promotion of *Mudarabah* and *Musharakah* finance, but this will involve moving away from the traditional culture of both Islamic and conventional banks, which is largely focused on the management of credit risk rather than getting involved in direct investment and appraising market opportunities.

Other studies of marketing issues facing Islamic banks have been country specific, with notable contributions by Sudin Haron and Wan Azmi on Malaysia focusing on marketing strategy,<sup>36</sup> while Asyraf Wajdi Dusuki and Nurdianawati Irwani Abdullah focus on the demand side, examining the attitudes of Islamic bank clients, also in Malaysia.<sup>37</sup> Analysing the findings of a survey of 750 respondents from four states in Malaysia, Dusuki and Abdullah found that Islamic credentials, financial reputation and the quality of services offered were the

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<sup>34</sup> Said M. Elfakhani, Imad J. Zbib and Zafar U. Ahmed, "Marketing of Islamic Financial Products", in M. Kabir Hassan and Mervyn K. Lewis (eds), *Handbook of Islamic Banking*, Edward Elgar, Cheltenham, 2007, pp. 116–127.

<sup>35</sup> Kamal Naser and Luiz Moutinho, "Strategic Marketing Management: The Case of Islamic Banks", *International Journal of Bank Marketing*, Vol. 15, No. 6, 1997, pp. 187–203.

<sup>36</sup> Sudin Haron and Wan Nursofiza Wan Azami, *Marketing Strategy of Islamic Banks: Lessons from Malaysia*, Kuala Lumpur Business School Working Paper Series, No. 6, Kuala Lumpur, May 2005.

<sup>37</sup> Asyraf Wajdi Dusuki and Nurdianawati Irwani Abdullah, "Why do Malaysian Customers Patronise Islamic Banks?", *International Journal of Bank Marketing*, Vol. 25, Issue 3, pp. 142–160.

major factors attracting clients to Islamic banks. Mohammad Tahir conducted a country study of marketing strategy for Islamic banks focusing on Pakistan. This resulted in similar findings to the Haron and Azmi study; notably, that new Islamic banks, which could be described as late arrivals, had more effective marketing strategies than pioneering institutions. This may be because new entrants have to compete more for market share in their effort to catch up. It may also indicate lethargy and complacency by well-established Islamic banks.

Although marketing strategy is important, it cannot be effective unless the products on offer are credible and convincing. Merely making products superficially customer friendly and attractive may encourage uptake, but it is not likely to change fundamental perceptions. In particular, Islamic banks can attract customers from those who are convinced that the products they offer are indeed *Sharī'ah* compliant, but the challenge is that even many Muslims, and evidence would suggest the majority, are unconvinced. Islamic banks have been successful in jurisdictions where they compete with conventional banks in raising their share of total deposits to 15 percent, or even in some cases such as Saudi Arabia to one quarter, but this still leaves the majority three-quarters not using Islamic financial products.

### **Islamic deposit credibility**

The constraint on growth is not merely communications, but the nature of the products on offer. On the deposit side the main selling point for Islamic current accounts is not simply that interest is not paid, as there is little or no interest on conventional current accounts, but the assurance that the deposits will not be used for *riba*-based lending. Where Islamic current accounts are offered by conventional banks, depositors need to be assured that there is an effective firewall between the Islamic and conventional operations. Unless separate and detailed asset and liability statements are published,

which is not usually the case, many depositors may remain unconvinced. Merely having the *Shari'ah* board affirming that the situation is satisfactory may be insufficient for the doubters and sceptics, who may point out that the members of the *Shari'ah* board are not accredited financial auditors.

The most distinctive deposits that Islamic banks offer are investment *Mudarabah* accounts, where depositors share in the bank's profits, and potentially also losses, rather than earning interest. The returns are seen as morally justified as they arise from risk sharing, rather than simply getting a return from hoarding without taking risks as with savings deposits with conventional banks.<sup>38</sup> Of course, with conventional bank deposits there is a default risk if the bank becomes insolvent or illiquid, but in practice with deposit protection insurance and central banks as lenders of last resort encouraged by governments to bail out failing banks, the risks are minimal. The returns on conventional bank accounts may be fixed or variable, but the rates will depend on the minimum lending rates set by central banks as a tool of monetary policy and interbank lending rates, as these are the major alternative to deposits for bank funding. In neither case will returns be related to bank profitability.

