Economic and Financial Review

Volume 49 | Number 2 Article 2

6-1-2011

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Recommended Citation
Musa J. (2011) Islamic banking: how has it diffused?. Economic and Financial Review 49(2), 95 - 99

Islamic Banking: How Has It Diffused?[+]

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I. Introduction

The paper reaffirms that countries with larger financial systems tend, all other things being equal, to grow faster because banks generally perform a fundamental economic role as financial intermediaries and as facilitators of effective payments system (King and Levine, 1993). In evaluating how Islamic banking services diffused the global economy using country level data for 1992 to 2006, the paper identifies income per capita, economic integration with Middle Eastern countries and share of Muslims population as factors influencing the development of Islamic banking worldwide.

The centrality of riba (interest) in Islamic banking, which prohibits Muslims from taking or accepting interest was said to limit the diffusion of Islamic banking system. However, the higher hurdles set by the Shariah law ensure the quality of Islamic banks. The sharing of profit and losses by Islamic banks and entrepreneurs makes the banks more prone to finance sound and viable projects, even if the entrepreneur has no credit history.

II. Highlights of the Paper

In section one, the paper states that Islamic banks are obviously becoming alternative to conventional banks in Islamic countries and countries with large Muslim populations like United Kingdom. It shows that assets of Islamic banks have grown at double digit rate and some conventional banks have opened Islamic windows with Shariah-compliant financial assets estimated at US$509 billion at end-end-2007 (Moody's 2008). It reveals that as much as half of the savings of the world's estimated 1.2 -1.6 billion Muslims would be in Islamic financial institutions by 2015. However, the authors believe that despite the phenomenal growth of Islamic banking in recent times, its global diffusion remains poorly understood.

Section 2 introduces Islamic banking as a niche for Muslim banking population. Islamic banks are said to offer custodian and other services found in traditional banking system. The major difference identified was that their services are based on principles of Shariah. The authors identified four distinguishing factors of Islamic banking to include:

[+] Written by Patrick Imam and Kangni Kpodar and Published as an IMF Working Paper, August 2010, WP/10/195.

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i. **Prohibition of interest (Riba).** Islam prohibits all forms of riba (interest paid on loans) on the grounds that interest rates are exploitative and inconsistent with the notion of fairness. Islam does not recognize time value of money. However, in case of a leasing agreement, time value of money is an integral part of rent, as longer leases are expected to yield higher returns.

ii. **Prohibition of maysir (games of chance) and of gharar (chance).** Islamic banking bans speculation that increases one's wealth by chance rather than productive efforts or taking excessive risk. This minimizes the possibilities of conflicts between contracting parties.

iii. **Prohibition of haram (illegal) activities. Only halal (legal)** activities are financed. However, the paper notes that it is becoming increasingly difficult to find pure halal investments. In that regard, Islamic scholars justify that when a small share (5.0 per cent) of a company's business deals with haram activities, that part of the dividend that is deemed tainted should be donated to charity.

iv. **Payment of part of bank profits to benefit society (Zakat).** It was noted that in countries where Zakat is not collected by the state, Islamic banks establish a Zakat fund (2.5 per cent of assets held) for collecting money to be donated to religious institutions and providing a minimum standard of living for the poor.

In section three, the authors reveal that traditional banking system four decades ago, was not attuned to devout Muslim individuals who would not like to put their money into financial institutions that were not based on religious principles, so, Islamic banking industry emerged on a modest scale to fill the gap. It identifies two crucial factors for the feasibility of Islamic banking. First, was bottom-up experiments in Egyptian villages, which grew into large industry in many countries spreading from Middle East to Indonesia, Malaysia, sub-Sahara Africa, and Europe and America. Second, top-down support from creation of Islamic Development Bank of Jeddah in 1975, which gave impetus to diffusion of Islamic banking. Other areas of diffusion included the introduction of products such as sukuks (Islamic bonds) and establishment of Islamic Financial Services Board (IFSB) in 2002, with a mandate to set prudential standards for Islamic banks. They show the importance of Islamic banking varying from being high in the Gulf and East Asia in absolute numbers but small in terms of investment finance as share of GDP compared with conventional banks.

Section four specifies the diffusion of Islamic banks to be a function of Muslims population, interest rates, income per capita, September, 11 attack, petroleum exporters and economic integration with Middle East. Others included distance from

Islamic financial centers, financial system development and macroeconomic stability.

The regression results using number of Islamic banks in a country as dependent variable reveal that income per capita, share of Muslim population, distance to the two Islamic financial centers (Bahrain and Malaysia) and existence of a developed banking system increased the diffusion of Islamic banking across countries. Besides, sound fiscal policy was said to be vital for financial development including Islamic banking. However, the authors discover that being a net oil exporter is not as important as people imagined. Similarly, as real interest rates rise and pass a threshold estimated at 3.5 per cent, the diffusion of Islamic banking starts to slow down. The results also suggest that less devout or nonreligious consumers see traditional and Islamic banks as substitutes because as they put more money into Islamic banks when opportunity costs fall and move money into conventional banks when the opportunity cost rises.

