Challenging CONVENTION

PHIL MOLYNEUX explores the origins of Islamic banking and considers the challenge it presents to conventional banks.

The key principles underlying Islamic banking and finance – namely the prohibition of Riba (narrowly interpreted as interest) and adherence to other Shariá (Islamic law) requirements – are as ancient as religion itself. However it is only since the 1960's that banks have offered Islamic financial services.

Shariá compliant services now amount to a global industry of around $2tn in assets, of which 80% is accounted for by Islamic banks (or Islamic windows of conventional banks), 15% Sukuk (Islamic bonds), 4% Islamic mutual funds and 1% Takaful (Islamic insurance). Iran is the biggest Islamic banking market (accounting for around 40% of global Islamic banking assets) followed by Saudi Arabia (14%), Malaysia (10%) and the United Arab Emirates (UAE) and Kuwait (both with 9% shares).

In the majority of Muslim countries Islamic banks compete head-on with their conventional counterparts. While Islamic banking and financial assets comprise under 1% of total global financial assets the sector has grown faster than conventional (western) finance since the 2007-08 banking crisis - according to The Economist (2014) this trend is expected to continue.

In addition to the growth in banking assets there is increasing competition between major financial centres to take the lead in Sukuk issuance and develop a broader array of Islamic investment products. In light of this, comparing the performance of Islamic and conventional banking provides interesting results.[1]

AN ALTERNATIVE SOLUTION

When commercial banking emerged after the industrial revolution, Muslim scholars expressed reservations with the western model of financial intermediation due to its reliance on interest. In response, they called for the development of alternative mechanisms to perform a financial intermediation function in Muslim societies.

However, the growing needs of traders, industrialists and other entrepreneurs were pressing and as a consequence Muslim economists and bankers took on the challenge of developing alternative models of financial intermediation. In the early 19th century most of the Muslim world was under colonial rule. When many of these countries gained independence post-WWII, practical experiments in interest-free financing started at a modest scale and gradually expanded in scope.

While credit societies and cooperatives working on an interest-free basis existed in several Muslim countries even during the colonial period, the semblance of banking institutions started emerging in the early 1960s.

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HUMBLE BEGINNINGS

The first interest-free institution with "bank" in its name, Nasser Social Bank, was established in Egypt in 1971. This was the first time a government in a Muslim country had provided public support for incorporating an interest-free institution. The objectives of the Nasser Social Bank were mainly social - providing interest-free loans to the poor and needy, scholarships to students and micro-credits to small projects on a profit or loss sharing (PLS) basis.

Probably one of the most important developments in the history of Islamic banking was the establishment of the Islamic Development Bank (IDB) in 1975. The IDB was founded as an international financial institution by representatives of member countries of the Organization of the Islamic Conference (OIC), and continues to promote economic and social development in the Muslim world in accordance with the principles of Shariá.

Between 1975 and 1990 the Islamic financial industry developed into an alternative model of financial intermediation, marked by the establishment of a number of Islamic financial institutions in the private sector. In addition, governments in three countries - Pakistan, Iran and Sudan - expressed the desire to gradually eliminate interest from their entire economies and substitute it with banking systems based entirely on Islamic principles.

Initiatives for the establishment of some infrastructure institutions supporting the Islamic financial industry also started in the 1990s. Initially, Islamic banking organisations had to work within the institutional framework that supported conventional banking which put them at a disadvantage. Though still in its infancy, steps were being made towards constructing a network of supporting institutions for the Islamic financial industry.

A CURRENT PERSPECTIVE

Today, Islamic banking and finance manifests itself in five ways:

1. Banks and financial institutions operate in countries where the promotion of an Islamic financial system receives active government support
2. Islamic banks and financial institutions operate in the private corporate sector competing with conventional (western) institutions
3. Islamic banking is practiced by conventional commercial banks (via Islamic windows), traditional Islamic banks as well as non-bank financial institutions
4. Multinational financial institutions (like the Islamic Development Bank in Jeddah) operate on Shariá principles
5. Islamic capital market instruments (mutual funds, Sukuk), and insurance (Takaful) are becoming more important.

WEIGHING UP THE RISKS

Islamic banking is characterised by features that appear to reduce risk – for example, religious beliefs which may encourage greater loyalty and discourage default. On the other hand risk is increased through factors such as the complexity of Islamic loan contracts, limited default penalties and moral hazard incentives caused by PLS contracts.

In terms of insolvency risk, the special relationship with depositors could provide Islamic banks with greater capacity to bear losses, but might also lead to operational limitations on investment and risk management activities making them less stable than their conventional counterparts.

Recent studies that have examined insolvency and other risks have typically found that small Islamic banks have lower default risk compared with small conventional banks, but the opposite is also the case for larger Islamic banks where insolvency risk is higher. The studies with the most comprehensive data samples find no such differences.

CONCLUSION

Research investigating Islamic banking and financial issues show that Islamic banks are at least as efficient and (particularly for smaller banks) have lower default / insolvency risk than their conventional counterparts. Islamic banks typically focus more on higher margin small business borrowers who are less likely to default. Studies also suggest that Islamic banks can be more competitive than conventional organisations, while other (albeit somewhat limited) evidence shows that the spread of Islamic banking can aid financial inclusion and economic development.

Despite ongoing interest in comparative research, there is no strong consensus on this. A small majority of studies do however find no major difference between Islamic and conventional banks in terms of cost and profit efficiency. CB

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