The Historical Development of Islamic Banking

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ABSTRACT

In the last few decades the increasing significance of Islamic banking has been observed. A distinctive feature of Islamic banks is the products, services and operations must comply with principles of Shariah. The purpose of this paper is to explore the roots and the development of Islamic Banking in the world by describing the main phase in the development process. The paper highlights the chronology of Islamic Banking globally and also traces the progress of Islamic Banking internationally. The finding shows the origin of Islamic finance dates back to the dawn of Islam 1,400 years ago and currently Islamic banks are expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority.

Keywords: Development, Islamic Bank.
INTRODUCTION AND OVERVIEW OF ISLAMIC BANKING

Islamic economics and financial institutions are guided by the Shariah which are founded upon the Qur’an, Sunnah, and fiqh. The Islamic financial system bans interest in all transactions. This is explicitly forbidden by Allah s.w.t which mentioned that Allah has permitted trade and forbidden usury (Al-Baqarah: 257). Thus, the payment or receipt of interest, which is the cornerstone of modern conventional banking, is explicitly prohibited in Islamic banking. Financial instruments and products that deal with interest are also prohibited. In other words, the prohibition of paying or receiving interest is the nucleus of Islamic banking and its financial instruments (Samad, Gardner, & Cook, 2005). Islamic system of finance emphasizes risk sharing which provides Islamic financial methods like murabaha, mudaraba, ijarah, musharakah, salam and istisna which guided by the Islamic principles derived from Holy Quran and the Sunnah to eventually facilitate trade and business in the society and to consequently bring economic well-being and prosperity. Whereas, the conventional economic system, emphasizes on the principles of time value and money (Ali, 2015).

Even though Islam ban on interest but it does not mean that capital is costless in an Islamic system. Islam recognizes capital as a factor of production but it does not allow the factor to make a prior or predetermined claim on the productive surplus in the form of interest. In Islam, the owner of capital can legitimately share the profits made by the entrepreneur through the profit sharing method but not predetermined rate of return. Islam does not deny that capital, as a factor of production, deserves to be rewarded. Islam allows the owners of capital a share in a surplus which is uncertain.

To put it differently, investors in the Islamic order have no right to demand a fixed rate of return. No one is entitled to any addition to the principal sum if he does not share in the risks involved. The owner of capital (rabbul-mal) may ‘invest’ by allowing an entrepreneur with ideas and expertise to use the capital for productive purposes and he may share the profits, if any, with the entrepreneur-borrower (mudarib); losses, if any, however, will be borne wholly by the rabbul-mal (Ariff, 1988). Thus, the notion of Al-ghurm bil ghurm (no risk no gain) and Al-kharaj bil daman (profit is recognized with liability) are widely applied in the Islamic banking practice especially in the contract of mudarabah and musyarakah. This is because, Islam makes a clear distinction between what is halal (lawful) and what is haram (unlawful) in pursuit of economic activities.

The objective of welfare and justice Islamic goals in its dealing with persons or institutions is considered them as partners and thus were profit is made it is shared equitably between them and were losses are incurred it is shared together. Unlike conventional banks, basic principle of operation is to maximise profit and thus, it does not seek to be welfare and justice oriented and it consider those who borrow from them not as partners but creditors. Any loss incurred is at the expense of these who received the advances from them (Ajagbe & Brimah, 2013).

In Islamic finance, some of the Shariah issues can be quite complex. Thus, forcing the Islamic institutions to seek the assistance of experts or by qualified Muslim scholar in interpreting them. As a result, it has become a common practice for Islamic banks to appoint their own board of Shariah scholars. Nevertheless, since expertise in these matters is still relatively scarce in some countries, different Islamic banks often share the same scholars. This phenomenon has the beneficial side-effect that it promotes consistency across the services and products offered by these institutions.

On the other hand, it may give rise to potential conflicts of interest, confidentiality concerns, as well as raise issues of intellectual property rights for scholars. This is why some jurisdictions (e.g., Malaysia) restrict the possibility of Shariah scholars sitting in several boards. Therefore, the first measure that an institution wishing to offer Islamic products must undertake, is to appoint a Shariah board or, at a very minimum, a Shariah counselor. This initial step is essential for the future operations.
of the institution, as it will help minimize Shariah risk, which is the risk that the terms agreed in a contract do not effectively comply with Islamic jurisprudence and thus are not valid under Islamic law (Sole, 2007).

HISTORICAL DEVELOPMENT OF ISLAMIC BANKING

It was in the 19th century that Muslims started to realize that the current system of banking and economy was based on riba that is interdicted in Islam and is categorically forbidden in all its shapes whether commercial or non-commercial; and there should be an alternate system where its operations, products and services conforms to the principles of Shariah (Ali, 2015). For that reason, the Islamic banks had emerged in the middle of 1970s. Islamic bank have undergone into three phase of development.

