Learning outcomes

Upon completion of this chapter, you should be able to:
1. Define Islamic finance and explain the distinctive features of Islamic finance.
2. Discuss the relationship between Islam and economics and the role of Islamic economics in social welfare.
3. Describe the evolution of Islamic finance from the early days to the modern Islamic finance and banking industry.
4. Identify the timeline of the development of contemporary Islamic finance and banking.

INTRODUCTION

The core concepts of Islamic finance are as old as Islam. Islam is not just a religion but a way of life. It provides guidance to its followers encompassing the social, religious, economic and political aspects of their lives. The Islamic law called Shariah law dictates specific dos and don’ts related to all aspects of a Muslim’s life, including commercial and financial transactions. From the time of the Prophet Muhammad, peace be upon him (PBUH), specific financial instruments were used that were designed as per the requirements of the Shariah principles. Shariah law will be discussed in much more detail in Chapter 2 of this book.

The birth of modern Islamic finance and banking though happened in the second half of the twentieth century as an extension of Islamic economics, through the joint efforts of Shariah scholars and bankers. The global expansion of Islamic finance and banking was accelerated by the discovery of oil, rise in petrodollars and budget surpluses of the Gulf Cooperation Council (GCC) countries, with the concomitant increased demand among global Muslims to bank according to their religious beliefs (Natt, Al Habshi & Zainal, 2009). Initially Islamic banking experiments were private...
initiatives of individuals, but later governments in some Muslim countries significantly encouraged their growth, changing existing and developing new legislation and removing various handicaps in the predominantly interest-based environment (Ahmad, 1994).

For more than 200 years the finance and banking activities in the world have been operated on the conventional interest-based system. Individuals, businesses and governments have been completely adapted to conventional banks and an alternative to this system was unthinkable and seemed impossible. The concept of Islamic banking first emerged as an experimental Islamic bank was established in Mit Ghamr, Egypt in 1963, and the world’s first commercial Islamic bank was set up in Dubai in 1975. Being new and different from the traditional conventional banking, there is a significant lack of awareness and knowledge about Islamic banking. Educational endeavours, trainings, seminars, conferences and the general spread of knowledge of the unique field of Islamic finance and banking are of utmost importance for its growth and acceptance in the global finance industry.

A major driving force that led to the revival of Islamic finance and banking in current times was the increasing awareness amongst the global Muslim population about the prohibition of interest in commercial transactions, mainly in banking and business operations, and their growing need to conduct their financial transactions as per their faith. This demand was predominant in the Muslim majority countries but began to grow amongst the Muslim population in non-Muslim countries also.

The operations of Islamic banks are quite similar to those of conventional banks, except that their transactions need to be free of interest and follow other Shariah law requirements. Although Islamic banking is still in its early days, starting from the feeble beginning of Mit Ghamr in 1963, it has been able to survive and grow at an unprecedented rate over the last five decades, something not seen in conventional finance, and is now viewed as an alternative form of finance and banking. It has attracted the attention of many investors and has the potential to attract new customers and grow further, earning market share.

**CREATION OF MONEY AND CONVENTIONAL FINANCE AND BANKING**

Before money was created, economic exchanges happened via the barter system. In the barter system one person exchanged a good or service with another person’s good or service. This system had many inconveniences. Two people had to meet up where each owned something that the other wanted. The inconveniences of the barter system led to the emergence of money as a medium of exchange. Money separated buying and selling as two separate activities. Historically, many things have been used as mediums of exchange, like livestock (cows, camels, horses), grains (wheat, barley), precious metals (gold, silver) and finally coins and paper money.

The creation of money led to the development of financial institutions whose main purpose was to bring together those with surplus money and those with a shortage of money. Financial institutions have played important roles in the economies of all societies over time, collecting money from customers, providing them with safekeeping services and lending or investing these funds. This process is called financial intermediation and it is the core business of banks. Financial intermediation will be discussed in much greater detail in Chapter 3.
Western commercial banking started in around the 14th century in Florence and became more established in the 18th century with the advent of the Industrial Revolution. It was established by three groups of people and to this day conventional banking shows traces of its ancestors. These groups were:

1. **Rich and reputable merchants.** Like a merchant the bank finances foreign trade, issues bills of exchange and provides capital to new business ventures.
2. **Money lenders.** Like money lenders the bank pools the savings of the masses and lends it out to those with a shortage of finances and makes a profit by charging higher interest to the borrowers and paying lower interest to the savers.
3. **Goldsmiths.** Like a goldsmith the bank serves as a trustee of customers’ valuables.

**DEFINITION OF ISLAMIC FINANCE AND BANKING**

Islamic finance and banking is a faith-based financial system and its foundation is laid down in Shariah law and the principles of Islamic economics. Islamic economics will be discussed further later in this chapter. Since the original knowledge of the system is derived from the divine source of Quran – the holy book of the Muslim faith – it supersedes scientific methods or human decisions. The guiding principles of Islamic finance and banking emphasize fairness, justice, empathy, cooperation, entrepreneurship, ethics and the general good of the environment and society, not just profit maximization. This unique religion-based financial system can be better defined and understood by elaborating its distinctive features as below.

**Distinctive Features of Islamic Finance**

1. **Religious basis.** Islamic finance is based on the rules and regulations derived from the Islamic faith and law, while conventional finance has no religious restrictions. All Islamic finance and banking contracts must be acceptable by Shariah law.
2. **Prohibition of interest.** At the core of Islamic finance is the prohibition of Riba – which is interest or usury, and means an addition to the loan amount with the passage of time. Earning money from money is not allowed. It is the time value of money which is prohibited in Islam. Islam identifies money as a medium of exchange but not having intrinsic value that can earn more money. In contrast, interest payment and interest charging are at the core of conventional finance. Riba and other prohibitions in Islamic finance will be discussed further in Chapter 2 of this book.
3. **Link to real assets.** To avoid money earning more money, all Islamic financial transactions are linked to a real asset and there is an exchange of goods and services, making them less risky.
4. **Bank as a partner.** Conventional banks borrow funds from depositors and lend the funds to borrowers/entrepreneurs, while Islamic banks act as a partner to both the depositors and the borrowers. Islamic banks also operate as a seller in certain financial transactions.
5. **Profit and loss sharing.** Conventional banks pay interest to the depositors and receive interest from the debtors to whom they lend funds. In contrast, predetermined
payments on loans are prohibited in Islamic finance; instead, the system operates on a profit and loss-sharing basis. An Islamic bank shares in the profit of the client to whom it provides financing and is also required to share in any loss incurred by the business. On the deposit side, the Islamic bank shares its profit and loss with the depositors, pro rata to their deposit amounts.

6. More prudent selection. Being a partner to the client, Islamic banks share in both the profit and loss of the borrower’s enterprise and this encourages Islamic banks to be more prudent in selecting their clients and the projects they finance. Conventional banks charge fixed interest from their borrowers regardless of whether the client makes a profit or a loss, hence they are more concerned about the creditworthiness of the client and their ability to provide collateral rather than their business success. Islamic banks, on the other hand, give more emphasis to the feasibility of the project and the capabilities of the entrepreneur.

7. Productive investment. Islam encourages Muslims to invest in productive enterprises rather than hoarding their money, since idle money cannot earn any interest income. As such, Muslim depositors are encouraged to finance as partners, enjoying profit as well as bearing loss. This stimulates the economy and encourages entrepreneurs to put in their best efforts to succeed, which finally benefits the community also (Kettel, 2010).

