Afro Eurasian Studies, Vol. 2, Issues 1&2, Spring & Fall 2013, 5-14

Reflecting on the Trajectory of Islamic Finance: From Mit Ghamr to the Globalisation of Islamic Finance

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Every civilisation has, historically, developed their own political, economic, and social order through which the formation of their society has been defined. The Muslims, from the 7th century onwards, aimed to create a system of an Islamic order by developing their own particular social formations according to the norms, principles, and values of Islamic ontology. Therefore, when history is referenced in the search for authenticity, the 'golden years' (*asr al-saadath* or 'the times of felicity') are seen as the necessary framework with which to organise Muslim societies, including their economic and financial systems.

Although the collapse of Muslim socio-political entities by the 20th century created a period of inevitable stagnation in this search for authenticity, the end of colonialism and the emergence of independent Muslim 'nations' provided a new opportunity to establish an identity for these societies. To this end, even though some societies have immediately opted for Islam as their ordering principle, others have sought salvation in non-native systems, namely, secularism in the form of nationalism, socialism, and capitalism. Global political and economic developments, however, resulted in another period of Islamic re-emergence since the 1970s all over the world. Coupled with this new search for authenticity, the rise of the petrodollar in the Middle East provided the necessary incentive to build upon the intellectual foundation of Islamic economics and finance that had been established in the late 1940s. Thus, the 1970s marked an increased intellectual effort to develop Islamic economics and banking along modern lines. The efforts of the founding fathers, such as M. Nejatullah Siddiqi, M. Umer Chapra, S. N. H. Naqvi, Anas Zarka, and Khurshid Ahmad, were heavily engaged in developing a human-centred economic system of Islam as a response to the observed underdevelopment in the Muslim world. As an extension of transforming these efforts into a practical reality, a number of Gulf businessmen and *Shari'ah* scholars aimed at institutionalising such intellectual acumen from early 1970s onwards. Thus, the establishment of the Islamic Development Bank (IDB) in 1974 followed by the formation of the first Islamic commercial bank in 1975 in Dubai. The creation of the IDB constitutes the first Muslim joint effort to find an institutional solution to the economic development problems in the Muslim world after the collapse of Muslim unity; it should therefore be considered as an important landmark in the development of Islamic economics and finance. Conversely, the establishment of the Dubai Islamic Bank as the first commercial bank in 1975 should be perceived as indicative of the rise of commercial corporate culture in the modern sense and the emergence of 'modern businessmen' integrated with the global financial world.

It should be noted that there were other institutionalisation attempts in terms of financing in the Muslim world prior to the first Islamic bank in 1975. In Pakistan during the 1950s, a number of localised attempts at Islamic financing, in the form of *musharakah* projects, could be considered as the precursor to modern Islamic finance. The first institutionalisation of an Islamic social bank and credit provisory institution, namely, Mit Ghamr Bank, came into existence in Egypt in 1963 under the efforts of the late Ahmad Al-Najjar. This first institutionalisation was claimed to be an 'optimal solution' for the economic and social development needs of the Muslim society. Therefore, it is distinguished from Islamic commercial banking, which became the banking model in 1975, as the second institutionalisation phase of Islamic finance.

With regard to *Shari'ah*-compliant investments, they did not necessitate 'institutionalised forms,' as the traditional Islamic financial modes have always remained operational on the periphery of the Muslim world one way or another. Despite the imposed nature of secular economic systems, Islamic modes such as *mudarabah* remained as important financing tools in practice, especially in agriculture in many parts of the Muslim world even in the 20th century. Major institutional development in terms of investment came, however, with the formation of the Tabung Haji in Malaysia, which aimed to invest the savings of Malaysian *bumiputeras* in a *Shari'ah*-compliant way, in that it invested the small savings of Malaysians to pay for their *hajj* trip. Thus, socially responsible investment according to the Islamic moral economy was institutionalised in 1967.

