Chapter 1

Islamic Banking in GCC: Emergence, Growth, and Prospects

Eda Orhun
https://orcid.org/0000-0001-7153-4892
Zayed University, UAE

ABSTRACT

This chapter offers a literature review discussing the origin, history, and the growth of Islamic Banking, especially in the GCC countries. It provides detailed information regarding how Islamic Banking evolved throughout the years and what are the current Islamic financial products. Another interesting topic covered in this literature review is the performance comparison of Islamic and conventional banks during different time periods. Accordingly, the chapter explores how the financial standing of Islamic banks altered in comparison to conventional banks before and after the financial crisis of 2008 by presenting earlier studies from various countries. It is concluded that some potential challenges and future opportunities of the Islamic Banking are yet to be explored.

1. HISTORY OF ISLAMIC BANKING

In the history of Islamic civilization, the notion of partnership and profit-sharing had been always more prominent than interest-based borrowing and lending since Riba (interest) is considered as ‘Haram’ (prohibited) according to the Islamic principles. However, these Islamic economic principles were forgotten after the rapid rise of the western model of financial intermediation and commercial banking in the post-industrial revolution era. Since the 1850s, almost all Muslim countries accepted laws and legal structures rooted from Western models since they were under direct or indirect pressure from the European countries. After the end of colonial period, although the foreign banks are nationalized in these Muslim countries, they were still run by following the Western style in a ‘neo-colonial’ system. But especially in rural and religious regions of the Islamic world, the people were skeptical towards these western financial institutions. In this respect, there was a strong need for the formation of a financial institution that watches over the Islamic principles or in other words that is interest-free. The first pioneering
initiative for the enlargement of Islamic finance and banking happened in Mit-Ghamr in Egypt. Getting inspired from the German savings banks, the Mit-Ghamr Islamic Savings Bank founded by El-Naggar who eventually took the role as the Secretary-General of the International Association of Islamic Banks in the succeeding years. The Mit-Ghamr project collected savings from the rural sector through savings, investments and Zakat accounts. Interest was not given to customers in the saving accounts, but they were authorized to withdraw their deposits when they need. Participants were also qualified to obtain small, short-term interest-free loans for fruitful motives. The money placed in the investment accounts could be withdrawn on a limited basis and were invested based on profit-sharing (Chachi, 2005). Wilson (1983) reported that: “The bank’s loans were used for different motives such as house building and repairs … Some loans were used to fund the acquisition of farm animals and fundamental upgrade to the irrigation systems as efficient water provision was absolutely necessary for a society rested solely on cultivation”. (Chachi, 2005; Molyneux & Iqbal, 2005) The Mit-Ghamr project that started in 1963 and continued until 1966 gained a big success in these short three years. In three years, the savings deposits increased from 25,000 Egyptian pounds to 125,000 Egyptian pounds. In a similar fashion, investment deposits more than doubled from 35,000 to 75,000 Egyptian pounds. The Mit-Ghamr project also had a zero-default rate by following a stricter and wiser loan lending policy. Despite its success, the Mit-Ghamr project was canceled due to political reasons in the following years. It is said today that this bank would have covered the whole Egypt by now due to its extreme success in its short life period if it was not canceled by the Egyptian authorities. Its extreme success created conflict with the local social authorities because they thought that Mit-Ghamr Islamic Savings Bank started to interfere with their own power. (Chachi, 2005) However, it proved that a financial institution governed by the Islamic principles was longed for and had a strong potential to be successful. After the abolishment of the Mit-Ghamr project, the first interest-free financial institution with the official title of ‘bank’ that is Nasser Social bank was founded again in Egypt in 1971. (Abedifar et al., 2015)

After observing the success of the Mit-Ghamr project and the government involvement in the establishment of interest-free Nasser Social bank, Muslim businessman who had surplus funds took initiatives to start an Islamic bank in their Muslim countries. Accordingly, the first so-called Islamic bank-Dubai Islamic Bank- got opened in Dubai, UAE in the year of 1975. With the start-up of the Dubai Islamic Bank, worldwide and official Islamic banking practice had started. The seeds of Dubai Islamic bank had been first planted during the First International Conference on Islamic Economics that took place in Saudi Arabia at the beginning of 1970s. The opening of the Dubai Islamic Bank was an important milestone as it was the first role model that other GGC countries would follow in the future. In this respect, the UAE authorities’ supportive attitude was very important and had led to a new era in the banking industry. Recently, UAE is the third-largest Islamic banking market by value and deposits held by Islamic banks and as of 2018 this value amounted to AED 392.4 billion with a yearly growth rate of 5%. (World Bank Group, 2018; Sophia, 2015) Following UAE; Kuwait, Bahrain, and Qatar passed legislations to found Islamic banks in 1977, 1979 and 1982 respectively. (Molyneux & Iqbal, 2005; Abdul Alim, 2014)

Despite these developments and its hosting of the First International Conference on Islamic Economics, Kingdom of Saudi Arabia had a skeptical attitude towards Islamic Banking for a very long time. Although Saudi Arabia was very supportive of the international Islamic finance inventiveness and especially the founding of Islamic Development Bank by taking the support of other 56 shareholding member countries, it was reluctant to adopt a national-wide Islamic Banking system that is fully Shari’ah-compliant (Wilson, 2009). Following a similar mindset, the authorities had kept the approval of the banking license of Al Rajhi Bank on hold for years until 1987. Before this time, several Al Rajhi