From the customer perspective, one criticism of investment *Mudarabah* accounts is that although returns are in theory related to bank profits, in practice they are often kept in line with returns offered by conventional banks, the argument being that Islamic banks, because of their minority status, are of necessity price takers in a competitive market for savings, rather than price makers. The existence of profit equalisation reserves only reinforces these practices, the aim being to draw on these reserves to maintain a competitive pay-out when actual Islamic bank profits are low or the bank is

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<sup>38</sup> Saiful Azhar Rosly and Mohammad Ashadi Mohd. Zaini, "Risk-Return Analysis of Islamic Banks' Investment Deposits and Shareholders' Funds", *Managerial Finance*, Vol. 34, No. 10, 2008, pp. 695–707.

suffering losses.<sup>39</sup> The Islamic Financial Services Board (IFSB) has issued detailed guidance notes on smoothing practices for investment accounts which clarify some of the issues,<sup>40</sup> but the underlying philosophy and rationale for these accounts can still be questioned. Given the workings of the investment accounts, critics can ask how meaningful the profit-sharing arrangements are, and indeed what the return to investment *Mudarabah* depositors actually represents.

There is also confusion among investment *Mudarabah* depositors over the nature of the risks they face. Returns cannot be guaranteed and rates cited are indicative, but in practice depositors usually always receive the projected rate regardless of how the Islamic bank actually performs in terms of profitability. Hence, depositors face a rate of return risk that is very similar, indeed often identical, to the interest rate risk faced by depositors in conventional banks with variable rate savings accounts.

Another risk is that in theory the deposits are subject to profit and losses and not merely profit sharing, as under *Mudarabah* contracts the *raab al maal*, the financier, or in this case the depositor, must bear any losses. The *Sharī'ah* boards of Islamic banks have been consistent in insisting that no guarantees can be given to depositors with investment *Mudarabah* accounts against losses. Islamic bank depositors are not shareholders, however, and they expect to get the nominal value of their deposit returned, rather than making capital gains or losses as is the case with equity investors. In other words, Islamic bank depositors, like their conventional counterparts, are very risk averse, and although rate of return risks are acceptable, risks to capital are unacceptable, regardless of the *Sharī'ah* boards' rulings. In short, the basic issue of whether investment

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<sup>39</sup> Neila Boulila Taktak, Sarra Ben Siam Zouari and AbdelKader Boudriga, "Do Islamic Banks Use Loan Loss Provisions to Smooth Their Results?", *Journal of Accounting and Business Research*, Vol. 1, Issue 2, pp. 114–127.

<sup>40</sup> IFSB, *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*, Kuala Lumpur, December 2010.

*Mudarabah* accounts are some type of quasi-equity investment or simply a bank liability like other deposits has never been adequately resolved.

The Accounting and Auditing Organisation for Islamic Financial Services (AAOIFI) has addressed these issues in its standard on the “equity” of investment account holders.<sup>41</sup> Its standard has the effect of minimising the investment account holders’ obligation to cover losses. In particular, losses should first be covered from undistributed profits and then from bank provisions for investment losses. Only if there is a remaining loss would the funds of investor depositors be called up. There is in any case only a limited liability by the investment account holders, as only sums deposited can be written down and there is no call on their other assets. Where the bank has been negligent, and this negligence is recognised by the *Sharī’ah* board, there is no liability by the investment depositors; rather, after the bank’s share in any profits has been deducted, it is the bank owners or shareholders who are liable.

### **Perceptions of Islamic debt financing facilities**

Whereas conventional banks provide most retail and commercial financing facilities through variable or fixed interest rate loans, Islamic banks offer financing that is potentially more tailored to their customers’ requirements. Rather than simply transferring financing risk to the customer, Islamic banks share risks with their clients, as it is this that provides the *Sharī’ah*, and moral, justification for their returns. This is potentially a very appealing proposition for Islamic bank customers, as the contractual terms for the financing are seen as fair and not exploitative. Ultimately, the role of the *Sharī’ah* boards in approving such contracts is to ensure they are consistent with Islamic teaching and therefore fair.

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<sup>41</sup> AAOIFI, *Equity of Investment Account Holders and their Equivalent*, Financial Accounting Standard No. 6, Manama, January 1999.

Although customers like reassurance that financing contracts are both *Sharī'ah* compliant and ensure justice between the signatories, they are also concerned with the cost of the financing. Islamic financing is not necessarily any cheaper or more expensive than its conventional equivalent, and it is important for the client to understand that the *Sharī'ah* compliance relates to the nature and terms of the contract, and not to the price charged for the financing.

Unfortunately, because many Islamic banks are small in relation to their conventional competitors, they cannot enjoy as great economies of scale and scope. Economies of scale can relate to the costs of account management and information technology systems. Banks with millions of customers have lower fixed costs per customer than those with only thousands of customers. Hence, Islamic banks often charge more for financing to cover the costs associated with a lack of economies of scale. Economies of scope refers to savings when several product lines can be offered derived from the one basic product – in the case of conventional banks, interest-based loans. Because Islamic banks offer a range of distinctive products based on different types of contracts, there is less scope for economies of scope which could reduce customer charges.

Higher charges for financing undoubtedly limit growth, as such charges may be seen as unfair, even though they are justified on cost grounds. Clients may be willing to pay higher charges because the costs of *Sharī'ah* compliance are seen as being legitimate additions which of necessity have to be borne by Islamic banks, but there is less understanding for paying more because of the absence of economies of scale and scope.

There is also an unwillingness to pay higher financing charges if clients are unconvinced about the merits of the financing methods on offer. Much Islamic bank financing involves *Murabahah* whereby the bank



purchases goods on behalf of a client and then proceeds to sell the goods to the client who pays by instalments, including a mark-up which represents the bank's profit on the transaction.<sup>42</sup> The advantage for the client, and the justification for the bank's profit, is that it takes temporary ownership of the good, and therefore has responsibility for the condition of the good when it is sold on to the client. If the good is defective, the client could pursue a legal claim against the bank as the seller. However, similar protection is available with conventional credit card transactions in many jurisdictions, even though the credit card provider does not own the good being purchased.<sup>43</sup> This reduces the added benefits from *Murabahah* when there are alternatives available which also provide protection.

Of course, from a *Sharī'ah* perspective *Murabahah* is permissible, whereas interest-based credit card transactions are not, although there is a question over whether the use of credit cards is permissible if clients pay their outstanding balances each month in full by direct debit and incur no interest charges. Most of the revenue for credit card providers comes from the retail establishment where the cards are used, as they have to pay a small percentage of the value of the transaction to the credit card company in return for a guaranteed immediate payment. It is this revenue, and not the interest on outstanding client balances, that accounts for most credit card profits.

Islamic bank clients and potential clients would be more willing to use *Murabahah* if it had unanimous support from the *Sharī'ah* scholars, but most clients know that their attitude ranges from grudging acceptance on grounds of necessity to regarding it as second best to *Musharakah* and *Mudarabah* partnership finance. There is criticism of both the structure of *Murabahah*

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<sup>42</sup> Hans Visser, *Islamic Finance: Principles and Practice*, Edward Elgar, Cheltenham, 2009, pp. 57–59.

<sup>43</sup> This is the case, for example, under the Consumer Credit Act of 2006 in the United Kingdom.

transactions, notably whether banks should be directly involved in trading activity,<sup>44</sup> and the benchmarking of the mark-up to prevailing rates of interest on conventional loans.<sup>45</sup> There is also the view that in the actual contracts used, the banks pass on most of the ownership risks to the clients, thus negating the justification for the mark-up.<sup>46</sup>

Even more controversial has been the use of *tawarruq* by Islamic banks which involves an extension of *Murabahah* whereby the bank arranges for the sale of the good once the client completes the purchase, with the proceeds from the sale being credited to the client's current account. In practice, this ensures the client gets a cash advance on the basis of deferred payments plus a mark-up, which achieves the same purpose as a loan with interest. At the 19th session of the International Islamic Fiqh Academy held in Sharjah in 2009 at which a number of papers critical of *tawarruq* were presented, the practice was prohibited.<sup>47</sup> The objection to *tawarruq* is that the trading activity is merely a device to ensure *Sharī'ah* compliance, but there is no real substance to the transaction. The goods involved are often used for hundreds of transactions, as nobody actually wants to take possession; the client only wants cash.

However *tawarruq* is still offered by a number of Islamic banks and conventional banks with Islamic affiliates. The practice continues because there is a demand for cash

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<sup>44</sup> Abdel-Rahman Yousri, "Islamic Banking Modes of Finance: Proposals for Further Evolution", in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perspectives on Wealth Creation*, Edinburgh University Press, 2005, pp. 43–44.