The second stage of the institutionalisation process from 1975 onwards can be traced back to the commercial Islamic banks, which provided the model that shaped the nature and operations of global Islamic finance. The initial strategy in place until the 1990s was overly protective to help this 'infant industry' develop. In order to protect the sector from any potential harms of competition, the 'one country one bank' strategy was embraced to support the early expansion of Islamic finance sector. As a result of the globalisation, internationalisation, and the increased capital accumulation in the GCC region, the Islamic banking and financial institutions have grown beyond their humble beginnings through the 1990s. During this 'globalised' institutional stage, or, in other words, the third institutional formation period, Islamic banks and financial institutions have advanced by leaps and bounds into the mainstream financial industry by attracting the attentions of regulators and private banks all over the world. For example, London was already home to a number of Islamic financial operations in the 1980s, but as early as 1994, the line of communication with the Bank of England was open to discuss the institutionalisation of Islamic banking in the UK, which led to the development of London as one of the centres of Islamic finance activity.

Economic and financial reforms in many Muslim countries during the 1980s and 1990s paved the way for trade and financial liberalisation, as well as financial diversification. Such liberalisation efforts created an opportunity for the expansion of the Islamic finance industry. Beyond the GCC region, emerging Muslim economies such as Indonesia, Malaysia, and Turkey, began to institutionalise Islamic banking in their respective countries from the mid-1980s onwards, while Iran and Sudan opted for full-Islamisation of their financial system. Although the political culture in Indonesia and Turkey has not facilitated the expansion of Islamic banking and finance until recently, Islamic identity-oriented policies in Malaysia resulted in unprecedented incentives for the development of Islamic finance and banking. Malaysian government instituted a strategic financial policy that is very conducive to expansion of Islamic finance. The environment in Malaysia served the Islamic financial sector tremendously by allowing the creation of institutions to build the necessary infrastructure, as well as educational and training initiatives. It should be noted that this has contributed to the development of the industry globally.

The current Islamic finance sector is believed to extend to over ninety countries in various forms (banks and financial institutions, fund management, project financing and so on) with an asset base of over USD$2 trillion by the mid-2012 (The Banker, 2012). Several non-Muslim countries, including the UK, France, and Luxembourg, have facilitated a regulatory and institutional environment conducive to Islamic finance; with many others following in their footsteps to develop such an environment. The motivation behind these moves is mainly to reap the benefits of the increased capital accumulation in the GCC region and, to lesser degree, to extend financial inclusion to their own Muslim population by providing *Shari'ah*-compliant financial services.

Reflecting on the aforementioned developments, Table 1 depicts the state and trends in Islamic banking in fifteen countries for 2009-2012, thereby indicating the success of the sector in terms of asset accumulation.