The second regression results based on Tobit Model, which used the share of Islamic bank assets in total banking assets as dependent variable, reveal that income per capita and share of Muslims in the population are important. The September 11th attack on US was seen to have a positive impact on assets of Islamic banks as Muslims kept more money at home for fear of expropriation. Rising oil prices also increased the diffusion of Islamic banks. Trading with Middle East countries had impact on assets of Islamic banks. However, distance to Islamic financial centers did not have significant impact on diffusion of Islamic banking as well as financial development in contrast to earlier finding using Poisson Model.

In section five, the authors conclude the paper with a remark that within a few decades Islamic banking moved from a niche market into mainstream. Generally, they observe that the probability of Islamic banking to develop in a given country increases with rises in the share of Muslim population, income per capita, and whether the country is a net exporter of oil. Trading with Middle East and proximity to Islamic financial centers were also identified as crucial for diffusion of Islamic banking.

III. Comments

The paper has evaluated the development of Islamic banking from a niche market in some jurisdictions to a well-recognized banking practice in the global financial market. This effort is highly commendable. The role of Islamic banks as financial intermediaries and facilitators of payments system in developing countries with large number of Muslims population was highlighted. However, there is the need to examine in more details various Islamic banking products and show how Islamic Financial Services Board relates with other similar bodies like Financial Service Authority of UK.

The Islamic (non-interest) banking, which has become a subject of intense public debate in Nigeria has been clearly discussed by the authors and could be a good reference material for Nigerians who require more information on the growth and development of Islamic (non-interest) banking worldwide. From both print and electronic media, many Nigerians perceive Islamic banking (non-interest banking) as a threat to other religious beliefs, but the authors' analysis has provided evidence for the phenomenon growth of the non interest banking (Islamic banking) in the countries with large number of Muslims population globally. They also reveal that Islamic banks have large number of non-Muslims as customers and tried to remove the fear being expressed by some Nigerians on the development of regulatory and supervisory framework for non-interest (Islamic) banking by the Central Bank of Nigeria and the establishment of the proposed Jaiz Bank in Nigeria. It is important to note that the word "Islamic" is not part of the name of the proposed non-interest (Islamic) bank, Jaiz Bank in compliance with the provisions of the Bank and Other Financial Institutions Act, 1999.

It is also imperative to note that the CBN intervention in the non-interest (Islamic) banking is not in form of official support like those of central banks of Malaysia and Bahrain as revealed by the paper but as a financial regulator that is statutorily required to put in place a legal and regulatory framework for Islamic (non-interest) banks. Generally, the CBN is required by law to regulate and supervise banking sector, including Islamic banking sub-sector, so as to protect consumers and investors; ensure sound, safe and stable financial environment; ensure healthy completion and efficient service delivery and prevent banking system failure among others. The non interest banking framework issued by the CBn has been made flexible to accommodate other religious beliefs.

IV. Concluding Remarks

In conclusion, the paper attempts to investigate the phenomenon growth of Islamic (non-interest) banking in countries with large number of Muslim population. It shows that Islamic banks are concentrated in the Middle East, North Africa, Southeast Asia, later spreading to sub-Sahara Africa, Central Asia and Western Europe. The outcomes of the econometric investigations identify the determinants of diffusion of Islamic banking to include Muslims population, interest rates, income per capita and September 11 2001 attack. Others included economic integration with the Middle East, distance from Islamic centers, financial system development and macroeconomic stability. It is clear that most of the factors that affect performance of conventional banks such as income per capita, September 11 attack, financial system development and macroeconomic stability also influenced Islamic banks globally. However, September 11 attack affected Islamic banks positively.

The paper notes that Islamic banks do not discriminate against non-Muslims in the areas of customers, investors or employment. However, it was made clear that Devout Muslims see Islamic (non-interest) banks as substitutes to conventional banks, while less devout Muslims and non-Muslim customers see them as complementary.

The effort of the authors to investigate the diffusion of Islamic banking in the global economy is highly educative and informative. However, there is the need to explain in greater details that Islam has encouraged a greater reliance on equity and profit-and-loss sharing by prohibiting interest. It places emphasis on primary mode (rate of return not determined in advance but depend on outcome of business venture) of Mudarabah (passive partnership), or Musharakah (active partnership) and shares of joint stock companies (which are a combination of both the Mudarabah and Shirkah forms of financing). It has also allowed certain secondary modes (where return is fixed in advance but the risk is shared) such as Murabah (cost plus service charge), Ijarah wa iqtina (hire purchase), Salam (forward delivery contract) and Istisna (contractual production) to take care of financial needs that are not amenable to primary modes. The primary and the secondary modes together are expected to intermediate efficiently and promptly between the surplus and the deficit units and thereby ensuring financial needs of countries with large Muslim population (Chapra, 1998).

It is a fact that opinions are naturally polemical; but the paper has provided convincing analysis to show that establishing Islamic (non-interest) banks should not be perceived as a threat of any kind to any nation but seen as a way of achieving financial inclusion and overall financial sector development.