8. Unnecessary and excessive risk. Islam prohibits any transactions that are based on excessive and unnecessary risk-taking leading to uncertainty. As such, speculative transactions are not allowed in Islamic finance.

---

**ECONOMICS AND ISLAM**

**Economics in Ancient Times**

Today we understand economics as the discipline that deals with the production, distribution and consumption of goods or services and wealth in general. Economic systems in societies from ancient times have been based either on religion or on capitalism. Faith-based systems promoted justice and fairness in economic activities and encouraged the rich to share their wealth with the poor. In contrast, capitalistic economic systems operated on the concepts of survival of the fittest, competition and profit maximization. During ancient times, economic activities like business and trade were mainly controlled by the rulers or by the religious leaders, and some rich and powerful merchants. Hence the profits generated were mostly consumed by the ruling elite, priests and rich merchants, and only small portions trickled down to the public.

During the 13th century, the below interlinked economic concepts began to appear and were the topic of significant discussions and debate.

**Justice in economic exchange.** The ancient Greek philosopher Aristotle considered the price of any good to be its intrinsic value, while according to the Romans the price of goods was decided by the factors of demand and supply and the contracting parties played a role in finalizing the price. On the other hand, Christian theologians believed that the intrinsic value meant the usefulness of the good and this would ultimately decide the price. Islam also recommends a just price for goods and services.
Private property. In their original form all three Abrahamic religions of Judaism, Christianity and Islam considered property to be ultimately owned by God with man serving only as its steward, and as such all property should benefit society. In Islam, the last of the Abrahamic religions, this view still holds and has a significant effect on Islamic economics and Islamic finance. The Church moved away from this view in around the 5th century and itself became the owner of substantial property and wealth. In the modern economy property is privately owned and is one of the factors of production.

Money, usury and prohibition of interest. In the early 4th century Aristotle opined that money was only a medium of exchange, without any intrinsic value of its own; hence money cannot earn money by itself. A complete ban on usury and the prohibition of interest was common to all three of the Abrahamic religions and not unique to Islam only. According to the Judaic belief, interest could not be charged from one’s brother, and that was interpreted as another Jew, basically suggesting that interest could be charged from those of another faith. In the case of Christianity, ‘brother’ was considered as all human beings. Both the Old and the New Testament forbade earning from usury. Initially, Christian theologians applied a total ban on usury, which over time changed to the prohibition of excessive interest only. The ban on interest was repealed in France in 1789 and in the Vatican in 1838 (Schoon, 2016). Islam is the only religion in which a total ban on any form of usury or interest continues to date. Some of the factors that contributed to Western societies’ gradual acceptance of interest in their economic life included the replacement of agriculture by the Industrial Revolution, the role of demand and supply in determining price, the acceptance of money as a factor of production and the separation of the Church from the State (Schoon, 2016).

Modern Economics

Adam Smith, the renowned economist whose works are the foundation of modern economic thought, with his seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776), said during the beginning of the Industrial Revolution that money or capital was a factor of production, like land or labour. As such it had a cost, not based on usury but on the risk and opportunity cost associated with it. Adam Smith believed in the free market concept, competitive forces and prices determined by the demand–supply mechanism. A significant economic theory defined by him was the concept of economic scarcity. According to this concept people had unlimited wants, while the resources available to meet these wants were limited. This leads to the classic economic problem. Islamic economics differs fundamentally from Adam Smith’s concept of economic scarcity, as will be discussed in the next subsection.

The modern economic system is described as a network of relationships between households, businesses and governments involved in the economic activities of production, distribution and consumption of goods and services in a manner that protects the rights of future generations and of the environment. Globally there are different economic models operating, and these differences are derived from the role of markets and governments and of morality and justice in these models. The four classic models, as discussed by Askari, Iqbal & Mirakhor (2015), are briefly defined below. The fifth model can be defined as Islamic economics, and this is covered in more detail in the next subsection.
Market economy. These economies are self-regulating, with no government intervention. Demand and supply determine prices. The disadvantages are that this system can cause polarization of wealth and can be detrimental to society – for example, the USA.

Mixed market economy. In these economies markets operate under the demand and supply mechanism but governments ensure that market rules beneficial to the country are not broken. Important economic sectors like public services, defence, infrastructure, etc. may be under governmental control – for example, Sweden, the UK, France.

Mixed socialist economy. In some market economies, to deal with income inequality, poverty and other social issues, some vital sectors are under governmental control, like banking, healthcare, education, energy, transportation, etc. – for example, China.

Command or planned economy. These economies are the opposite of the market economy. Government decides about production, distribution and consumption. Communist countries usually have this kind of economy – for example, Cuba, North Korea and the former Soviet Union.

Islamic Economics

Islamic economics, as a term, was first coined by Abul Ala Al Mawdudi, who sought to develop Islamic social science (Kuran, 2004). Since Islam is a way of life, it provides guidance for its followers in the material as well as the non-material aspects of their lives. According to Askari, Iqbal & Mirakhor (2015), Islamic economics involves studying rules provided in the Islamic holy book, the Quran, and the Sunnah (teachings of the Prophet Muhammad) pertaining to the economic concepts, comparing and contrasting these with contemporary economics, identifying the gaps and finding ways to bridge these gaps. Askari, Iqbal & Mirakhor (2015) further emphasized that social and economic justice is at the basis of Islamic economics, providing equal opportunity in the utilization of natural resources for all in society. It encourages cooperation and collaboration between individuals and society.

Islamic economics assists in the allocation and distribution of scarce resources, without curbing individual freedom, causing macroeconomic and ecological imbalances, or weakening family and social solidarity; it aims to find a balance between individual and social benefits related to private or public property ownership (Ginena & Hamid, 2015). Islamic economics encourages productive activities and the creation of wealth, considering it as an act of worship provided that these activities are compliant with Shariah rulings. Though on the flip side, Islam does not agree that material gain is the main reason for existence. Islamic economics discourages the hoarding of wealth.

History of Islamic Economic Thought

Mohammad Nejatullah Siddiqui, in his History of Islamic Economic Thought (2010), divided the development of Islamic economics into three periods. The first period began from the hijra (when the Prophet Muhammad migrated from Makkah to Medina, which is the first year in the Muslim calendar) to AH450, corresponding to AD1058. During this period the Prophet, his companions and other Islamic scholars concentrated
on Shariah rulings relating to economic issues. The second period, spreading from AH450 to AH850, corresponding to AD1058 to AD1446, was a glorious period in the development of Islamic economics. This period focused on the following issues: individuals should satisfy their basic needs only and consider the needs of society; rulers must preserve justice and introduce accounting and fair pricing. The third period was from AH850 to AH1350, corresponding to AD1446 to AD1932, and it was a period of stagnation in intellectual and individual thinking. The economic concepts that were discussed and developed during the initial period of Islam included money as a medium of exchange, usury, taxation, market regulations, permissible economic behaviour, labour, wages, prices and ethical commercial behaviour (Askari, Iqbal & Mirakhor, 2015).

**Principles of Islamic Economics**

Some of the most important principles that guide the discipline of Islamic economics are detailed below.