1. Pre Islamic Era

Before the coming of Islam, banking activities has begun in the Arab but its operation has the element of riba. Meccan of that time used the money either giving it to another party to be traded through al-Qirad or mudarabah and the profits is share by both party or lending the money to gain benefits which consider as riba (Mohammad & et, al, 2013). However, the coming of Islam has resulted in complete prohibition of all activities that involve riba, and this prohibition did not prevent the development of trade that took place either nationally or internationally (Sudin, 1996) cited in (Mohammad & et, al, 2013) and the origin of Islamic finance dates back to the dawn of Islam 1,400 years ago (Ajagbe & Brimah, 2013). Prophet Muhammad before the time of his prophet hood had applied the concept of trust. Due to his noble conducts such as honesty and integrity, the Arabs of his had appointed him as their wealth keeper (Hamoud, 1985) cited in (Mohammad & et. al, 2013).

Apart from that, during the time of the Prophet there was also a man by the name al-Zubayr al-Awwam who took the role as a bank, and kept the deposits for other people. However, this form of money keeping was modified by him to loans. Abd Allah bin Al-Zubayr, the son of Al- Zubayr narrated that when people brought their money to be kept by his father, he will tell that person that the money is being borrowed, instead of being deposited, as his father was worried that he might lose the money. Al-Zubayr’s action resulted in two main objectives; the first is by taking the deposit as loans, he has the right to use the money. Secondly, if the deposit is not used, the owner will experience loss; so if it is regarded as a loan, it is safer as the borrower is responsible in returning the money (Sudin, 1996) cited in (Mohammad & et. al, 2013; and Ajagbe & Brimah, 2013).

Other than that, there were evidences that the development of Islamic banking foundation had started since the time of the Prophet. Among these foundations was the development of Bayt al Mal, which was the central bank for Islamic countries and played a role in aiding the poor, especially the Muslims (Mohammad & et. al, 2013). Furthermore, there is clear broad structure of principles practice by Prophet Muhammad (p.b.u.h) for example contract of mudarabah between Khadijah and Prophet (p.b.u.h), musyarakah whereby Al-Sa‘ib Ibn Abi Al-Sa‘ib became a partner of the Prophet (p.b.u.h.) before his prophethood, bay‘ al-salam was practiced in the agricultural sector of Madinah during the time of the Prophet (p.b.u.h.) and benevolent loans (qard hasan) which is another form of financing were also encouraged during that time.

2. Islamic Era

The beginnings of Islamic banking, in its wider sense, date back to the early days of Islam and the rise of the Islamic Empire. The boom in the internal and external trades in the dawn of Islam led to the creation of Islamic financial tools such as deposits, money transfers, checks, bills of exchange, and so forth to cope with these commercial developments. Later, the Europeans adopted these Muslim practices and continued to evolve them until modern days. (Alharbi, 2015). In Islamic countries,
Islamic financial practices withered gradually due to the weakening of the Islamic empire, until these practices were replaced by the Western financial model in the early 16th century. However, Islamic financial practices emerged again in the middle of 19th century.

3. Modern Islamic Era
The late 19th and early 20th century is widely known as the beginning of the era of Islamic resurgence. Some of those responsible for this resurgence are Muhammad Abduh (1849), Rashid Reda (1865), Muhammad Iqbal (1975), Abul Aala Maudud (1937), Hasan AlBanna (1939), Hifz Al-Rahman (1942), Muhammad Hamidullah (1944), Anwar Qureshi (1946), Naiem Siddiqi (1948), Mohammad Yousuf Al-Dean (1950) and Muhammad Uzair (1955). Their thoughts became the impetus for Muslims to apply Islamic teachings in all aspects of life including political, social and economic. Since Islam prohibits riba, it is obvious that elimination of riba from the economic and banking system became the most popular topic among contemporary Islamic scholars.

The first attempt at Islamic banking system can be seen in Malaysia in the mid 1940s and Pakistan in the late 1950s (Perry & Rehman, 2011; and Ajagbe & Brimah, 2013). The objective of this institution setup by Malaysia was to invest prospective pilgrim savings in the real estate and plantations in accordance with Shariah but it was unsuccessful. While, Pakistan establishment of Local Islamic Bank in the rural area. During that time, the owners of the land who were obedient to the Islamic teachings deposited their money to the bank, which was later loaned to other land owners for the purpose of agriculture development. The borrowers during that time were not charged for lateness in paying back their loans, other than a small amount for the purpose of bank operation. However, the operation of the bank was met with failure due to a number of factors such as the increase in the number of borrowers compared to the money being kept there, which resulted in vast difference between available capital and credit demanded, as well as the problem of the bank employees not having autonomous power on the bank operation. This was because the depositors of that time were hoping to get more benefits as a return for the money that they lent out (CIFP, 2006) cited in (Mohammad & et. al, 2013)