Table 1: Top 25 Countries by *Shari'ah*-Compliant Assets

2009			2010			2011			2012		
Rank	**Country**	***Shari'ah*-Compliant Assets $m**	**Rank**	**Country**	***Shari'ah*-Compliant Assets $m**	**Rank**	**Country**	***Shari'ah*-Compliant Assets $m**	**Rank**	**Country**	***Shari'ah*-Compliant Assets $m**
1	Iran	293,165.80	1	Iran	314,897.40	1	Iran	387,952.57	1	Iran	465,574.92
2	Saudi Arabia	127,896.10	2	Saudi Arabia	138,238.50	2	Saudi Arabia	150,945.43	2	Malaysia	221,025.52
3	Malaysia	86,288.20	3	Malaysia	102,639.40	3	Malaysia	133,406.38	3	Saudi Arabia	185,223.00
4	UAE	84,036.50	4	UAE	85,622.60	4	UAE	94,126.66	4	UAE	89,309.38
5	Kuwait	67,630.20	5	Kuwait	69,088.80	5	Kuwait	79,647.85	5	Kuwait	78,587.25
6	Bahrain	46,159.40	6	Bahrain	44,858.30	6	Bahrain	78,857.47	6	Bahrain	62,171.53
7	Qatar	27,515.40	7	Qatar	34,676.00	7	Qatar	52,322.38	7	Qatar	45,301.30
8	UK	19,410.50	8	Turkey	22,561.30	8	Turkey	28,015.20	8	Turkey	29,292.86
9	Turkey	17,827.50	9	UK	18,949.00	9	UK	19,041.79	9	UK	18,605.43
10	Bangladesh	7453.3	10	Bangladesh	9,365.50	10	Sudan	12,139.45	10	Indonesia	15,963.97
11	Sudan	7151.1	11	Sudan	9,259.80	11	Bangladesh	11,677.10	11	Bangladesh	12,572.97
12	Egypt	6299.7	12	Egypt	7,227.70	12	Indonesia	10,531.61	12	Sudan	9,825.23
13	Pakistan	5126.1	13	Indonesia	7,222.20	13	Syria	8,690.20	13	Egypt	8,296.32
14	Jordan	4621.6	14	Pakistan	6,203.10	14	Egypt	7,888.22	14	Pakistan	7,328.34
15	Syria	3838.8	15	Syria	5,527.70	15	Switzerland	6,582.48	15	Switzerland	6,551.37

Source: The Banker (various issues).

In substantiating the argument, Table 2 shows the regional dynamics in Islamic banking and finance. As it is apparent in growth trends, Africa and Asia have become the new 'tipping points' of what is now a truly global sector. As the trends in both tables demonstrate, despite the deceleration precipitated by the global financial crisis, Islamic banks and financial institutions have performed well, and a couple of localised defaults notwithstanding, they have not faced any major financial defaults and failures.

Table 2: IBF-Regional and Global Growth Totals ($ million)

	2006	2007	% Change	2008	% Change	2009	% Change	2010	% Change	2011	% Change
GCC	127,826.60	178,129.60	39.4	262,665.40	47.5	353,237.50	34.5	372,484.20	5.5	434,893.10	16.75
Non-GCC MENA	136,157.60	176,822.20	29.9	248,264	40.4	315,090.50	26.9	337,948.20	7.3	416,382.20	23.21
MENA Total	263,984,2	354,951.70	34.5	510,929.40	43.9	668,328.50	30.8	710,434.00	6.3	851,275.30	19.82
Sub-Saharan Africa	3039.3	4708	54.9	6662.1	41.5	8369.7	25.6	10,765.10	28.6	13,711.10	27.37
Asia	98, 709.6	119,346.50	20.9	86,360.30	-27.6	106,797.30	23.7	130,904.10	22.6	166,652.80	27.31
Australia/Europe/America	20,300.20	21,475.70	5.8	35,105.20	63.5	38,654.80	10.1	42,779.50	10.7	53,939.10	26.09
Global Total	386,033.30	500,481.90	29.7	639,076.90	27.7	822,135.10	28.6	894,882.70	8.9	1,086,462.90	21.41
% of MENA total to Global Total	68.4	70.9		79.9		81.3		79.39		78.35	

Source: The Banker (various issues)

The success of Islamic banks and financial institutions in increasing their operations and asset bases, even during the financial crisis, is an indication of their resilience and vindicates their stability. This success may also be attributed to the business cycles of the countries home to the majority of Islamic banks and financial institutions, as GCC countries, Malaysia and most other Muslim countries have not been deeply affected by the financial crisis. Therefore, it is difficult to isolate the inherent salient features of Islamic finance that contribute to its resilience and stability from the macroeconomic state of the home countries. The recent experience of the sector should be studied further to clarify the distinction.

