



**AN EMPIRICAL ANALYSIS OF
ISLAMIC BANKING DIVISION
PROFITABILITY PERFORMANCE**

BY

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ABSTRACT

In this paper an attempt is made to evaluate the profitability performance of Islamic banking business between 1996 to 1999, with specific reference to Islamic Banking Division (IBD). In doing so, the financial ratio approach has been adopted to reflect the managerial efficiency of the Islamic banking firms. In this study seven financial ratios were computed to measure Islamic banking performance, namely the return on equity, return on asset, return on deposits, profit margin, asset utilization, net operating margin and operating expenses ratio. This study shall consist of two parts. First, it looks at the profitability performance of IBD of selected financial institutions providing Islamic products in the conventional banks. Secondly, the study evaluates the impact of the Asian financial crisis on the Islamic banking performance, IBD in specific.

Among others, the study discovered that IBD has performed relatively better than conventional banks (CB) on giving return to its shareholders and depositors. This may be caused by IBDs utilizing conventional banking operation overhead and their smaller default payment leading to lower costs thus contributing to a higher earning percentage for IBD. In portfolio management however, IBD is less efficient compared with the CB as shown by a lower asset utilization and investment margin ratios.

During the 1997-1998 economic downturn, both the financial institutions were severely affected by the crisis but the impact is more intense on the CB industry due to its high level of bad loans. On the performance of IBD during an upswing event of interest rate, the performance of IBD showed a decline in its investment margin, indicating its weakness in generating commendable profits during this period. This may be caused by the high dependence on the fixed-rate financing mechanism such as *al-bai-bithaman ajil* by the IBDs, whilst its deposits are in essence, are mostly variable rate liabilities.

ملخص البحث

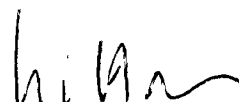
لقد حاول الباحث خلال هذه الدراسة المتواضعة تقييم أداء ومردودية مشاريع البنوك الإسلامية خلال الفترة الممتدة بين ١٩٩٦ و ١٩٩٩، مع الإشارة بأنه تم الاعتماد بصورة خاصة على قطاع الصيرفة الإسلامية بماليزيا (IBD). ولاستقاء عناصر الموضوع، فقد ارتأى الباحث استعمال طريقة النسب المالية من أجل تحديد مدى الفعالية التسييرية لمؤسسات المصارف الإسلامية. لقد اعتمدت هذه الدراسة ٧ مؤشرات للتحليل المالي (نسب مالية) وذلك بغية قياس أداء وفعالية النشاط المصرفي الإسلامي. هذه النسب يمكن إنجازها فيما يلي: نسبة المساهمة، عائد الموجودات (الأصول المصرفية)، عائد الودائع، الهامش الاستثماري، نسبة استعمال الموجودات، الهامش الربحي العامل، ونسبة النفقات العاملة. كما أن هذه الدراسة تنقسم إلى قسمين: قسم يعنى بمردودية (الربحية) وأداء قطاع الصيرفة الإسلامية (IBD) عبر مجموعة مختارة من المؤسسات المالية التي تشمل نشاطها بعض معاملات الصيرفة الإسلامية. أما القسم الثاني فيتناول تقييم حجم الأثر الذي خلفته الأزمة المالية الآسيوية الأخيرة على مستوى مردودية ونشاط البنوك الإسلامية، وبالأخص (IBD).

لقد توصل الباحث إلى نتائج مهمة: من بينها إبراز أفضلية قطاع الصيرفة الإسلامية (IBD) مقارنة نظيرتها من البنوك التقليدية (CB) لسيما فيما يتعلق بحجم الفوائد الموزعة على المساهمين والمودعين. ويرجع ذلك إلى كون عمليات الإخلال أو التخلف عن الدفع تبقى محدودة لدى مجموعة (IBD) وهذا بدوره يعمل على تخفيض عنصر التكلفة ومن ثم رفع نسبة المداخل للمساهمين في هذه الأخيرة. لكن فيما يخص تسيير المحافظ المالية، فإن البنوك التقليدية (CB) تبدو أكثر فعالية من البنوك الإسلامية (IBD)، وهذا ما تحلّيه بوضوح سببي استعمال الموجودات، والهامش الاستثماري، حيث أن قيمتها كانت أصغر في (CB) منها في (IBD).