1. Religion and economics are interrelated in Islam.
2. Economic and social fairness and justice is not forced on individuals, but they are encouraged to implement it.
3. Property and wealth is ultimately owned by the Creator, though man has control over it as trustee.
4. People are expected to be moderate in their expenses and avoid wastage and luxury.
5. Productive activities are encouraged, and all can pursue personal economic gain as long as they are Shariah-compliant and do not harm society or the environment.
6. All Halal trade and business, legitimate and permissible in Islam, is encouraged while all Haram trade and business, unlawful and prohibited in Islam, is to be avoided.
7. All human beings have the right to equal opportunity, and those who own wealth are responsible for sharing it with the community. To achieve this, Islamic economics dictates compulsory charity Zakat, which is a religious tax, designed to reduce the gap between the rich and the poor, as well as encouraging additional non-compulsory charity Sadaqah.

**Islam’s Solution to the Classic Economic Problem**

According to conventional economics the classic economic problem is that of scarcity, since wants can be unlimited while resources are limited. Islamic economics has a two-pronged solution to this problem, as follows.

1. On the demand side, man should not have unlimited wants. They should concentrate on basic needs only, avoiding unnecessary luxury and wastage. As such, each would consume less of the available resources.
2. On the supply side, man should increase the resources Allah has provided by productive activity. Productive effort is a way of serving the Creator and thus increasing the available resources. Every capable individual should work for a living and the wealth they earn is not only to benefit them, but should also benefit society and the environment.
ISLAM AND THE WELFARE ECONOMY

Islam says that human beings are trustees only of the wealth they own, while the real owner is Allah. All Muslims are brothers and sisters and are responsible for each other's wellbeing. This establishes the welfare economy in Islam. Two important concepts encouraged by Islam and working towards the common good are Al-Adl, which means to be just and fair in dealings with others and Al-Ihsan, which encourages Muslims to go beyond the minimum obligation towards others and to show kindness. Other concepts in Islam that aim to achieve social welfare are Islam's special dictate related to property ownership and the charitable endeavours of Zakat and Sadaqah.

Property Ownership in Islamic Economics

In all practical senses, property ownership is allowed in Islam. The ultimate ownership of everything though vests in the Creator, and humans are only trustees of the property. As such, property should also be available for the benefit of the public and the environment. This identifies elements of both the capitalistic and the social systems. Islamic economics is not in conflict with the market economy. Demand and supply, competition, rights of contracting parties to determine price and earning profit from productive endeavours are all accepted concepts, provided fairness and justice are maintained.

In Islamic economics, the ownership rights of property are dealt with based on the below principles.

1. Allah is the ultimate owner of all property and He has allowed people to possess and use the property in trust, in such a manner that it is available to benefit society and future generations and causes no harm to the environment.
2. All human beings should have access to the natural resources bestowed by Allah.
3. Property can be acquired by people through their own productive activities or by diverse types of transfers like exchanges, contracts, gifts, donations or inheritance.
4. Islam limits the accumulation of wealth (thus socially harmful hoarding, which is prohibited) and dictates that all Muslims have a duty to share their income and wealth with the less fortunate, via Zakat, which is compulsory or Sadaqah, which is voluntary.
5. Islam recommends taking care of our property and discourages waste or destruction.

Zakat and Sadaqah

Every Muslim has specific economic obligations towards society – of which Zakat is compulsory charity and Sadaqah is voluntary charity.

Zakat is a compulsory levy imposed on Muslims who own above a certain minimum level of wealth. Zakat aims to take surplus money or wealth from the well-to-do members of Muslim society and give it to those in need. In the context of the economic system, Zakat is an obligation and can be defined as a duty or tax on a certain kind of wealth at the rate of 2.5% each lunar year. To motivate the practicing Muslim to participate in the process, the rewards of paying Zakat are identified in the Quran and Sunnah as increased prosperity in this world, purification of all assets and income, as well as the religious merit of purifying sins.
Zakat serves as the backbone of the Islamic economic system and encourages the rich to support the poor in the community. It was the first formal form of quantified taxation known to civilization, and is a form of social insurance. In Islamic countries it could be a source of income for the government treasury (which in Arabic is called the Bait-al-Maal) and used for public service expenses. Zakat is also a very important tool acting against the hoarding of wealth, since money utilized in productive endeavour is taxed only on its income while idle, unproductive money is taxed on the principal amount.

The Quran has identified certain categories of people who are most eligible to receive Zakat. These are the poor – who cannot feed or clothe themselves, the needy – who have income but not sufficient to meet all their needs, those who need financial help to integrate back into society, those who have high debt and need help to repay it, travellers, the disabled, the unemployed, orphans, slaves – to help buy their freedom, the Zakat collectors and general spending in the way of Allah.

In traditional Islamic society, the wealth subject to Zakat was gold and silver, including any jewellery of these metals, agricultural produce like dates, wheat, etc., all mineral assets, trading assets and productive animals like camels, sheep, etc. In modern Islamic society, the wealth subject to Zakat is determined by Islamic scholars as cash savings, gold, silver, other non-productive assets and the income of productive assets employed in a business. Any wealth that belongs to the government, or is for the benefit of the community or a charitable endowment or Waqf asset, is not subject to Zakat. For Zakat calculation the current market value of the asset is considered and for an individual or a company the net worth is calculated, which is assets minus liabilities.

**Ban on Interest versus Cost of Capital in Islam**

Islamic economics recognizes capital as one of the factors of production, and as such there is a cost to this capital. On the other hand, Islam considers money only as a medium of exchange and does not agree with money being treated as a commodity or having an intrinsic value (thus earning money from money). This is considered as Riba or interest, which is basically income against the time value of money or via exchange of goods in unequal quality or quantity. Riba will be discussed in further detail in Chapter 2. Islamic economics does not accept interest as the measure of investment efficiency, rather it believes that yields are determined by sharing in both profit and loss or by the negotiated prices of sales or lease transactions. All Islamic financial transactions need to be linked to an underlying real asset, or there should be an investment in a business and this investment of capital will earn a profit or make a loss as is the case with the underlying asset or business. To conclude, Islam allows for the cost of capital by allowing capital to share in the surplus but not without being part of the deficit also in any investment.

**Conventional Economics versus Islamic Economics**

Table 1.1 specifies the differences between conventional and Islamic economics.
<table>
<thead>
<tr>
<th>Factors</th>
<th>Conventional Economics</th>
<th>Islamic Economics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership of wealth and property</td>
<td>In capitalism individuals can be the absolute owners, while in socialism society collectively is the owner.</td>
<td>Absolute ownership is with God, man is only the trustee.</td>
</tr>
<tr>
<td>Wants and resources</td>
<td>Wants are unlimited while resources are limited, creating the scarcity problem.</td>
<td>Wants should be limited and sufficient resources have been provided by the Creator. Scarcity is created by improper distribution of resources, overconsumption, luxury and wastage.</td>
</tr>
<tr>
<td>Accumulation of wealth</td>
<td>Any amount of wealth can be accumulated, and the owner can use or waste it as they please.</td>
<td>Individuals can accumulate wealth if this is done in a Shariah-compliant manner, though the owner needs to share this wealth with the less privileged in society through the compulsory Zakat and voluntary Sadaqah. Islam says produce more than is needed and consume only what is needed.</td>
</tr>
<tr>
<td>Market economy</td>
<td>The market economy is the main determinant in capitalism, while in socialism demand and supply are not linked to prices, since supply is decided centrally.</td>
<td>The market economy applies, demand and supply determine prices, although all this needs to be done within a framework of social wellbeing.</td>
</tr>
<tr>
<td>Role of the State</td>
<td>In capitalism, markets play a more dominant role than the State, while in socialism, the State plays a dominant role.</td>
<td>The State ensures ethical activities, protects individuals’ and society’s interest and ensures efficient allocation of resources.</td>
</tr>
<tr>
<td>Law of inheritance</td>
<td>Individuals can pass on their wealth and property to anyone they please.</td>
<td>Islam has specific inheritance laws and does not allow giving away more than one-third of one’s assets to anyone besides the legitimate heirs, thus ensuring fairness in the process of transfer of wealth and property.</td>
</tr>
<tr>
<td>Economic cycles</td>
<td>Economic cycles show significant ups and downs.</td>
<td>These ups and downs are reduced in Islamic economics through the moderation of consumption and the avoidance of luxury, wastage and unnecessary debts.</td>
</tr>
<tr>
<td>Reward for capital</td>
<td>Interest is accepted as the reward for capital.</td>
<td>Interest is completely forbidden, and an alternative profit and loss-sharing mechanism is applied as the reward for capital.</td>
</tr>
<tr>
<td>Social welfare</td>
<td>In capitalism, this is achieved by the free market and self-interest, while in socialism, the State achieves this by centralized production and distribution.</td>
<td>Islam encourages productivity at the individual level but through the moral requirements of sharing one’s wealth aims to create social welfare.</td>
</tr>
</tbody>
</table>
EVOLUTION OF ISLAMIC FINANCE

