



developments that matter in financial markets

Islamic Banking: Scope and Spread

"Islamic finance is poised to play a bigger and more central role in global finance."
Lim Hng Kiang, Minister for Trade and Industry, Singapore

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Introduction

Islamic banking practice started on a modest scale in 1963 in Mit Ghamr, Egypt, and has shown tremendous progress during the last 40 years. A large number of Islamic banks were established during this period in different regions under different economic and social milieu. Today, there are more than 430 Islamic banks and financial institutions spread across 75-plus countries and about 191 conventional banks have Islamic windows. Islamic banking, which is currently concentrated in the Middle East, North Africa, and South-East Asia, is spreading its wings to sub-Saharan Africa, Central Asia, and western Europe. More than 70 percent of the Islamic banks are in the Middle East, 14 percent in South-East Asia, and 15 percent in sub-Saharan Africa. Assets held by Islamic banks or through Islamic banking windows of conventional banks rose by 28.6 percent to \$822 billion in 2009 from \$639 billion in 2008, according to a survey of Top 500 Islamic Financial Institutions by *The Banker* in July 2010.

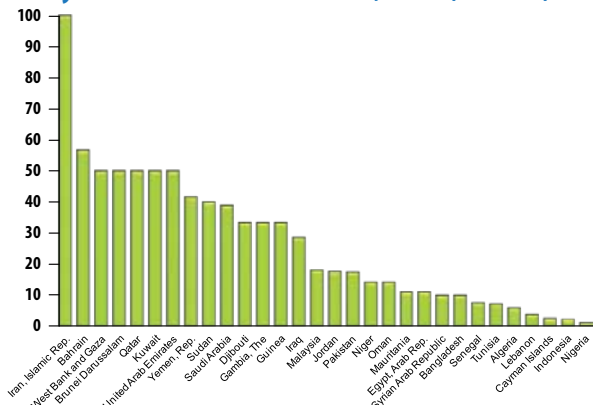
Islamic Banking vs. Conventional Banking

Islamic banking refers to a system of banking that is consistent with Islamic law (Shariah), which prohibits collection and payment of interest (*riba*). However, in Shariah, there are many ways to share profit or returns between a bank and its customers. For example, in a deposit product, profits from a deposit arrangement will be shared between a bank and its depositors based on an agreed ratio and paid as dividends. Islamic banking also avoids activities such as speculation and investing in businesses that are taboo under Shariah.

Governance Structure

Islamic banking services are offered through three types of governance structures: full-fledged Islamic banks, Islamic banking windows of conventional banks, and Islamic banking subsidiaries of conventional banks.

Figure 1: Share of Islamic Banks in Total Banking System in Selected Countries, 2006 (Percent)



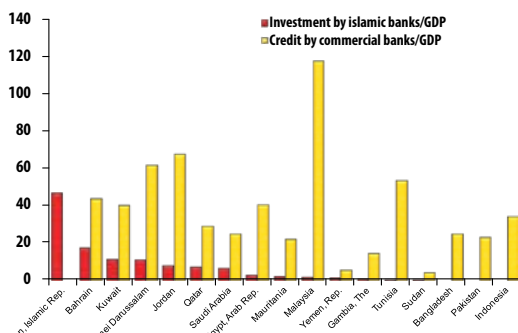
Source: IMF working paper, WP/10/195, August 2010

Figure 1 shows the percentage of Islamic banks in the total banking system of countries that follow Islamic banking as well as conventional banking.

Performance of Islamic Banks vs. Conventional banks

Islamic banks have proved to be a viable and efficient way of financial intermediation in the Middle East. According to a recent IMF study, the probability for Islamic banking to develop in a given country rises with the share of Muslim population, per capita income, and the country's net export of oil. The distance to the two main Islamic financial centres, Bahrain and Malaysia, does matter for the diffusion of Islamic banks across countries. Islamic banks diffuse faster when a country is closer to one of the above two centres. If the importance of Islamic banks in the economy by assets is measured, in almost all countries having Islamic banks, except Iran, the ratio of credit of conventional banks to GDP is substantially higher than the investment to GDP ratio of Islamic banks, which accounts for less than 20 percent of GDP in most countries, as shown in Figure 2.

Figure 2: Comparing Investment by Islamic Banks with Credit by Conventional Banks in Selected Countries (average 1992-2006, percent of GDP)



Source: IMF working paper, WP/10/195, August 2010

Western financial markets such as London have evolved regulatory guidelines on Islamic banking products and services. India with sizeable Muslim population offers enormous opportunities for growth in this segment. In 2008, a Planning Commission panel on financial sector reforms headed by Dr Raghuram Rajan recommended introduction of interest-free banking. The committee opined that the non-availability of interest-free banking results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of savings from other countries in the region.

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