في أعقاب الأزمة المالية الحادة التي شهدتها المنطقة خلال الفترة ١٩٩٧—١٩٩٨ تضرر كثير من مؤسسات القطاع المالي بماليزيا بما في ذلك (CB) و (IBD)، لكن البنوك التقليدية (CB) كانت الأكثر تصررا وذلك لارتفاع نسبة الديون المدومة بميزانيتها. مع ارتفاع محسوس في سعر الفائدة تدنى مستوى أداء السوك الإسلامية وذلك من خلال انخفاض نسبة الهامش الاستثماري ها، والذي يعكس طبيعته ضعف ومحدودية هذه البنوك في إمكانية إدراج عوائد ربحية منتظمة خلال هذه الفترة. ولعل هذا الأخير ناتج عن كون المصارف الإسلامية ترتبط بصورة كثيرة على الأساليب التمويلية الثابتة كالبائع شمس آحل، في حين أن ودائعها في حقيقة الأمر عبارة عن مستحقات مالية متغيرة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Economics



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This research was submitted to the Department of Economics and is accepted as partial fulfillment of the requirements for the degree of Master of Economics



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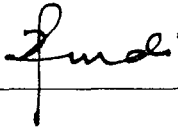


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DECLARATION

I hereby declare that this research is a result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

MOHD AFANDI BIN ABU BAKAR



9th JULY 2001

*This work is dedicated to my beloved wife, Hajjah Amanah bt Hj. Hadith,
and my lovely sons, Muhammad Amirulfathi and Muhammad Sallehuddin
for their encouragement, support, and love.
May the divine guidance and happiness in this world and the next.*

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LIST OF ABBREVIATIONS

AU	Asset Utilization
BBA	al Bay' Bithaman Ajil
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
CB	Conventional Bank / Interest Based Bank
IB	Islamic Banking
IBD	Islamic Banking Division
IBDCB	Islamic Banking Division of Commercial Bank
IBDFC	Islamic Banking Division of Finance Company
IM	Investment Margin for Islamic Bank Interest Margin for Conventional Bank
LR	Loan Recovery Ratio
NOM	Net Operating Margin
OER	Operating Expenses Ratio
PM	Profit Margin
PMFB	Pilgrims Management Fund Board (Lembaga Urusan Tabung Haji)
ROA	Return on Asset
ROD	Return on Deposit
ROE	Return on Equity
SAW	Solallahhu`alaihiwasallam (Peace Be Upon Him)
SWT	Subhanahu Wa Ta'ala (Praise be to Allah and the Most High)

CHAPTER 1

INTRODUCTION

1.0 Problem Statement

The introduction of the Interest-Free Banking Scheme (IFBS) on March 4, 1993 marked the second phase of Islamic banking in Malaysia. Prior to that, BIMB has dominated the Islamic banking business for almost a decade. By the end of 1993, a total of 21 financial institutions had participated in the Interest Free Banking Scheme (IFBS). Seven years later, almost all conventional financial institutions have some basic Islamic banking facilities. By using existing banking branches and therefore readily expanding Islamic services, the system was able to reduce the marketing problem of providing interest free facilities. The significance of this event is that Islamic banking operations are open to competition. To increase market size, new interest-free products were introduced. This event has provided more depth to the Islamic banking operations in Malaysia and will keep the participating banks on guard to improve performance.

Although the word 'Interest Free Banking' and 'Islamic Banking' are often used interchangeably, there is a basic difference between the two concepts. Ziauddin Ahmad (1984) defined Interest Free Banking as a mechanical concept, denoting a mode of banking practices which steers clear of interest, while Islamic Banking is essentially a normative concept and could be defined as a conduct of banking in consonance with the ethos of the value system of Islam ¹

¹ Dr Ziauddin Ahmad, "Concept and Models of Islamic Banking an Assessment", A paper presented at the Seminar on Islamization of Banking, Karachi, on 27 – 29 November 1984, p 1

In this research, Islamic banking will refer to the banking system as defined by the Islamic Banking Act 1983 and observed by BIMB while the Interest Free Banking System is governed by the Banking and Financial Institution Act 1992 (amended). This is in conjunction with Bank Negara Malaysia's directive, that, as of 1st December 1998, all Interest Free Banking Scheme will be named Islamic Banking Division (IBD). Although an identical banking law does not govern both institutions, the underlying Shariah principles on which these banks operate remain the same.