Early Days

Islamic finance began with Islam in the early 7th century. The first Islamic financial institution established was the Bait al Maal or public treasury set up by Prophet Muhammad. Later, during the times of the Caliphs, various new issues and questions came to light, discussions were held amongst the companions of the Prophet and judgements were reached. This process is called Ijtihad, and many economic reforms were made through Ijtihad, but it was always important to maintain consistency with the Quran and Sunnah. Early in his Caliphate, the first Caliph Abu Bakr Al Siddique had to deal with a revolt against the paying of Zakat. Zakat was the main financial tool to ensure social welfare and justice in Islamic society, compelling the rich to share their wealth and income with the less privileged. The second Caliph Umar Ibn al-Khattab formalized the management of the Bait al Maal, which dealt with the revenue and expenses of the Islamic State. Later Umar identified Bait al Maal’s main revenue sources to be Zakat, Sadaqah, a land tax called Kharaj, a tax on non-Muslims residing in Muslim States called Jizya, and other customs duties and toll income. The funds collected in the Bait al Maal were used for various governmental expenses and for public welfare activities, paying allowances to the needy, the elderly, the disabled, orphans, widows, etc.

The Islamic civilization flourished between the late 6th and the early 11th centuries. Muslim traders conducted financial transactions based on the Shariah rulings, using financial tools like Musharaka (joint venture) and Mudaraba (trust financing), Wakala (agency), Qard Hasan (benevolent loan), Salam (forward contracts) and Ijara (leasing). These products will be discussed in the later chapters of this book. Some evidence of the achievements of early Islamic financial activities is given below.

1. The Prophet acted as an agent for his wife’s trading business and collected a commission as revenue.
2. Islamic financial systems encouraged trade and business contracts to be written and witnessed, reducing possibilities of conflict.
3. Trade and Islam arrived in Malaysia and Indonesia before the Europeans. Shipping business in the Indian Ocean used Mudaraba or trust financing as a form of financing. Besides the owners of the ship and cargo, the captain of the ship and each sailor was also a partner, not earning a salary but sharing in the profit along with the owners. As such, everyone had a stake. History shows that rarely did mutiny, deliberate drowning or damage of cargo on Muslim ships happen, compared with regular shipping.
4. Expansion of various forms of trade in the Islamic world led to the development of Islamic mercantile law in accordance with Islamic Shariah law. In comparison, Europe at this time was using a mediaeval form of business cooperation known as Commenda.

From the 12th century on to the middle of the 20th century, Islamic finance gradually disappeared. Some of the reasons for this were as follows.
1. The fall of the Ottoman Empire.
2. The dominance of Western countries and conventional financial institutions.
3. The onset of colonization around the Muslim world, with Shariah institutions consequently losing their capabilities under the colonial powers.
4. The continued growth of business and finance in Europe, developing larger enterprises, using the small savings of the masses to finance investment projects.
5. The application of any existing Islamic financial principles and tools went into inertia and disuse.
6. The differences between conventional finance and Shariah restrictions got blurred amongst most people, including the Muslim population.

Birth of Modern Islamic Finance

The concept of modern Islamic finance emerged in the mid-20th century with Asian and Arab Muslim-majority countries gaining independence from Western colonial powers, searching for their own identity and being inspired by Islamic economics distinct from both the Western capitalist and Eastern socialist models. Islamic finance and banking evolved from the concepts of Islamic economics, based on the profit and loss-sharing (PLS) system, and is considered more equitable and stable (Chapra, 2007; El-Gamal, 2006; Siddiqi, 2006). The idea of interest-free financing has existed since the birth of Islam, but its reintroduction into the world of finance is only a few decades old.

Modern Islamic banking is about 60 years old. The guiding principle of Islamic banks is the Shariah law, which prohibits the payment or receipt of interest and recommends the sharing of risk and of profit/loss between the bank and its customers. Islamic finance also emphasizes socio-economic justice and equitable distribution of wealth (Amin, Hamid, Lada & Baba, 2009). This is in stark contrast to conventional banks, which operate primarily on an interest basis and on a profit-maximization principle.

Previously, the prohibition of interest made banking difficult for religiously oriented Muslims globally, and especially in the Gulf region – they either left their money in current accounts with no interest in conventional banks or stayed outside the formal banking system altogether, which hindered the free flow of capital between global financial markets and the GCC. The advent of affluence in the region, with the discovery of oil and the introduction of petrodollars, magnified the problem (Smith, 2006). The introduction of Islamic banking was a major solution, providing a distinctive means of financial intermediation. Islamic banking was conceptualized through the efforts of Islamic political activists, Muslim legal scholars, economists and businessmen, applying Shariah law to the modern economy and innovatively structuring traditional Islamic financial instruments to provide customers with most of the services associated with conventional banks, within Shariah restrictions (Smith, 2006). Today, Islamic banking has established its place globally.

Institutional Developments During the Revival of Modern Islamic Finance

During the early part of the 20th century, towards the end of the colonial era, several religious scholars in Egypt, India, Pakistan, Malaysia and Indonesia began to rethink the Shariah rulings relating to the financial aspects of the life of a Muslim and tried to
reconcile the Shariah prohibition of interest or Riba with existing conventional banking. Significant academic research took place in these Muslim-majority countries during the 1940s and 1950s, which led to institutional experimentation in Islamic finance and banking. Some of the major developments during the following decades are set out below.

**The Mit Ghamr Experiment**

Dr Ahmad El-Najjar, an economist, first experimented with the idea of interest-free banking by setting up the Mit Ghamr savings project in Egypt in 1963. This was the world’s first interest-free bank, set up through community effort and the pioneering endeavours of its founder Dr El-Najjar. The bank was modelled on the German cooperative savings bank, using the principles of rural banking. The Islamic cooperative savings bank had three types of accounts:

1. **Savings account.** This account was aimed at collecting the savings of depositors and allowed withdrawal on demand; the depositors, like the members of a cooperative, could also take small, short-term interest-free loans for productive purposes.
2. **Investment account.** This account allowed restrictive withdrawal, almost like the fixed deposits in conventional banks, and the funds in these accounts were invested in Shariah-compliant projects on a PLS basis shared between the bank and the investors; part of the profits/losses was passed on to the depositors, proportionate to their deposits.
3. **Zakat account.** This special account collected Zakat money from the members and redistributed the funds amongst the poor and needy as per the Quranic guidance of possible Zakat recipients.