In critically reflecting on the progress made over the recent years, it has been observed and highlighted that Islamic finance has been converging towards conventional banking and finance in its instruments, operations, and priorities. This move has led to a debate on the aspirations and realities of Islamic finance. The idealistic aspirations of Islamic finance are defined by the Islamic moral economy. However, the reality of Islamic finance is driven by the market conditions and requirements. In fact, commercial Islamic banking in its current form is not necessarily perceived as the best answer to the over-emphasised social and developmentalist goal of the Islamic moral economy. On the other hand, the contribution of commercial Islamic banks and financial institutions in terms of accumulating funds and leading economic growth is evidenced by many empirical studies and through actual experience. Thus, the on-going debate between 'development' and 'growth' has again risen to the top of the agenda for Islamic finance, as the founding fathers aimed for a developmentalist objective, rather than a source of financialization in their conception of Islamic finance.

Considering that the Arab countries as well as the emerging economies of Asia and Africa have turned to Islamic finance in recent years in order to finance economic development and answer employment needs of their constituents (as such demands have led to revolutions as in the case of Arab Spring), it becomes apparent that Islamic finance should also address developmentalist objectives through its operations. Failure to do so will result in the zealot population in the Muslim world, buoyed up on the hype of the expectations for Islamic finance, facing yet another disappointment from the expectation they build for a financial system labelled Islamic. Thus, in this new phase of institutional structuring, developmentalist-oriented Islamic financial institutions, in the form of Islamic social banks, Islamic microfinance, *zakah* funds, and *waqf*s should be built as complimentary institutions alongside the commercial Islamic banks and financial institutions. These non-banking Islamic financial institutions should aim to have a developmentalist impact beyond the economic growth objectives of commercial Islamic banking. Considering that civil society oriented Islamic finance, in the form of Islamic microfinance in Indonesia has immensely contributed to economic development, individual empowerment and capacity building throughout the country, perhaps developmentalist countries should consider non-banking Islamic financial institutions to reach the economic and social objectives. It is also important to note that *sukuk* type of financial products can further contribute to development objectives through infrastructure financing. In addition to the need for institutionalisation, new and authentic financial instruments with a high developmentalist impact should therefore be engineered to contribute to the new micro-trajectories.

Ultimately, the Islamic banking and finance sector has experienced substantial and unprecedented growth in recent years. Although its overall asset size (US$2 trillion in 2012) remains rather small when compared to that of the global financial system, the progress of Islamic finance can better be put in context through increased efficiency and profitability, as is evidenced by many empirical studies. Besides, comparing the current asset size of Islamic banking and finance with the size of assets in 1985 at US$10 billion draws a stark picture of its growth and further potential. . Although the recent success and resilience of Islamic banking and finance cannot be denied, it is important that this ethical financial proposition should remain true to its aspirational worldview in order to be considered a success in terms of making a difference rather than mimicking the conventional banking experience. As with regard to the current practice, the concerns and claims over the practice of Islamic banks and financial institutions deviating from the aspirational values are a valid argument.

This special issue of Afro Eurasian Studies Journal aims to highlight some of the topics discussed so far: a number of empirical papers in the following pages provide evidence of the progress and evaluate performance of Islamic banking and finance sector. Some discuss particular technical and operational aspects of Islamic financial institutions including *takaful*. In addition, papers on Islamic economics, Islamic corporate social responsibility or CSR, and Islamic microfinance offer conceptual underpinnings of the Islamic moral economy. Furthermore, professional papers detail the reflections of those involved in the industry on some of the issues discussed above.

Izhar and Hassan in their paper examine operational risk in Islamic banks in a structured manner and lay out some issues that are specific to Islamic financial institutions along with others that are common with conventional institutions. In the following article, Chusaini and Ismal explore the credit risk management practices in Indonesian Islamic banking industry and document the effective risk management practices of the industry players and provide suggestions for further improvements. Khafafa and Shafii shift the research orientation to demand conditions of Islamic banking industry, as they explore and analyze the customer satisfaction in Libyan Islamic commercial banks. Their attempt to provide empirical evidence for the relationship between customers' satisfaction and perceived service quality should be of interest to the banks themselves as well as the policy makers in the country.