The second attempt was through setting of banking basic principle and Islamic finance that are to be practiced. The endeavor took place in Egypt from 1963 until 1967 through the establishment of Mit Ghamr Savings Bank in the town of Mit Ghamr led by Ahmad El Najjar, in the area of the Nile River Delta, which is 40 kilometers from Cairo (Ready, 1967) cited in (Mohammad & et. al, 2013). Its functioned essentially as saving- investment institutions rather than as commercial banks (Ariff, 1988). Although the services are considered basic banking services, it was nevertheless sufficient to meet the banking needs of the surrounding community. However, the existence of the bank was short-lived. The whole operation of Mit Ghamr Bank was taken over by the National Bank of Egypt and Egypt Central Bank in mid-1967, which changed the whole bank operation to the riba system. (Mohammad & et. al, 2013). But, the establishment of Mit Ghamr Saving Bank marked a new milestone in the revolution of the modern Islamic banking system. This bank was considered to be the most innovative and successful experiment with interest-free banking.

At the same time, Malaysia also take an initiative by establishing the Muslim Pilgrim,s Saving Corporation Malaysia in 1963. Muslim Pilgrims Savings Corporation set up in 1963 to help people save for performing hajj (pilgrimage to Mecca and Medina). In 1969, this body evolved into the Pilgrims Management and Fund Board or the Tabung Haji as it is now popularly known. The Tabung Haji has been acting as a finance company that invests the savings of would-be pilgrims in accordance with Shariah, but its role is rather limited, as it is a non-bank financial institution.
After Mit Ghamr converted into conventional system, the Nasir Social Bank was established in Egypt in 1971 and declared as an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Ariff, 1988; and Kamal, Lokesh & Bala, 2008). In 1974, the finance ministers of all Islamic countries held a convention on the establishment of the Islamic Development Bank (IDB). IDB was considered to be the first international Islamic bank that was established with the founding member of 22 Islamic countries. The bank’s principal office was located in Jeddah, Saudi Arabia and has two regional offices in Rabat, Morocco and Kuala Lumpur, Malaysia. The purpose of the bank is to foster the economic development and social progress of member countries (OIC) and Muslim communities individually as well as jointly in accordance with the principles of shariah. This was a landmark in the history of Islamic banking (Ali, 2015).

The establishment of IDB 1974 paved the way for the establishment of other Islamic banks in various Muslim countries. Throughout the 1970’s, a number of Islamic banks were founded, mostly in the Arab Middle East. Immediately after the establishment of IDB in 1974, the Dubai Islamic Bank was incorporated. In the year 1977, three more Islamic Banks commenced business for example Faisal Islamic Bank of Egypt, Faisal Islamic Bank of Sudan, Kuwait Finance House and Bahrain Islamic Bank in year 1979 (Perry & Rehman, 2011). While throughout the 1980’s, several Islamic Institutions has established for example Qatar Islamic bank, Islamic bank Bangladesh limited, Bank Islam Malaysia Berhad, Al-Baraka Islamic Bank of Bahrain, ANZ Global Islamic Finance of UK and among others. Some countries including Pakistan, Iran, Sudan, Malaysia and Bahrain initiated efforts to implement Islamic banking at larger scales in their respective countries during 1980s. In the next decade some of the conventional banks also introduced Islamic banking products and services by operating separate Islamic banking units and divisions (Ali, 2015).

In the case of Malaysia, the success of the Tabung Haji provided the main impetus for establishing Bank Islam Malaysia Berhad (BIMB) which represents a full-fledged Islamic commercial bank in Malaysia. The Tabung Haji also contributed 12.5 per cent of BIMB’s initial capital of M$80 million. BIMB has a complement of fourteen branches in several parts of the country. At the same time, some countries attempted to establish full Islamic banking systems and disconnect themselves from the traditional Western style financial system. Iran, for example, changed over to Islamic banking in August 1983, when they commenced a three-year transition period (Perry & Rehman, 2011) and Sudan also shown the whole implementation of Islamic banking system. While some countries practice dual baking system whereby the conventional banking system operating in parallel with the Islamic banking system for example Bangladesh, Bahrain, Malaysia and Pakistan.

CONCLUSION
As a conclusion, modern Islamic banks have undergone three stages of development. It’s starting with the argument regarding the practice of riba in the conventional banks in the early 1900s. During that time, a lot of studies and writings on the interest free banking. Next, the emergence and establishment of Islamic banks begin in 1940s. This stage involved tremendous development at both the intellectual and implementation levels. The early banks became pillars for the continued development of the Islamic financial system. During the year of 1970s, there are a lot of developments of Islamic banks around the world and until now Islamic banks had shown a very positive growth.

Islamic banking is steadily moving into an increasing number of conventional financial systems. It is expanding not only in nations with majority Muslim populations, but also in other countries where Muslims are a minority, such as the United Kingdom or Japan. Similarly, countries like India, the Kyrgyz Republic, and Syria have recently granted, or are considering granting, licenses for Islamic banking activities (Sole, 2007)
References:


