

ISLAMIC BANKING: ANALYSIS ON EMERGENCE, GROWTH AND PRINCIPLES

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Submitted September 26, 2024; Revised December 19, 2024; Accepted December 25, 2024; Published March 20, 2025

ABSTRACT

Islamic finance is experiencing significant growth in international finance, particularly in a few key countries. Its endurance and widespread appeal are demonstrated by its recent over 20 percent annual growth, which is primarily attributable to the ownership, participation, and equity principles that regulate Islamic financial activity. Theoretically, Islamic banking can withstand economic shocks because it limits excessive risk-taking, promotes risk-sharing, and keeps a close relationship with actual economic activity. While these banks encounter similar risks to those faced by conventional banks, they are also subject to unique, idiosyncratic risks that require tailored risk management practices. The rapid expansion of Islamic finance has significant macroeconomic policy implications that warrant careful consideration.

Keywords: Islamic Banking, Emergence, Growth, Principles.

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INTRODUCTION

A banking system that conforms to the rules set forth by Islamic Shariah and is in line with the spirit, ethos, and value system of Islam is known as Islamic banking. A particular range of interest-free financial services and products is referred to as "interest-free banking". The more inclusive term "Islamic banking" describes strategies based on abstaining from interest-based transactions that are prohibited by Islamic Shariah in addition to immoral and antisocial conduct. In practice, Islamic banking is just the conversion of loans made with traditional money into exchanges for real services and physical assets. The Islamic banking paradigm makes it easier to create a system that fosters economic growth [1-3].

The primary goal of Islamic banking is to engage in interest-free activities based on Shariah principles and to conduct only Halal (permissible) transactions. It emphasizes the long-term advantages of Islamic banking and presents it as an interest-free alternative to traditional banking. Islamic banking is appealing because it fosters cooperation and mutually beneficial behavior among various stakeholders, contributing to a welfare-oriented society [4, 5]. A fundamental aspect of Islamic banking involves the distribution of risk among lenders, investors, and debtors. It emphasizes fairness and freedom within a system that is centrally guided yet individually managed in accordance with the directives of Allah Almighty. The three main

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characteristics of Islamic banking are objectivity, risk sharing, and no interest. These characteristics set it apart from traditional banking.

EMERGENCE

The field of Islamic finance is growing in the context of global finance. Islamic banking started out as experimental projects in Egypt in the early 1960s before taking on its current form. Muslim investors' funds were mobilized by the Mit-Ghamr Islamic Saving Associations (MGISA), which provided returns in line with Shariah regulations. The MGISA grew quickly, with deposits rising at a pace of more than 100% annually in its first three years of operation [6]. In order to pay for their Hajj pilgrimage, Muslims in Malaysia were then able to gradually save and invest in financial instruments that complied with Shariah thanks to the Pilgrims Fund Corporation (PFC). By 2012, the PFC boasted over \$12 billion in deposits and eight million account customers.

Formally, Islamic banking started in the late 1970s with few institutions and little assets. However, in the last 20 years, it has grown dramatically, with total assets reaching around \$2 trillion by the end of 2014. After the first significant Islamic commercial bank, the Dubai Islamic Bank, was established in the United Arab Emirates, the foundation of the Islamic Development Bank (IsDB) in 1975 represented a turning point for Islamic banking. The success of the Dubai Islamic Bank led to the formation of several similar institutions, including Faisal Islamic Bank in Sudan and Kuwait Finance House in Kuwait, both founded in 1977 [7].

Serious initiatives to put Pakistan's banking industry under Shariah conformity began in the late 1970s. The legal framework was altered in 1980 to permit the establishment of Shariah-compliant profit-sharing companies and the initiation of bank financing through the use of Islamic instruments. In a similar vein, Iran enacted new banking laws in

August 1983 that allowed banks to convert from interest-bearing to interest-free accounts while also providing them with a three-year grace period to comply with Islamic law. Sudan began working to align the financial industry as a whole with Shariah regulations in 1984.

The regulatory and standards-setting bodies that make up the financial infrastructure are changing quickly to match the explosive rise of Islamic finance. International standard-setting bodies have been set up to direct the industry's activities on a worldwide scale; yet, standardizing Islamic products between nations still presents a difficulty. Accounting, auditing, and Shari'ah standards for financial reporting inside Islamic financial institutions have been issued since 1991 by the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). The Islamic Financial Services Board (IFSB), which was founded in Malaysia in 2002, is in charge of developing regulatory and supervisory standards and guidelines and encouraging the implementation of them by the appropriate regulatory bodies [8, 9].

In 2001, Bahrain's International Islamic Financial Market (IIFM) was tasked with developing rules for the issue of Islamic financial instruments and encouraging active secondary market trade.

More recently, in 2010, the Malaysia-based International Islamic Liquidity Management Corporation (IILM) began issuing Shari'ah-compliant short-term financial instruments to facilitate cross-border Islamic liquidity management. This article aims to provide a general overview of the main policy issues and challenges that policymakers and practitioners must deal with.

KEY COMPONENTS OF ISLAMIC BANKING AND FINANCE

The cornerstones of Islamic banking and economics are unchangeable precepts drawn from the Shari'ah legal system. Unlike legal systems that focus solely on secular aspects

of life, Shari'ah jurisprudence integrates religious and secular dimensions, encompassing transactions in the political, economic, and social spheres (muamalat).

It is required in Islamic economics to engage in useful human activity. Islam does not support all human desires; it forbids, among other things, the manufacture of weapons and other harmful devices, alcohol, pork products, tobacco and other drug use, gambling (maysir), speculation, and pornography [10].

THREE PRINCIPLES GOVERN ISLAMIC FINANCE

Principle of equity: This idea is frequently used by academics to support the ban on prearranged payments (riba), which is intended to defend the weaker party in financial transactions.

Principle of Participation: The ban on riba, sometimes known as interest-free finance, does not imply that capital should not be rewarded. According to a fundamental principle of Shari'ah, "reward (i.e., profit) comes with risk-taking." Thus, it is imperative that investment profits are obtained by taking calculated risks, as opposed to earning them gradually, which emphasizes the ban on riba.

Principle of Ownership: Prior to transactions, asset ownership is required under the concepts of "you cannot be dispossessed of property except based on right" and "do not sell what you do not own" (such as in short-selling). Because of this, Islamic finance is frequently described as asset-based financing, creating a close relationship between the actual economy and finance [11].

DIFFERENCES BETWEEN CONVENTIONAL & ISLAMIC FINANCE

1. Exclusive financing for Halal enterprises
2. Equity-based financing: Under a partnership, profit and loss sharing

3. Asset-based Financing: Purchasing and selling products and services
4. Steer clear of Maisir, Qimar, and Gharar [uncertainty]

5. Interest-free transactions

6. No risk-free return on deposits

7. To purchase shares, an investor must adhere to Shari'ah.

8. Profit and loss sharing asset-based Sukuk

9. Using a rental agreement to lease

10. Home financing combines partnering and leasing [12-13].

CHALLENGES FOR ISLAMIC FINANCE

1. Utilizing IBOR as a benchmark for profit.

2. Applying par value when selling shares of IFI in house financing.

3. Employing par value for the purchase of Sukuk at the time of redemption.

4. Implementing a financial penalty in the event of customer default.

5. Relying on an independent party to guarantee capital for Sukuk.

6. Using time-value-based software to calculate installments.

7. Minimal application of profit and loss sharing, Salam, and Istisna'a financing modes.

8. Lack of cash financing for day-to-day operations, except through Musharakah [14].

MECHANISM OF A MURABAHA FINANCE TRANSACTION

A customer identifies specific goods they need and promises to purchase these goods from the Islamic bank, provided that the bank buys them from the supplier and takes possession.

The Islamic bank then purchases the goods from the supplier, making an immediate payment, and takes possession of the goods (either physically or constructively).

After acquiring the goods, the Islamic bank sells them to the customer, adding a profit markup, typically on a deferred payment basis for a mutually agreed period.

The customer makes the deferred payment to the Islamic bank either during or after the agreed period [15].

APPLICATIONS OF MURABAHA CONTRACT IN ISLAMIC FINANCE

One of the contracts that is currently most frequently used in Islamic banking and the investing industry is murabaha.

The different items that use murabaha include the following: Credit card; Islamic fund; profit rate swaps; home financing; auto financing; working capital financing; project financing; goods financing; trade financing (LC based on Murabaha); Sukuk based on Murabaha; credit card [16]

DISADVANTAGES OF ISLAMIC BANKING AND FINANCE

Despite the many advantages of Islamic banking and finance, there are also several disadvantages to consider.

Limited Range of Products

As a relatively younger industry, Islamic banking does not offer as wide a variety of financial products as conventional banking. For example, options for long-term financing or retirement plans are fewer, which may limit choices for some customers.

Complexity in Operations

Islamic banking practices are frequently more complicated than those of traditional banking due to the delicate nature of adhering to Sharia law. Islamic banks are required by Sharia law to carry out a number of activities, such as leasing or buying and reselling, rather than lending money and collecting interest.

Higher Costs

In some cases, the costs associated with Islamic banking services can exceed those of conventional banking. This is often due to the additional overhead required to ensure products are Sharia-compliant, including expenses related to advisory boards of Islamic scholars who verify compliance.

Uncertainty and Ambiguity

Islamic banking contracts can involve

uncertainty, as they are based on tangible assets. For instance, if a business venture funded by a Mudaraba contract fails, the customer risks losing their entire investment.

Lack of Standardization

Islamic banking and finance currently lack a unified global standard, which can lead to inconsistencies in practices and products. A financial product deemed Sharia-compliant in one country may be viewed differently in another, creating confusion for customers and potentially hindering the growth of the Islamic finance industry on a global scale [17].

ADVANTAGES OF ISLAMIC BANKING AND FINANCE

Let's explore the significant advantages and exceptional benefits of Islamic banking and finance.

Promotes Financial Justice

Financial justice is the core principle of Islamic finance. Unlike conventional banking, where the burden of profit or loss typically falls solely on the entrepreneur, Islamic banking strives for a balance between the lender and the beneficiary. When a project is financed by an Islamic bank, the resulting profits and losses are shared equally. If a financier expects to earn profits, they must also be prepared to share in any potential losses.

Financial Inclusion

Because traditional banking systems rely on interest-based transactions, which are categorically forbidden by Shariah law, many Muslims steer clear of them. The result is that around 75% of Muslims worldwide do not have a bank account. This problem is addressed by Islamic banking, which lowers obstacles so that Muslims can utilize and profit from the financial system.

Reduces the Impact of Harmful Products and Practices

Regardless of their legality in a given nation, Islamic banking forbids the use of products

and services that are prohibited in Islam, such as alcohol, tobacco, gambling, and pornography.

Strengthens Financial Stability

Islamic finance emphasizes cautious investment and thorough decision-making, in contrast to conventional banking practices. Financial institutions typically avoid companies deemed risky. This cautious approach is why Islamic financial institutions were largely unaffected during the 2008 global financial crisis and the Covid-19 pandemic. By implementing careful audits and analyses, Islamic finance reduces risk and enhances financial stability.

Moral Values

The emphasis on moral values is a significant advantage of Islamic banking and finance. These values promote socially responsible investments and foster better relationships and behaviors among individuals and corporations.

Ethical Investments

Islamic banks invest exclusively in ethical sectors, avoiding industries such as alcohol, gambling, and pork products. This commitment to ethical responsibility ensures that investments contribute positively to society. For example, funds might be allocated to sustainable energy initiatives or healthcare advancements.

Risk-Sharing

A key principle of Islamic finance is risk-sharing, differing from conventional finance, which typically places the risk on one party. Both lender and borrower share the risks associated with investments, creating a more equitable system. For instance, if a business funded by an Islamic bank fails, the resulting loss is distributed between the bank and the client.

Prohibition of Interest

Interest (Riba) is not allowed to be charged or paid in Islamic banking since it is viewed as exploitative. For example, in Islamic house finance, the client and the bank jointly buy a

property, with the client eventually owning the bank's portion.

Asset-Backed Financing

In Islamic banking, every financial transaction needs to be backed by a material good or service. By prohibiting speculative transactions that lead to debt accumulation, this rule lowers the likelihood of financial crises.

Economic Stability

Through its principles of risk-sharing and asset-backed financing, Islamic banking fosters greater economic stability. It discourages reckless speculation and encourages sustainable growth.

Transparency

Islamic banking systems emphasize transparency and mutual consent, ensuring that all parties clearly understand the terms of the contract. This transparency protects clients' rights and fosters trust in the financial sector.

Support for Entrepreneurship

Islamic banking promotes entrepreneurship by providing profit-sharing investment opportunities, such as Musharakah. This approach allows startups and small businesses to secure funding without the burden of interest-based repayments.

Religious Comfort

By offering a banking system that aligns with Islamic law, Islamic banking provides financial services to individuals who avoid conventional banking due to religious beliefs.

Buying Assets in Installments

A key benefit of Islamic banking is its unique products, such as Ijarah (leasing), which offer protection against inflation. Under an Ijarah contract, the cost of assets is paid in instalments as rent.

Welfare

Islamic banking endeavours to promote welfare and alleviate poverty. The administrative costs incurred by Islamic banks, such as those from late payments, are

donated to charity, contributing to societal well-being and wealth redistribution [19].

CONCLUSIONS

The 21st century has brought a blend of threats and opportunities with the rise of Islamic banking practices worldwide. Islamic finance is guided by three main principles: ownership, participation, and equity. According to these tenets, an Islamic financial system is essentially asset-based since it restricts financing to trade, productive endeavours, and actual assets. When completely followed, these guidelines

encourage suitable leverage and aid in reducing conjecture and moral hazard.

Author(s) Contribution: data collection, A. Maryam; review, F. Noor; formatting, M. Warisha.

Funding: This research did not receive any specific grant from funding agencies in the public, commercial, or not-for-profit sectors.

Ethical Approval: Not applicable

Conflict of Interest: The author(s) declared no potential conflict of interest.

Consent for Publication: All authors approved the manuscript for publication.

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