<sup>45</sup> Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics and Practice*, Cambridge University Press, 2006, pp. 67–68; Abu Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia*, Brown Walker Press, Florida, 2010, pp. 199–202.

<sup>46</sup> Charles Tripp, *Islam and the Moral Economy: The Challenge of Capitalism*, Cambridge University Press, 2006, p. 143; Robert W. Hefner, "Ambivalent Embrace: Islamic Economics and Global Capitalism", in Jonathan B. Imber (ed.), *Markets, Morals and Religion*, Transaction Publishers, New Brunswick, NJ, 2008, pp. 141–156, specifically p. 148.

<sup>47</sup> Abdur Rahman Yusri Ahmad, *Tawarruq, its Concepts, its Practices and its Economics: Implications of its Promotion by Islamic Banks*; Sami ibn Ibrahim al-Suwaylim, *Tawarruq Banking Products*; Ibrahim Fadhil Dabu, *Tawarruq: Its Reality and Types*. Downloadable from the International Islamic Research Academy, Kuala Lumpur: <http://www.isra.my/media-centre/downloads/summary/20/77.html>.

advances, but Islamic banks cannot provide overdraft facilities as these involve interest payments. Although *tawarruq* may satisfy the needs of some Islamic bank clients, the concern is that such practices result in damage to the reputation of the Islamic finance industry and wider scepticism. There is no moral argument supporting the proposition that *tawarruq* is better than a conventional overdraft, especially if the pricing and the purpose are identical. Merely arguing that the legal contracts are different is unconvincing for many.

Similar views prevail with respect to the *Ijarah* leasing contracts that have become increasingly popular in recent years, although it is important to stress that these should not be classified with *tawarruq*, and there is no case for any prohibition. *Ijarah* contracts are seen as just, as the client pays rent, a legitimate return in Islam given the recognition of private property, rather than paying interest. There is substance to an *Ijarah* contract as, in return for the rent payment, the lessee obtains usufruct rights to occupy property or use equipment.<sup>48</sup> In order to justify the rental receipts, the owner has to be responsible for the property or equipment being leased, with a liability to pay insurance and cover maintenance costs. *Ijarah* contracts are regarded as being similar to operational leases, where ownership obligations are maintained, rather than financing leases, where most, or even all, responsibilities are transferred to the lessee.

Although *Ijarah* seems attractive both from the *Shari'ah* and the client perspective, the contract has been subject to practical problems, which have resulted in the inherently moral nature of these agreements being undermined. Regulators are often uncomfortable with Islamic banks acquiring medium to long-term ownership of assets, as this introduces market and other risks outside the traditional realm of bank supervision. What happens if the asset being leased declines in value, and

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<sup>48</sup> Frank E. Vogel and Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk and Return*, Kluwer Law International, The Hague, 1998, pp. 143–145.

how will any residual value be treated at the end of the period? It can be argued that *Ijarah* should be undertaken by leasing companies where the shareholders bear the risks, not by banks with depositors who expect some degree of protection by the regulatory authorities.

In a sense, with *Ijarah*, Islamic banks are between a rock and a hard place as there are pressures to reduce the ownership risks and pass many of the responsibilities for the maintenance of the asset to the lessee, but this then may result in the contract ceasing to be *Shari'ah* compliant as its moral integrity is undermined. For example, in practice with many *Ijarah* agreements, lessees remain liable for the rental payments even if the asset suffers total destruction. Where there are diminishing usufruct benefits from a lease, the lessees are also expected to continue making payments as specified, unless they can prove breach of contract by the owner.

Usually the asset will be either purchased for a predetermined sum at the end of the lease period, or passed as a gift if there are additional instalment payments built into the contract in addition to the rent, these variants on *Ijarah* being referred to as *Ijarah wa iqtina*.<sup>49</sup> The actual market value of the asset at the end of the contract period is not taken into account. Therefore, the lessee is the party entirely exposed to market risk, while for the previous owner the *Ijarah* contract becomes a mere financing arrangement with risk transfer rather than risk sharing.

It is these practices that undermine the moral case for Islamic financial contracts such as *Murabahah* and *Ijarah*. Increasingly well-educated and discerning clients and potential clients of Islamic banks are aware of these issues. The tendency by Islamic banks to undermine the

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<sup>49</sup> Mervyn K. Lewis and Latifa M. Algaoud, *Islamic Banking*, Edward Elgar, Cheltenham, 2001, pp. 56–57.

moral integrity of Islamic financial products by mimicking their conventional counterparts has undoubtedly increased public scepticism about the merits of what is on offer.

### Participatory contracts

There has been limited use of *Mudarabah* and *Musharakah* contracts for financing by Islamic banks, although the former is used for deposits. The practical objections to these contracts are well known, especially the moral hazard and asymmetric information problems that increase risk for the Islamic banks to unacceptable levels.<sup>50</sup> In particular, it is difficult for the financier to monitor effectively how the funds are being used, and there is the temptation to under-report profits that have to be shared with the financier.

To overcome these difficulties, the contracts have been modified, the most important type of *Musharakah* now being *Musharakah mutanaqisah*, or diminishing partnership, which is increasingly used for Islamic mortgages.<sup>51</sup> As *Musharakah* is a partnership contract, the client contributes a proportion of the purchase price of the property, typically 10–20 percent, with the bank putting up the major remaining share. Over a period of 15 to 25 years the client gradually purchases the bank's share through monthly repayments and in addition makes rental payments to the bank to cover the usufruct of the property which the client enjoys. In effect, there are two written contracts, one a *Musharakah mutanaqisah* agreement and the second an *Ijarah* agreement to cover the rent.<sup>52</sup> The repayment amounts are predetermined, and will be designed to cover the full cost of the bank's investment, effectively providing an

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<sup>50</sup> Habib Ahmed, "Incentive-Compatible Profit-Sharing Contracts: A Theoretical Treatment", in Munawar Iqbal and David T. Llewellyn, *Islamic Banking and Finance: New Perspectives on Profit-Sharing and Risk*, Edward Elgar, Cheltenham, 2002, pp. 40–54.

<sup>51</sup> Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice*, Wiley, Singapore, 2007, pp. 9193.

<sup>52</sup> HM Revenue and Customs, VATFIN8400 – Islamic Products: Shared Ownership (Diminishing Musharakah), London, 2011: <http://www.hmrc.gov.uk/manuals/vatfinmanual/VATFIN8400.htm>.

exit route for the bank. The rent element may vary, usually with prevailing interest rates on conventional mortgage, even though benchmarking the rental payments to a rental index may be preferable from a *Sharī'ah* perspective and in terms of fairness.

To make *Musharakah mutanaqisah* more competitive with conventional mortgages in terms of the initial monthly payments, the question of most concern to clients, the repayments are structured so that they are very low for the first few years, but then increase steeply. If there were equal repayments, with the client paying more rent at the outset reflecting the bank's substantial share in the ownership of the property, the monthly payments would be front loaded, which would deter most clients. Hence the aim is to make the payments back loaded, when hopefully the client's income will have increased, making the monthly commitment more affordable. The criticism of this structure is that it encourages short-term thinking by the client, while increasing their long-term debt.

The other issue is that there is no risk sharing in the contract, an essential feature of *Musharakah*. The bank is subject to credit risk by the client, and there is a conflicting rate of return risk, with the client more exposed and the bank getting a higher rent if interest rates rise. There is no market risk, however, as the client does not want to share any capital gains on the value of the property, and the bank seeks to avoid all capital losses. In other words, there is no meaningful equity participation, as *Musharakah mutanaqisah* is best classified as a debt contract with the client repaying the initial sum advanced and hoping to make a substantial long-term capital gain on the property which is not shared with any other party.

In summary, in substance the *Musharakah mutanaqisah* resembles a conventional mortgage contract with the added *Ijarah* contract, but it provides for identical payments to interest charges even if they are designated

as rent. It is, of course, easy to criticise these contracts as adding no moral value to conventional mortgages, but they are what Islamic banks and their clients seem to want. The contracts are cleverly engineered from a financial perspective, but serve no particular moral purpose.

### **Financial exclusion**

Islamic banks, like their conventional counterparts, largely cater for those with regular salaries, reasonably secure employment and some capital that has been built up over a period of time or inherited. Most people living in the Muslim world do not fall into this category, especially the large youthful population who are either unemployed or have occasional informal employment for meagre remuneration. The popular uprising by the youth of the Arab world from Morocco to Egypt in north Africa and from Yemen to Bahrain in the Middle East highlights their frustrations and dissatisfaction with the economic and political systems of the countries in which they live. In this fluid situation there are opportunities as well as threats to Islamic banking and finance, and questions about how the industry should respond. Being too identified with the former status quo may no longer be helpful, but the issue remains as to how to widen the appeal of Islamic banking and finance and serve the masses rather than a largely middle- and upper-class elite.

Despite the criticism of existing Islamic financing methods as detailed above, it would be mistaken to ignore the achievements of the industry over the last four decades, or the value of the moral debates that have taken place over financial issues, a factor that has been sadly lacking in conventional finance where greed and fear are accepted as major determinants of financial decision making. It would also be unrealistic to expect that Islamic banks could solve all the economic problems of the Muslim world and create overnight prosperous, devout and morally upright societies. Although it is

worthwhile having a great vision, any practical contribution that Islamic finance can provide to improve the economic prospects for unemployed or only casually employed Muslim youth has to be carefully evaluated in the light of past experience of what is potentially feasible and what is not.

It is also important to recognise that finance can be a constraint on economic advance, but usually other constraints are more significant, notably human resource constraints. The youth of the Muslim world may be more educated, numerate and literate than ever before, but these attributes in themselves do not guarantee employment or even remunerative self-employment.

There has been little work undertaken on financial exclusion among Muslims apart from one detailed survey of the Muslim community in the United Kingdom.<sup>53</sup> A key question is whether many of the pious exclude themselves because they do not want to deal with *riba*-based banks, or whether they are willing to seek finance, but both Islamic and conventional banks are reluctant to provide finance as they lack regular employment or collateral. In the case of the United Kingdom, all these factors are important and it was found that existing Islamic banks and the *Shari'ah*-compliant affiliates of conventional banks dealt largely with high- and middle-income customers.

One solution may be to encourage the development of Islamic microfinance, and there is a limited empirical literature on this topic,<sup>54</sup> but the question of how to make it sustainable is a major challenge.<sup>55</sup> A comprehensive survey in 2007 of 125 Islamic microfinance institutions in 19 Muslim-majority countries found that only 380,000

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<sup>53</sup> Mohamed Hersi Warsame, *The Role of Islamic Finance in Tackling Financial Exclusion in the United Kingdom*, Durham University Doctoral Thesis, 2009.

<sup>54</sup> Habib Ahmed, "Financing Micro Enterprises: An Analytical Study of Islamic Microfinance Institutions", *Islamic Economic Studies*, Vol. 9, 2002, pp. 27–64; Dahlia El-Hawary and Wafik Grais, *Islamic Financial Services and Microfinance*, World Bank Paper, Washington, 2005.

<sup>55</sup> Rodney Wilson, "Making Development Assistance Sustainable through Islamic Microfinance", *International Islamic University of Malaysia (IIUM) Journal of Economics and Management*, Vol. 15, No. 2, 2007, pp. 197–217.



customers were using microfinance, a minute proportion of the Muslim population.<sup>56</sup> The major challenges are the high costs of credit scoring and administering large numbers of small funding amounts, as well as the potentially high risk of project failure and subsequent default. If a considerable degree of trust can be established between the Islamic microfinance institutions and their clients this can reduce monitoring costs, but often microfinance is expensive – indeed, not much cheaper than traditional moneylenders who are often accused of lending at usurious rates.

Another issue is that if there are subsidies the beneficiaries may be those who could in any case qualify for bank finance, but see Islamic finance as a supplementary facility which they can take advantage of. A survey of *Musharakah* funding beneficiaries in the greater Cairo area revealed that the recipients, although they lived in poor neighbourhoods, were often of above-average socioeconomic status.<sup>57</sup> There are evidently moral hazard and selection problems with Islamic microfinance, which is far from being a panacea for solving the problems of the poor.

The type of institutional arrangements used can be a critical factor for the sustainability of Islamic microfinance. One form of organisation is to establish Islamic credit unions, which are owned by their members, rather than having institutional arrangements such as Islamic banks, which are owned by shareholders. This avoids conflicts of interest between shareholders and clients. Making potential beneficiaries the key stakeholders in a credit union increases the level of trust. Such an organisation can foster a sense of belonging and mutuality. Credit unions are normally run on a not-for-profit basis. For such organisations to be established, a prerequisite is to have specific laws or

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<sup>56</sup> Nimrah Karim, Michael Tarazi and Xavier Reille, *Islamic Finance: An Emerging Market Niche*, Consultative Group to Assist the Poor (CGAP), Washington, DC, August 2008.

<sup>57</sup> Mohamed Nasr, "The Demand for Musharaka in Urban Egypt by Small Businesses as a Test of the Pecking Order Hypothesis", in Munawar Iqbal and Rodney Wilson (eds), *Islamic Perceptions on Wealth Creation*, Edinburgh University Press, 2005, pp. 217–227.

regulations pertaining to credit unions such as the United Kingdom Credit Union Act of 1979.<sup>58</sup> It is also helpful to have an association of credit unions which has a voluntary code of conduct and can disseminate good practice, as in the case of the United Kingdom.<sup>59</sup>

This type of financial infrastructure is found in many developed countries where credit unions have a long history, but is often absent in the Muslim world. One of the largest of this type of organisation is the Islamic Credit Union of Canada, which provides a wide range of services for its members – from current account facilities, including debit cards and bill payments, to Islamic *takaful* insurance and retirement pensions.<sup>60</sup> In the United Kingdom the Tower Hamlets Community Credit Union, although a conventional organisation, is currently examining how it can provide Islamic financing for the many Muslim residents of this London borough. At present, it provides unsecured loans at interest rates of as low as 1 percent per month up to a maximum of £7,500 per borrower.<sup>61</sup> In East Anglia the long-established Norfolk Credit Union is also investigating the provision of *Shari'ah*-compliant financial services.<sup>62</sup>

An alternative organisational structure to a credit union is a cooperative, but the distinction between the two types of organisation is often blurred and in practice the differences are more functional than institutional. Whereas credit unions mostly concentrate on personal savings and retail finance, cooperatives are more often financing micro enterprises, including farms, the aim being local infrastructure improvements such as irrigation and drainage schemes.

There are many Islamic cooperative organisations in South and South-East Asia providing microfinance, many of which benefit from co-funding from international

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<sup>58</sup> <http://www.legislation.gov.uk/ukpga/1979/34?view=extent>.

<sup>59</sup> Association of British Credit Unions, <http://www.abcul.org/home>.

<sup>60</sup> <http://www.icucan.org/>.

<sup>61</sup> <http://www.theccu.co.uk>.

<sup>62</sup> <http://www.norfolkcu.co.uk>.

donor agencies and non-government organisations. After the 2004 tsunami in Aceh Province in Indonesia, for example, Islamic cooperatives played a major role in reconstruction helped by the German development assistance programme GTZ.<sup>63</sup> There has also been a wider long-standing German commitment to Islamic microfinance in other regions of Indonesia.<sup>64</sup>

In India, where there has been no government support through legislation or regulation for Islamic banking, *Shari'ah*-compliant finance has been largely confined to the cooperative sector. There are a large number of Muslim cooperatives which provide microfinance, probably exceeding 300 institutions, but as many are informal rather than registered cooperatives, and as the legal position varies from state to state, there is no exact number. It is evident, however, that despite strong local support, the Muslim cooperatives have experienced mixed fortunes.<sup>65</sup> The Indian government's unhelpful stance has constrained expansion, as have the economic problems facing many rural areas of India, which the cooperatives primarily serve rather than the booming cities. There have also been examples of mismanagement and corruption within the cooperatives, which has somewhat tarnished their image.

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<sup>63</sup> Iman Budi Utama, *Reconstructing Islamic Cooperatives in Aceh, Indonesia*, 2006: <http://www.microfinancegateway.org/gm/document-1.9.27280/baitul%20qirad.pdf>.

<sup>64</sup> Hans Dieter Seibel, *Islamic Microfinance in Indonesia*, GTZ Financial Systems Development and the Federal Ministry for Economic Cooperation and Development, 2004: <http://www.gtz.de/de/dokumente/en-islamic-mf-indonesia.pdf.pdf>.

<sup>65</sup> Shariq Nisar and Mohsin Aziz, *Islamic Non-Banking Financial Institutions in India: Special Focus on Regulation*, Paper presented at a Seminar on Non-Bank Financial Institutions: Islamic Alternatives, IBFIM-IRT1, Kuala Lumpur, 2004: <http://www.philadelphia.edu.jo/courses/Markets/Files/Markets/90028.pdf>.