1.1 Scope of Study

The fundamental objective of a firm is to maximize shareholders' wealth. Wealth maximization requires the management to evaluate and balance the trade-off between opportunity for higher returns, the probability of not realizing these expected returns and the possibility that the business might fail. It has a lot to do with the observance of the principles of profitability, safety and liquidity in the banking business, with special focus given to the principle of profitability. With these objectives in mind, this research will attempt to evaluate and compare the profitability performances of IBD in a given period.

In evaluating the performances of the Malaysian Islamic banking operations in Malaysia, it is worthy to note that the Malaysian financial system itself is rather unique relative to other countries where Islamic banking is also found. Islamic banking in Malaysia operates on a dual banking system, which allows conventional and Islamic banking to coexist and compete for deposits and financing. Although the market size of Islamic banking today is still marginal, the competitive environment is expected to stimulate the provision of new Islamic facilities as the industry enters the new

millennium. Therefore, it is crucial to make comparison between the Islamic and conventional banking system in terms of profit performance. Since bank profit is the difference between total revenues arising from loans or financing and total cost arising from deposits, the performance of both banking system can be measured by taking a special look at profitability.

Another important event taking place within the period considered under study is the Asian financial crisis, which Malaysia entered into in the middle of 1997. Malaysians experienced the most difficult time in 1997 and 1998 as the financial crisis made its presence felt in Malaysian economy. A major breakdown is forthcoming if not for the role of the two special purpose vehicles (SPV) Danaharta and Danamodal.² Islamic banking operation is not an exception, as it was also badly affected by the crisis. This is attested by Bank Negara Malaysia in her 1997 annual report that, "The tight liquidity situation has put pressure on the operations of Islamic banking. The current turmoil revealed a structural weakness in Islamic banking operations particularly under a volatile economic environment".³ The unsettled economic conditions of the past few years have been given priority discussion, from both a theoretical and practical view point to evaluate the soundness of the Islamic financial operational system and seeking remedies to overcome barriers. It is recognized that banks behave differently at different stages of the business cycle. To accurately describe bank behavior, these differences should be incorporated in the study. As such, this research will attempt to

² Danaharta and Danamodal was an institutions formed by the Malaysian government to ease the problems of bad debts and depleting capital in the local banking firms during the 1997 financial crisis.

³ Bank Negara Annual Report, 1997. Quoted by Dr. Rosly, Saiful Azhar, The Economic Crisis. Impacts on Islamic Banking Operations, Unpublished Paper, International Islamic University Malaysia, 1998. Lecture note.

look at the effect of the financial crisis on the profitability performances of Islamic banking operations. It will try to explain the reason if any, the significant effects of the crisis on the Islamic banking operations.

The profitability performance is measured by using the ratio analysis that includes the return on equity, return on assets, return on deposits, profit margin, assets utilization, net operating margin and operating expenses ratio.

1.2 Objective of the Study

This study will attempt to:

1. assess the performance of the IBD since it was introduced in 1993. This study will look into the IBD profitability performance compared to the conventional bank. Since the Malaysian Islamic banking model is based on dual banking system. The purpose is to look at whether there is any significant progress of the Islamic banking industry since the introduction of IBD in the Islamic banking industry, which was once monopolized by BIMB. If the profitability ratio of the IBD is found to be equal if not better than the conventional bank, then the IBD is considered to be in good position.
2. investigate the impact of the 1997 financial crisis and interest rate volatility in the Islamic banking industry, that is, whether the Islamic banking is able to profit and protect itself from the economy cycle and volatile interest rate movement. This test is most important, for if there is any significant effect on the Islamic banking industry; it should be able to explain why it has taken place. This study will therefore attempt to explain and suggest the remedy for such problems.

1.3 Hypothesis of the Study

Having been in the market for just eight years, IBD operations are considered new in the Malaysian financial market. Therefore it is expected that the means of the profitability ratio of the interest based banking system will outperform the IBD operations. The expectation is based on three reasons. Firstly, Islamic banking activities are considered new in the Malaysian financial system compared to the conventional banking system, which has influenced the Malaysian economy since the colonial period. Secondly, the market size and assets of Islamic banking today is marginally small compared to the conventional banking, and thirdly, conventional banking operation is more efficient compared to the Islamic banking. This expectation is based on Samad's (1999) finding in his studies, which observed that the managerial efficiency of the conventional banking sector is better than that of BIMB.

Viewed from the business cycle's effect on profitability performances, the means of the profitability performance of interest based system is expected to be better than that of IBD either during an upswing or downswing of the cycle. This is based on the reports from BNM (1997) and Rosly's (1998) argument that with the absence of floating rate assets the Islamic banking is trapped in a negative fund gap strategy.

1.4 Significance of the Study

The topic discussed in this paper is important since a study on the performance of the Islamic banking industry involving the IBD has not been attempted yet. Based on the available literature, most of the previous studies are found to be descriptive in nature while only a few empirical studies were attempted and they only involved the BIMB.

The conclusion of this study might be useful in gauging the financial standing of the Islamic banking industry, which in turn can serve as the basis for decision making. More importantly, the conclusion of this study might be useful in the Islamic banking model building and policy making particularly in a dual banking system and in a volatile economy condition.

1.5 Organization of This Study

This study shall consist of seven chapters. In Chapter one the introduction of the research paper is given. Definition of related terms, a component of related tools used for the analysis and the objectives and significance of the study are briefly discussed in this chapter. This chapter also carries the hypothesis of this study. Chapter two of the research paper will discuss the conceptual framework of the Islamic banking operations, the historical background of the emergence of Islamic banking and the background of Malaysian Islamic banking. Chapter three will be the review of previous studies. Chapter four will provide the Malaysian Islamic banking achievements in terms of assets, deposits and financing mobilization for the period of 1990 to 2000. Chapter five defines the meaning of banking profitability performances and presents the analytical tool for measuring return performances. The empirical evidence of profitability performances, statistical inference and analysis from selected banking institutions will be discussed in Chapter six. The conclusion will be offered in the last chapter.

CHAPTER 2

ISLAMIC BANKING CONCEPT AND BACKGROUND

2.0 The Concept of Islamic Banking

There are various Islamic financial institutions today carrying out a spectrum of banking operations on a competitive basis. For example, there are four main categories of Islamic banks, namely development, investment, commercial and savings banks.⁴ In Malaysia, Islamic banks namely Bank Islam Malaysia Berhad and Bank Muamalat together with the Islamic banking divisions embrace all categories of banks operations. These include home and vehicle financing, trade finance and syndication financing. Thus, operations of Islamic banking include practically all aspects of business, commerce and investment as applied in modern Western banks, but without infringement of Shariah principle.

In Islam, all institutional development in a given society is to be based from the principles of Shariah. It follows that the concept and operations of Islamic banking should be consistent with the Islamic Shariah principles, which are derived from the Holy Quran and the Sunnah. Generally speaking, Islam prohibits all such transactions, which depends on chance and speculations (Quran, 2:219; 5:90). No matter what the forms are, the essence of disapproved business conduct comprises unjustified appropriation of others' wealth and rights. This is exactly what the Quran has strictly forbidden by calling it as "zulm" or injustice (Quran, 2:188; 4:29).

⁴ Nawawi, Razali, The Operations of Islamic Bank, Seminar on "Contemporary Dimensions in Islamic Financial System", 12-13 April 1995, Pacific Hotel, Kuala Lumpur, Organize by Kulliyah of Laws IIUM and BSN Commercial Bank (Malaysia) Berhad. P 81.

In the case of banking business, the Western banking operations are primarily based on interest; banks pay interest on deposits and charge interest on loans. When money is lent on interest, then money by itself is independent of any labor, effort or the assumption of any risk and increases over time. The increase is realized through exploitation of labor, goods or property since Allah (SWT) has unambiguously declared nothing can be had without effort or labor (53:39). Since injustice lies at the root of interest of all undesirable business conduct, therefore, it is well known that the payment and receipts of interest is strictly prohibited in Islam, regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged.⁵ The Holy Quran and the Hadith had explicitly prohibited riba (Appendix 1).

In Islamic banks, the imposition of interest on loans is not permitted because of the prohibition of riba (usury). In the case of loan, it is known as riba al-Nasiah. Riba al-Nasiah is the additional amount sought on loan, usually on the basis of time (also known, as riba al-Jahiliyyah is the one expressly prohibited by the Quran).⁶ Although Islamic banking is governed by the principles of Shariah, it essentially performs the same functions as those in a conventional system that is they act as financial intermediaries. The Islamic banking system is aimed at meeting the requirement of those who ask for capital for specific investment. It provides the financing of working capital, industry, agriculture or any other lawful investments and services, but without charging interest in any form.

⁵ Unjust appropriation of others wealth, by whatever means and methods, is forbidden by the Quran, 2:188; 4:29. Interest, definitely involves unlawful consumption of others' wealth. It is therefore, abhorrent and evil.

⁶ In some cases, the injustice may not be apparent. In order to nip the evil in the bud, Islam seeks to block all those channels that eventually lead to injustice.

With the absence of interest in the system, the Islamic banking operations must run on other alternatives. There are two alternatives brought forward by Ziauddin Ahmad. The first option is that no return can be paid on any type of bank deposits and all loans and advances will be provided on an interest free basis. The second alternative is that banking should be conducted on the basis of profit and loss sharing".⁷

Both these alternatives are in tune with Islamic norms of justice, and are also capable of assisting the achievement of the socio-economic objectives of an Islamic society. In Islam, a financial institution is not just an institution that acts as a middleman in transferring funds from ultimate lenders to the ultimate borrowers. Dr. Ahmad al-Najjar (1983) defined the Islamic financial institutions not mere 'houses of finance', but rather developmental institutions ideologically based on Islamic principles. "They are institutions which believe that their funds are part of the property of Allah to whom all property belongs. Consequently, dealing in those funds should be bound by the Shariah principles. They believe that all their services are morally based and that money has a social function, therefore it should be employed for the welfare of society. They also believe that their functions are not confined merely to the financial and economic affairs of society but are also concerned with social and educational affairs"⁸

Thus from the above statement, the Islamic concept of financial institutions is not only concerned with financial or economic affairs alone but as a social and educational

⁷ Ziauddin Ahmad, "Concept and Models of Islamic Banking an Assessment", A paper presented at the Seminar on Islamization of Banking, Karachi, on 27 – 29 November 1984, p 8

⁸ Ahmad al Najjar, "Islamic Banks Prepare for the Future" Arabia, September 1983, p 63

affairs of the society as well. The aim of Islamic injunctions on economic and commerce is to secure the rights of the public and maintain the solidarity of society. It seeks to inculcate morality in business and specifically the most important agenda is to make the law of Allah (SWT) supreme in business enterprise.

2.1 Historical Background of Islamic Banking

The banking system was introduced into the Muslim countries at a time after the fall of the Muslim government especially during the colonialism period. The main banks in the home country of the colonial powers established local branches in the capitals of the subject countries and they catered mainly the trade requirements. With the passage of time and other socio-economic forces, it became difficult to engage in trade and other activities without making use of banks. As a result, local banks were established on the same lines as foreign banks.

But it seems that the history of Islamic financial institution can be traced back to the time of the prophet Muhammad (SAW) with the existence of Bait-al-Mal or the 'House of the Treasury'. It dealt with both business transaction and charity. During the glitter stage of the Islamic empires, the Bait-al-Mal played an important role as the 'Central National Finance House', with its branches all over the Islamic state. Its operations were based on the Shariah principles, adopting social justice and introducing laws and instruments, which helped in the maintenance and dispensation of justice and equity. But, as been mentioned above, after the fall of the Muslim government, Islamic banking was the subject of mainly theoretical discussions and the efforts to introduce Islamic banking were only private and individual initiatives. The

earliest references to the theoretical discussions of modern Islamic banking can be found in Anwar Qureshi, Naiem Siddiqi and Mahmud Ahmad in the 1940's. Sayyed Abul A'la Mawdudi and Muhammad Hamidullah did a more elaborate exposition of interest free financial system in the 50's. With the increase in awareness and the desire to see Islam become the pillar and as a way of life, works specifically devoted to this subject began to appear in the 1960's and 70's. Young Muslim economists like Abdullah al-Araby, Nejatullah Siddiqi, Baqir al-Sadr and Ahmad al-Najjar was the main contributors.⁹

The practical effort of modern Islamic banking began with the establishment of interest free banking in Egypt in 1963 on an experimental basis. It was launched by Ahmad al Najjar in the rural Egyptian town of Mit Ghamr but it was closed in 1967.¹⁰ The pioneering effort, led by Ahmad al-Najjar himself, took the form of a savings bank based on profit sharing.

The early seventies saw the institutional involvement. Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, the First International Conference on Islamic Economics in Mecca in 1976, the International economic Conference in London in 1977 were the result of such involvement. In 1972, the Egyptian government revived al Najjar's experiment. The experiment began attracting the attention of bankers, thinkers and economists in Muslim countries who were concerned with economic and social progress for

⁹ Abdul Gafoor, ALM, Abdul Gafoor, ALM. Interest-Free Commercial Banking, AS Noordeen, Kuala Lumpur. 1996, p 37 – 38.

¹⁰ For more detail information, see Neinhaus, Volker, Islamic Banking, Journal of the Arab Banker's Association, London, November 1986, p 5-7.