The Mit Ghamr experiment had unexpected success and the savings deposits grew each year. However, the secular government in Egypt had reservations about the religious basis of this first Islamic bank and despite its success the project was abandoned for political reasons. The closing down of the Mit Ghamr experimental bank was not the end of Islamic banking, rather it was the beginning of this new and unique banking niche within the global banking industry. Within a few years Egypt had 9 Islamic banks and 9 years after the inception of the Mit Ghamr experiment, in 1972, it was integrated into the Nasr Social Bank.

**Tabung Haji**

Around the same time as the Mit Ghamr experiment was pioneered in Egypt, on the other side of the world in Malaysia the Tabung Haji institution was set up, also in 1963. The purpose of this institution was to manage the savings of Hajj pilgrims by investing them in a Shariah-compliant manner over a period of time and then the savings would be used towards their Hajj expenses. Hajj is the pilgrimage to Makkah that is compulsory for all able-bodied Muslims once in their lifetime provided they have the financial ability. The Tabung Haji institution is in operation to date, and it set up the platform for Malaysia to play a leading role in the global Islamic finance and banking industry. Malaysia’s first fully fledged commercial Islamic bank, Bank Islam Malaysia, was set up two decades later in 1983.
Islamic Development Bank

The Islamic Development Bank (IDB) was established in 1975 to foster economic development and social progress amongst the member Muslim countries and to enhance the growth of the Islamic finance and banking industry. Its head office was set up in Jeddah, Kingdom of Saudi Arabia (KSA). Currently the bank has 57 countries enrolled as its members; a prerequisite for members is to be a member of the Organization of Islamic Cooperation (OIC). The core functions of the IDB include the following.

1. Participating in productive projects in member countries via equity participation or lending.
2. Providing financial assistance to member country governments.
3. Providing funds to Muslim communities in non-Muslim countries.
4. Promoting foreign trade amongst member countries.

Dubai Islamic Bank

The oil boom in the 1970s triggered a rapid growth of Islamic financial institutions in the Middle East and North Africa. The world’s first fully fledged commercial Islamic bank was the Dubai Islamic Bank, set up in Dubai, United Arab Emirates (UAE) in 1975. It was established as a public limited company with a capital of AED50 million and the governments of Dubai and Kuwait owned 20% and 10% of its shares, respectively. The bank has grown, with both governmental and public support since its inception, and currently is the largest and most reputable Islamic bank in the country.

RAPID GROWTH OF THE ISLAMIC FINANCE AND BANKING INDUSTRY

Islamic finance concepts have been in existence and practiced for centuries, but have been institutionalized only in the last few decades, offering Shariah-compliant products and services. With the development of viable Islamic alternatives to conventional finance products, large numbers of Muslims are seeking Shariah-based solutions to their financial needs. Some non-Muslims also are Islamic bank customers, and some conventional banks are offering Islamic products on a limited scale via the Islamic windows within their regular distribution channel or by special branches or subsidiaries specifically established to offer Islamic banking products. Over the last five decades there has been rapid growth in Islamic finance institutions, instruments, regulations, educational and training facilities, publications and conferences and seminars on the topic (Hasan, 2014). The remarkable growth of an industry only a few decades old, with growing global interest, indicates the tremendous opportunities existing in this niche business for the participating banks.

Modern Islamic finance and banking, when first introduced, suffered from a lack of understanding by the existing industry as well as by potential customers. As such it was quite a while before significant success was achieved by this niche segment of the finance and banking industry. The industry developed through three periods. The first was a period of conceptualization (1950–1975), when Islamic scholars raised Muslim consciousness about the prohibition of interest, mostly from a religious aspect. The second was a period of experimentation (1975–1990), PLS Islamic banks were set up, Islamic
financial instruments and institutions were established, Western financial institutions entered the market and the sector was accepted as an interest-free alternative to conventional banking. The third period (1990–present) is about earning recognition, confidence and credibility in domestic and international markets, the innovation of products and the standardization of products and procedures (Iqbal & Mirakhor, 1999).

The design of modern Islamic banking has mostly followed the structure of conventional banks, with the exclusion of interest-based transactions, replacing interest with a PLS system. Significant innovations in this unique banking system are yet to come, and so up to now the industry has mainly endeavoured to provide reasonably Shariah-compliant alternatives to the products and services offered by the more universally accepted conventional banks. Hence, some mismatch can be seen between the current structure of the Islamic finance and banking industry and its original objectives. The significant similarity of Islamic banking products and operations to conventional banking allowed the conventional banks to enter this niche segment of the industry with windows or subsidiaries. This also allowed Islamic banking to grow faster, as it was not viewed as isolated from the global financial infrastructure.

**ISLAMIC FINANCE AND BANKING IN MUSLIM COMMUNITIES AND COUNTRIES**

The revival of Islamic finance can clearly be linked to the religious movements in Muslim countries after they gained independence from the colonial powers to restore their Islamic values, including those related to financial and commercial dealings. Islamic banks provided Muslims with the opportunity to bank and invest in accordance with their religious beliefs and without interest, while previously they had to deal with interest if they wanted to participate in the banking system. The Muslim population numbers 1.8 billion, which is about a quarter of the estimated global population of 7.4 billion (Pew Research Institute, 2017). Moreover, Islam is the fastest growing religion and some Muslim countries are the richest in the world, like Qatar, Brunei, UAE, Saudi Arabia, etc. Most Muslim countries apply Shariah law to some extent in their social framework.

Starting from the Middle East, Islamic finance grew and expanded in South and South-East Asia. Bahrain and Malaysia have played pivotal roles in their respective regions to enhance research, innovation and development in the areas of Islamic finance. Bahrain was the first GCC country to contribute to the progress in this industry by setting up and supporting the development of several major international Islamic regulatory and standard setting bodies, like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Bahrain Central Bank has also provided a highly supportive role in the development of the Islamic finance industry. On the other side of the world, Malaysia, starting from Tabung Haji, is another major player and driving force in the internationalization of the sector. With the support of the Malaysian government, Bank Islam Malaysia was set up and the country has a well-designed dual banking system to meet the demands of a large Muslim population aspiring to Shariah-compliant banking. Today Malaysia is one of the most developed Islamic finance centres and the base for another major international Islamic regulatory and standard setting body, the International Financial Services Board (IFSB).
Pakistan, despite its decision to go completely Shariah-compliant in the financial sector, still operates on the dual banking system. The rapid growth experienced in the GCC countries over the last few decades has also served as a catalyst in the growth of Islamic finance and banking. KSA, UAE, Qatar and Kuwait have all formally set up regulatory structures to support Islamic finance and banking, and all of the GCC countries are using the dual banking system. Significant development in Islamic finance and banking is also evident in the rest of the Muslim nations in the Middle East, North and East Africa, as well as in South and South-East Asia – for example, Egypt, Jordan, Libya, Bangladesh and Indonesia.

**ISLAMIC FINANCE AND BANKING IN NON-MUSLIM COUNTRIES**

Islamic finance and banking has been spreading in some non-Muslim countries as well over the decades. Amanah Bank was set up in the Philippines in 1973. In Europe, Islamic banking first arrived in Luxembourg in 1978 and during the 1980s many other experimentations happened in Islamic finance and banking. In 1982 Faisal Finance House was set up in Geneva. Since 2002 the Bank of England and the Financial Services Authority in the UK have taken several measures to encourage and develop the sector and make London a major international hub of Islamic finance, and have licensed several Islamic banks. Dallah Albaraka Group established the first fully fledged Islamic bank in the UK in 2004, called the Islamic Bank of Britain. The bank was acquired by Masraf al Rayan of Qatar in 2014 and rebranded as Al Rayan Bank. In Europe, besides the UK, France, Germany, Italy, Luxembourg, Switzerland and the Netherlands are also trying to serve the minority Muslim population and take advantage of the opportunities in the fast-growing Islamic finance sector.

In Singapore, the first Islamic bank, Islamic Bank of Asia, was incorporated in 2007. Singapore currently plays a significant role in Islamic finance, especially due to its geographic and economic proximity to Kuala Lumpur, Malaysia, a major Islamic finance hub. Hong Kong is also participating in Islamic finance. In the USA Lariba, the American Finance House, has been operating since 1987. University Islamic Bank is another provider of Islamic finance in the USA. The major provider of Islamic finance in Canada since 1980 is Ansar Financial and Housing Cooperative, which plays a valuable role in providing Shariah-compliant home financing and other investment options. Similarly, Australia also offers some Shariah-compliant home financing.

**SUB-SECTORS IN THE ISLAMIC FINANCE AND BANKING INDUSTRY**

The Islamic finance and banking industry today comprises the following sub-sectors.

1. **Islamic banking.** This includes the deposit-taking banks that operate within Shariah guidance, like the Bahrain Islamic Bank. Conventional banks offering Shariah-compliant products may also participate via an Islamic window within their main operations or an independent subsidiary, like HSBC Amanah.

2. **Islamic insurance or Takaful.** These are the Shariah-compliant insurance companies, like the Qatar Takaful Company.
3. **Islamic capital markets.** These include Shariah-compliant shares, bonds, mutual and other investment funds and products, indices and the secondary markets.

4. **Islamic non-bank financial institutions.** Within this sub-sector are the variety of financial institutions that are not banks and operate within the Islamic financial principles. Some of these are Islamic finance companies, Islamic housing cooperatives, Islamic leasing and factoring companies, Islamic microfinance, charitable endowments (called Waqf in Arabic), private equity and venture capital firms, Hajj and Zakat management bodies, etc.

---

**CURRENT STATUS OF MODERN ISLAMIC FINANCE AND BANKING**

Islamic finance and banking, though still in its early days, has been able to provide a worthwhile alternative to conventional finance and banking. Some key issues and statistics related to the growth of the Islamic banking and finance industry, almost non-existent six decades ago, are discussed below (Abdullah, Sidek & Adnan, 2012; Benaissa, Nordin & Stockmeier, 2003; Duran & Garcia-Lopez, 2012; Hasan, 2014; Hassan, Kayed & Oseni, 2013; O’Sullivan, 2009; Pew Research Institute, 2017; PriceWaterhouseCooper Middle East, Financial Services, 2017; Rammal, 2010; Shamma & Maher, 2012; The Banker, 2010; World Islamic Banking Competitiveness Report, 2016).

**Number of countries with Islamic finance and banking presence.** Estimated to be around 75.

**Number of Islamic finance and banking institutions globally.** It is estimated that about 500 Islamic financial institutions, along with about a further 190 conventional institutions, offer Islamic finance products today. Many conventional financial institutions in Europe and North America, as well as in Asia, have opened Islamic banking windows or subsidiaries. Included within this group are global players such as Standard Chartered Bank, Citibank, HSBC, ABN AMRO and UBS. The global spread of Islamic finance products is also likely to happen in Latin America, Africa and the Commonwealth of Independent States (CIS) countries. The growth and expansion of the Islamic finance industry continued during the global financial crisis. Islamic commercial banking is experiencing a huge expansion in products and areas of influence across the world. This growth is expected to continue as legal and regulatory challenges are faced and dealt with and the emerging Islamic finance industry establishes itself as a potential alternative mode of finance.

**Muslim population.** The Muslim population is currently about 1.8 billion, a quarter of the world population of approximately 7.4 billion, and is expected to increase by 35%, twice the rate at which the non-Muslim population is growing, and reach 2.2 billion by 2030. The global Muslim population is growing faster than any other religious group. Simultaneous to the increase in numbers, Muslims are also increasingly interested in using Shariah-compliant financial instruments rather than conventional products.

**Asset size and growth rate of the Islamic finance and banking industry.** The industry crossed US$1.6 trillion by 2013 from only US$300 billion in 2007. This is still a very small percentage of the global finance and banking industry, standing currently at US$94.7 trillion. As per PriceWaterhouseCooper Middle East, Financial Services (2017), the Islamic finance and banking industry is expected to reach US$2.6 trillion
by the end of 2017. The world’s largest Islamic banks have outpaced average growth in conventional banks and are growing at approximately 15% annually.

**Presence in the affluent GCC region.** Some of the world’s largest Islamic banks are located within the GCC countries and comprise about 20% of the GCC’s banking assets (and expected to grow further), posing a serious challenge to the conventional banks. Oil-producing Middle Eastern economies, which are predominantly of Muslim faith, are booming with an increase in oil prices and this economic boom is expected to be a catalyst towards the growth of the Islamic finance industry.

**Shift of economic power to Asia.** Over the last decade a major shift of economic growth and development has been happening in Asia, including countries in South and South-East and Central Asia, several of which are Muslim-majority countries or with a large Muslim population, and is expected to assist in the expansion of Islamic finance.

**Presence in the UK.** The UK plays a pivotal role within the non-Muslim region of Islamic finance and banking operations. According to Schoon (2016), as of 2015 the UK had more than 25 organizations offering Islamic financial services and the Prudential Regulation Authority has regulated seven fully Sharia-compliant institutions, moving the UK towards its goal to be the largest Islamic financial centre outside the Muslim world.

### TIMELINE OF DEVELOPMENT OF CONTEMPORARY ISLAMIC FINANCE AND BANKING

To understand the modern Islamic finance and banking industry it is important to walk through the timeline with the geographic positioning of the various events in the development of this emerging niche segment of the finance industry that may be the chosen finance method of more and more customers from the Muslim population, comprising a quarter of the world population, as well as winning some customers from the non-Muslim population. In the timeline below, individual years are placed in chronological order. Entire periods are highlighted in bold.

**1890s** Commercial banking in the Muslim world. By the opening of Barclay’s bank in Cairo, mainly to facilitate the construction of the Suez Canal, formal commercial banking first arrived in a Muslim-majority country. It was interest-based and brought about the first criticism from Islamic scholars.

**1900–1950** Discussions on the prohibition of Riba. Islamic scholars and Islamic economists began discussing the prohibition of Riba in the Middle East and the Indian Subcontinent.

**1951–1962** Design of interest-free banking. Shariah-compliant alternatives to interest-based products were researched in various parts of the Muslim world. Initial descriptions of interest-free banking based on two-tier Mudaraba, as well as the Wakala method, emerged. In Pakistan, a small experimental interest-free savings and loan society was established in a rural area to provide loans to poor landowners for agricultural purposes.
1963–1975 **Founding period.** The institutional foundation of the Islamic finance and banking industry was established during this period, from experimental efforts to moderate success.

1963 **Mit Ghamr savings association.** Established by Dr Ahmad El-Najjar. Followed the model of German savings banks. Interest-free and based on the PLS mechanism. Successful initially, but later ended for political reasons and due to lack of government support.