## Conclusions

Although much has been achieved by the Islamic banking and the Islamic finance industry more generally during the last four decades, it is evident from this survey that there are many obstacles to its growth. It is clear that to a large extent Islamic banks have been substitutes for their conventional counterparts, rather than complementary. There has been *Shari'ah*-compliant financial deepening, but little contribution to overall financial deepening which could help facilitate economic development. However, as the causal relationship between financial deepening and economic development is debatable, and as most Islamic banks are retail institutions, their growth may be more a consequence of economic development than a contributing factor.

Islamic banking has enjoyed much popular support and can be viewed as a bottom-up movement, but political commitment to *Shari'ah*-compliant finance by government is important. The industry has done best in supportive legislative and regulatory environments such as Malaysia and Bahrain, but remains on the margins of the banking systems of North Africa despite its long history in Egypt. Indeed, there appears to be more resistance to Islamic banking in some Muslim-majority countries than in Muslim-minority countries such as the United Kingdom, where Islamic banking is seen as a business opportunity rather than a political issue.

It is easy to blame the failure of Islamic banking to develop faster and gain more market share on poor advertising and other marketing tools. However, these factors are superficial and transitory. Of greater importance are public perceptions of the services offered by Islamic banks and the credibility of the products themselves. Having a product endorsement by a board of respected *Shari'ah* scholars is sufficient for many clients, but the more highly educated clients and potential clients, especially those who are younger and more curious, inevitably question the merits of the

products themselves. They may be respectful of the *Sharī'ah* scholars, but they still need to be convinced of the moral, and not merely the financial, benefits of the deposit and finance facilities offered.

A detailed examination of the products reveals that there are many unanswered questions about the deposit facilities, including the assurances from conventional banks offering Islamic current accounts that these funds are adequately segregated and do not get utilised for lending with interest. There are also questions about the integrity of the investment *Mudarabah* accounts, in theory the most distinctive type of deposit offered by Islamic banks. The issues concern how the profit distributions are determined and whether there is any meaningful risk sharing required to justify the returns.

On the financing side, *Murabahah* has its critics, but is in substance *Sharī'ah* compliant. *Tawarruq* seems one step too far, as in practice the result is identical to that from interest-based loans. *Ijarah* has been increasing in popularity, but there is the issue of whether it should be offered by banks or leasing companies. There has also been the tendency, indeed the temptation, to transfer risk to the lessee, resulting in *Ijarah* resembling a financing lease, which is prohibited under *Sharī'ah*, rather than an operational lease. *Mudarabah* and *Musharakah*, the equity-type Islamic financing methods, were much favoured by the early advocates of Islamic finance, but they were relatively little used. However, diminishing *Musharakah* has taken off as a vehicle for housing finance. Closer examination reveals that the diminishing *Musharakah* structures used for Islamic mortgages result in the contracts taking on many debt financing features without any meaningful profit and loss sharing.

It is evident that Islamic product structuring needs to be revisited not only by Islamic finance professionals but also by academics. Most of the contracts have been developed by law firms from templates for conventional

finance contracts. There has been a focus on the prohibition of *riba*, narrowly interpreted as taking all references to interest out of the contracts. *Gharar*, or contractual uncertainty, has often received insufficient attention by both the commercial lawyers and the *Shari'ah* scholars approving the contracts. Most importantly, what has not been given due emphasis is the moral purpose of the contracts and whether they are inherently more just than their conventional counterparts. Clearly, more research needs to be conducted on these fundamental challenges if a knowledgeable and questioning younger generation are to be convinced of the intrinsic merits of the Islamic financial products offered.

Microfinance is arguably of greater significance to most Muslims than retail banking, as the majority do not earn monthly salaries, enjoy secure employment or have any collateral. The microfinance industry has been subject to many scandals, however, involving exploitation and corruption, especially in South Asia. The development of an Islamic microfinance industry committed to financial propriety, honest employee behaviour and the highest moral standards could overcome these shortcomings. At present, financial exclusion remains the norm for most Muslims and Islamic banking has made little contribution to financial widening. Again, although there is a limited literature on Islamic microfinance and a few empirical examinations, more research is needed into how it can be organised, whether through credit unions or cooperatives, and the types of financing which can be provided.

In short, more academic research is required on the structuring of Islamic financial products. To a considerable extent, despite the proliferation of universities offering courses in Islamic finance, research has lagged behind the development of the Islamic finance industry. It is this that explains the gap between the moral aspirations of the industry and the more

mundane realities. There is clearly much work to be done.



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