This special issue has a number of empirical papers on the experience of Islamic banking, or as it is called 'participation banks' in Turkey, as Turkey has recently made important inroads in developing its Islamic finance industry after a rather long stagnation period. The first empirical paper in this section is by Asutay and Ergec, who conduct a comparative study across countries and industries in their paper analyzing the money supply and bank money creation in Islamic and conventional banking industries in Turkey and Malaysia. The dynamics governing both sectors yield important clues particularly for policy makers in each country. In the second empirical study, Aysan, Disli and Ozturk analyze the impact of a regulatory change on the competitiveness of Islamic banking industry in Turkey. The surprising outcome tells that the Islamic banking industry has turned more monopolistic as they have become more integrated with conventional banking. In using primary data to further explore Turkish case, Savaşan, Saraç and Gürdal utilize a survey of institutional customers of Islamic banking in Turkey in the case of Sakarya to explore the demand conditions and propose solutions to the demand side problems. Last among studies on Turkey's case, Kansoy and Karlioglu discuss how Islamic finance practice may help the aspirations of Turkish government to turn Istanbul into a global financial hub.

The second section of the special issue is comprised of two studies on Islamic economics: one on development issue on a philosophical level and the other methodologies of Islamic economics and jurisprudence. Zaman, in reflecting on the relative underdevelopment in the Muslim world, lays bare the misconceptions about the meaning of economic development and debunks Western imposed myths and their misplaced superiority complex with the objective of constructing an authentic development strategy based on Islamic norms. In his paper, Yas provides a brief anthology of various schools of thought on methodological approaches in understanding Islamic economics. The study explores and analyses advantages and shortcomings of each approach thoroughly and opens up the discussion on how to approach the modern problems the Islamic finance industry is currently facing.

In order to disseminate knowledge on the particular aspects of Islamic finance, this special issue also comes with a number of conceptual and issue oriented surveys in Islamic finance. Mohammed provides a systematic analysis of liquidity risk and its management in Islamic financial institutions, through which he explores the developing liquidity instrument opportunity space for Islamic banks with the help of new product innovation. AlNemer explores an important yet underexposed financial product; *takaful*, which is an insurance policy that complies with Islamic law. He presents the fundamental issues such as different models as observed in the industry, but also draw on regulative aspects of *talaful*. In shifting the attention from banks and financial issues to developmentalism, Riwajanti aims to demonstrate the potential of Islamic microfinance as an alternative tool for poverty alleviation, thus serving the developmentalist objectives of the industry, by which she presents a number of Islamic finance models in microfinance. To further shed light on the aspirational dynamics of Islamic economics and finance, Platonova explores and explains the Islamic perspectives on Corporate Social Responsibility (CSR) and social justice as an alternative to the Western constructs, in which various models are also discussed alongside rationalising CSR through the foundational dimensions of Islamic moral economy.

Market practitioners have also contributed to this special issue via their professional perspectives on the current state of affairs and what future holds for the Islamic finance industry. Ulus defines *sukuk* as a *Shari'ah* compliant fixed income product and discusses its considerable and growing presence in the global financial market. Onal provides a professional look at the liquidity issue in Islamic financial industry and institutional efforts such as International Islamic Liquidity Management Corporation for its effective management. Lastly, Dar provides valuable insight as to how Turkey can become the next global hub for Islamic banking and finance through favourable regulatory environment and education.

It is expected that the papers presented in this special issue will be of use to many stakeholders of the industry but also can help the sceptics to revisit the issues. Empirical and conceptual papers respond to market conditions and developing intellectual acumen. In other words, while it is essential that the current practice of the sector should be explored and examined, Islamic moral economy related theoretic knowledge should also be developed to inform the market practices which may deviate from its social optimality. We hope this special issue on Islamic finance can contribute to both of the aims in its way.

Reference

The Banker, various issues. *Special Issue on Islamic Finance*. London: Financial Times.