**Tabung Haji or Pilgrims Fund Corporation.** A Shariah-compliant savings institution set up in Malaysia to enable Muslims to save gradually for their Hajj expenditures. Started with 1,281 registered members with RM46,000 in 1963 and by 2004 had 4 million depositors with more than US$2 billion invested. Tabung Haji is still operational and as such can be declared the oldest Islamic finance institution in the world.

**Few books** on Islamic finance and banking and on the profit and loss mode instead of interest were published.

1972 **Nasr Social Bank** in Egypt integrated within itself the Mit Ghamr project and was established as a social bank and not as a profit-oriented institution, serving mainly those with low income and ignored by commercial banks.

**3rd Conference of Foreign Ministers of Islamic Countries.** An important meeting where decisions were taken to establish Shariah-compliant and interest-free Islamic financial institutions.

1973 **Philippines Amanah Bank.** Established to serve the special banking needs of the Muslim community. It did not operate as a strictly Islamic bank, since interest-based operations co-existed with the Islamic products.

1975–1990 **Formative period.** Commercial and developmental Islamic finance and banking institutions established around the Muslim world. The products and services on offer are mainly replications of conventional finance, with some new purely Shariah-compliant products introduced.

1975 **The Islamic Development Bank.** Established as a multilateral bank and an intergovernmental institution to foster economic and social development amongst member countries, also bringing institutional recognition to the developing Islamic finance and banking industry.

**Dubai Islamic Bank.** Established as the first major Islamic commercial bank, in Dubai, UAE, with full government support and some government shareholding.

1976 **First International Conference on Islamic Economics.** Held in Makkah, KSA.

1977 **Kuwait Finance House, Bahrain Islamic Bank, Faisal Islamic Bank of Sudan and Faisal Islamic Bank of Egypt.** Established as pioneering institutions in their respective countries.

1978 **Jordan Islamic Bank.** Launched formal Islamic banking in Jordan.

**Centre for Research in Islamic Economics.** Established at the King Abdul Aziz University, Jeddah, KSA as the first specialized research institution for Islamic economics and finance.

**Islamic Finance House, Luxembourg.** Established as the first for Islamic finance in Europe.

1979 **First Takaful Company.** Set up by the Faisal Islamic Bank of Sudan and called the Sudanese Islamic Insurance Company.

(Continued)
1980 Pakistan passes legislature to establish Shariah compliance across its entire financial system. The decision though was never fully implemented in the industry and despite the growth of Islamic banking, the country still operates on the dual banking system.

1981 Islamic Research and Training Institute. Set up by the IDB in Jeddah, KSA. Dar Al-Maal Al-Islami Trust. Provides Islamic banking, investment and insurance services to Muslim communities in the GCC, Switzerland, Luxembourg, Jersey, Bahrain, Egypt and Pakistan. Founded in 1981 in Cointrin, Switzerland.

1983 Sudan reforms its banking system on Shariah principles, applied in the North of the country while dual banking continued in the South.

Bank Islam Malaysia Berhad. Founded as Malaysia’s first fully fledged Islamic bank.

Bank Islami Bangladesh. Established as this Muslim-majority country’s first pure Islamic bank.

1984 Iran makes true its promise during the 1979 revolution and establishes interest-free banking in the entire country.

1987 Al Rajhi of KSA operated in Shariah-compliant finance and commerce since 1957 and was consolidated into one umbrella institution, Al Rajhi Trading and Exchange Corporation, in 1978. In 1987 it was formalized as the Al Rajhi Banking and Investment Saudi Joint Stock Company.

1990–now Development period. This period is the new horizon for Islamic finance and banking, with the industry aiming not only to innovate and establish purely Shariah-compliant yet realistically applicable products but also to establish regulatory and standard setting institutes. Through this dual effort the Islamic finance and banking industry is working towards integrating with the global finance and banking industry and to earn its trust and confidence and be accepted as a reliable alternative to conventional finance.


1991 Bank Muamalat. Indonesia’s first Islamic bank set up.

1990s Global expansion. Islamic finance began spreading in Europe and the rest of the world. An Islamic Finance Forum was set up at Harvard University, Islamic indexes were developed by Dow Jones and the Financial Times.

2000s Entry of large conventional banks. Many European and American conventional banks – like UBS, BNP Paribas, Credit Suisse, ABN Amro, Deutsche Bank, Citibank, Merrill Lynch, HSBC and Barclays – entered the industry operating via Islamic windows, which are partially separate operations within the same distribution channel of the bank.

Several international Islamic regulatory bodies were also established during this decade – Islamic Financial Services Board, International Islamic Financial Market, Council for Islamic Banks & Financial Institutions, International Islamic Rating Agency, Liquidity Management Centre. These will be covered in more detail in Chapter 3.

2002 UK and Singapore governments extend support to the Islamic financial institutions via various tax-neutrality rulings.

2004 Islamic Bank of Britain set up. The European Union’s first Shariah-compliant bank, today renamed the Al Rayan Bank.

2006 Dubai financial market announces restructuring to set up the world’s first Islamic stock exchange.
KEY TERMS AND CONCEPTS

<table>
<thead>
<tr>
<th>Term</th>
<th>Term</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classic economic problem</td>
<td>Islamic economics</td>
<td>Quran</td>
</tr>
<tr>
<td>Conventional banking</td>
<td>Islamic finance</td>
<td>Sadaqah</td>
</tr>
<tr>
<td>Cooperative savings bank</td>
<td>Islamic law</td>
<td>Scarcity of resources</td>
</tr>
<tr>
<td>economics</td>
<td>Islamic window</td>
<td>Shariah law</td>
</tr>
<tr>
<td>Hajj</td>
<td>Medium of exchange</td>
<td>Social welfare</td>
</tr>
<tr>
<td>Islamic banking</td>
<td>Money</td>
<td>Zakat</td>
</tr>
</tbody>
</table>

CHAPTER SUMMARY

Islam is a way of life and has influence on all aspects of a Muslim’s life. The Islamic law, Shariah, prohibits any dealing with interest and over the last six decades the Muslims globally became interested in conducting their finance and banking in an interest-free manner. Before the emergence of modern Islamic finance and banking, conventional banking dominated the world, starting from the Florentine merchants and growing with the Industrial Revolution. Islamic finance and banking is religion-based and has unique features like being profit and loss-based rather than interest-based, real asset-linked, in partnership rather than a debtor-creditor relationship, with a prudent choice of projects and avoidance of speculation and excessive risk.

Economics in ancient times was linked to religion or capitalism. All three Abrahamic religions agreed on justice in economic exchange, that the ultimate owner of property was the Creator, while the prohibition of usury or interest had different interpretations. Modern economic thought, as laid out by Adam Smith, considered money or capital as part of the factor of production. A key issue in modern economics was the classic economic problem – unlimited wants and limited resources. Islamic economics is rooted in the Quran and Sunnah, and dictates that wants should be limited, production encouraged, waste and luxury discouraged. Thus solving the classic economic problem.

Islamic economics is closely tied to social welfare. The Islamic doctrine of property ownership dictates Allah as the ultimate owner and humans as the trustee, and as such the benefits of assets need to be shared via the modes of compulsory Zakat and voluntary Sadaqah. Islam totally bans interest, although it permits the cost of capital in the form of sharing in the profit, provided the losses are shared too. There are clear distinctions between conventional and Islamic economics related to ownership and accumulation of wealth, wants and resources, role of the State, economic cycles and market economy, rewards of capital, social welfare and inheritance law.

Islamic finance began with the advent of Islam and early Islamic finance concepts and tools developed during the times of the Prophet and the Caliphs with achievements in financing government treasury, social welfare, business and trade. From the 12th century to almost the middle of the 20th century was the period of decline and almost obliteration of Islamic finance due to the fall of the Ottomans, the dominance of Western economies and institutions, colonization and disuse. The revival of Islamic finance began from the middle of the 20th century, with discussions amongst scholars and experts leading to experimentations like Mit Ghamr savings bank, Tabung Haji and further institutional developments of the Islamic Development Bank and the Dubai Islamic Bank.
Muslims interested in living by their faith and following the Shariah rulings related to their financial and banking transactions were prohibited from dealing with interest and were unable to use conventional banking since most of their products are interest-based. To meet this demand from Muslims, Islamic finance and banking is growing and is now accepted and identified as a new, niche sector within the global finance industry. It has spread significantly in the Muslim-majority countries in the Middle East and North and East Africa, as well as South and South-East Asia, with Bahrain and Malaysia being major hubs. The sector is also gaining a significant foothold in the Western world, serving the Muslim population as well as taking advantage of the potential in this unique sector.

The Islamic finance and banking industry today is operating in about 75 countries, with almost 500 Islamic institutions and another 190 conventional financial institutions participating in Islamic finance. The rapid growth has been driven by an increase in the Muslim population and their desire to participate in Shariah-compliant finance and banking, affluence in the Middle East (especially in the GCC) and the economic rise of Asia.

END OF CHAPTER QUESTIONS AND ACTIVITIES

Discussion Questions

1. Briefly discuss the creation of money in the world.
2. Discuss the early establishment of commercial banking in Europe.
3. Which three groups of people established the original banking system in the Western world? What are their similarities to a modern bank?
4. Define Islamic finance.
5. Briefly discuss the distinctive features of Islamic finance.
6. Give a summary of economics in ancient times.
7. Who is Adam Smith and what is his role in modern economic thought?
8. Briefly describe the four classic economic models.
9. Describe Islamic economics.
10. Discuss the principles of Islamic economics.
11. What is Islam’s solution to the classic economic problem?
12. How is property ownership dealt with in Islamic economics?
13. What is Sadaqah?
14. Discuss Zakat as a financial and social welfare tool in Islamic economics.
15. Why is Zakat an important feature of the Islamic welfare society? How is it different from a conventional tax?
16. Does Islamic economics agree to assign a cost to capital?
17. What are the core differences between conventional economics and Islamic economics?
18. Discuss some of the achievements of Islamic finance during the early days of the Islamic civilization.
19. Why is the period between the 12th century and the 20th century so meaningful for Islamic finance? What happened during this period and why?
20. Discuss the Mit Ghamr story.
21. What is Tabung Haji? Why is it important in the development of modern Islamic finance and banking?

22. What roles did the Islamic Development Bank and the Dubai Islamic Bank have in the progress of modern Islamic finance and banking?

23. Discuss the rapid growth of modern Islamic finance and banking amongst the Muslim-majority countries.

24. Discuss the spread of modern Islamic finance and banking in the non-Muslim countries of the world.

25. What are the main sub-sectors within the modern Islamic finance and banking industry?

26. Discuss the status of the modern Islamic finance and banking industry globally.

27. Walk through the timeline of the development of the modern Islamic finance and banking industry.

**Multiple Choice Questions**

Circle the letter next to the most accurate answer.

1. A key principle related to Islamic finance is:
   a. Encouragement to use Riba and loss
   b. Earning money from money
   c. Avoid hoarding
   d. Hoarding

2. Which one below is not forbidden in Islamic finance and banking:
   a. All kinds of risk
   b. Hoarding of goods
   c. Speculative behaviour
   d. Making money out of money

3. Which of the following statement(s) is/are correct about the early evolution of Islamic finance?
   a. Islamic finance was born in the early 7th century and continued to develop up to the 11th century
   b. Islamic finance contracts like Mudaraba and Musharaka were in use for trade and business
   c. Islamic traders and ships faced frequent events of mutiny while at sea
   d. Only a and b

4. Western conventional banking was established by three groups of people. Which group below is not one of them?
   a. Rich merchants
   b. Goldsmiths
   c. Money lenders
   d. Land owners

5. Islamic economics ensures:
   a. Socio-economic justice
   b. Harmony between the moral and material needs of society
   c. Shariah compliance in economic activities
   d. All of the above
6. Zakat is an important financial tool in Islam. Zakat application differs for money used in a productive manner or kept idle as cash. Which statement below best describes this goal of Zakat?
   a. To finance government expenses only
   b. To encourage holding cash
   c. To encourage productive activities
   d. To discourage acquisition of material goods

7. Islamic economics differs from conventional economics as it requires the benefit of society and the environment in addition to individual gain and business profit. Which statement below best describes this?
   a. To create public good
   b. To encourage profitable ventures
   c. To moderate profit through application of Zakat
   d. To control acquisition of material goods

8. The world’s first Islamic banking experiment happened in:
   a. UK
   b. Malaysia
   c. Egypt
   d. Bahrain

9. The first commercial Islamic bank of the world was set up in:
   a. Egypt in 1963
   b. Dubai in 1975
   c. Saudi Arabia in 1960
   d. Malaysia in 1970

10. The world’s first commercial Islamic bank was:
    a. Qatar Islamic Bank
    b. Dubai Islamic Bank
    c. May Bank Islamic
    d. Commercial Bank of Dubai

True/False Questions

Write T for true and F for false next to the statement.

1. Islam and trading arrived in Malaysia and Indonesia after the Europeans did.
2. Dubai Islamic Bank is the world’s first commercially successful Islamic bank.
3. Islamic mercantile law for trading and partnership was already developed before European commercial law was developed.
4. London is an important centre for Islamic banking and insurance.
5. Islamic finance began from the time of the Prophet and continued growing uninterrupted to the present.
6. The main objective of Islamic banks is to make attractive returns for their shareholders.
7. The main objective of Islamic banks is to ensure Haram activities are not financed.
8. The main objective of Islamic banks is to provide an alternative to interest-based finance.
9. The main objective of Islamic banks is to finance the construction of masjids.
10. The goal of Islamic economics is to ensure socio-economic justice.
11. The goal of Islamic economics is to provide freely available financing for Muslims.
12. The goal of Islamic economics is to establish harmony between the moral and material needs of society.
13. Conventional banks base their lending criteria largely on creditworthiness and collateral.
14. Islamic banks base their lending criteria on investment potential and managerial capability of the borrower rather than on collateral only.
15. Hoarding of any goods is not allowed in Islamic finance.

Calculation Problems

1. Khalid has kept £2 million in his savings account with Al Rayan Bank. Last year he earned profit at an average rate of 6%. He did not take any money out of the account. Sara invested £2 million in a bakery business. She earned £150,000 last year and took £60,000 as her annual salary to manage the business. Calculate the Zakat applicable to both. What can we infer from this about Zakat as a financial tool?

2. Amna and her sister Mariam inherited (Arab Emirates dirham) AED1 million each from their father after he passed away. Amna has kept her AED1 million in her savings account with Abu Dhabi Islamic Bank. The bank shared profit with depositors last year at an average rate of 3%. The cash was in the account for the entire year. Mariam invested her AED1 million in a partnership with a friend to start and manage school uniform and other accessories production. As a start-up business they only earned AED70,000 in the first year. Mariam and her friend kept AED30,000 each as their annual management salary and split the rest as their profit. Calculate the Zakat applicable to both Amna and Mariam. From these calculations what do you learn about Zakat as an encouragement to participate in productive endeavours?