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Sustainability of An Interest-Free Banking System: A Study of Islamic Banking in the Middle-East Countries

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Abstract

This study examines the sustainability of an interest-free banking system, with a specific focus on Islamic banking in the Middle-East Countries. Islamic banking is an unknown concept in most part of the world and is only associated with a dislike to interest, but Islamic banking contains much more than just prohibition of interest. Islamic banking governed by the Sharia Law does not only focus on an interest-free banking system but it also focuses on aspects like risk-sharing, profit-making, asset-backed financing etc., Islamic banking stress on the concept that society can be served with ethics and finance. The main motive behind this banking system is to eradicate injustice in the society. Islamic banking is different from conventional banking, because of its close ties with religion. Islamic banking was an unknown concept in non-Islamic countries but in recent times it has gain a very huge popularity in many parts and countries of the world. Islamic banking has been always practiced in the Islamic world, but because of political influences, the implementation of Islamic banking system varies in different Islamic country. As the implementation of Islamic banking varies to some extent between Islamic countries, it is very crucial for the banks activities to be controlled by a Religious Supervisory Board to harmonised the implementation and govern it according to the sharia law. This study focuses on how does this system of an interest-free, asset-backed financing system sustains itself, and how does these principles help in the growth and sustainability of Islamic banks in the Arab and Muslim world. It concludes with its effort to harmonize rules and regulations for achieving more growth in the Islamic world and beyond.

Keyword: *Interest-Free Banking System, Islamic Baking, Islamic country Middle-East Countries and Sustainability etc.*

1. Introduction:

Islamic Banking system is a financial framework that works according to the Islamic law (sharia law). The Islamic banking system doesn't just revolve around an interest-free system but rather its core idea is to promote justice, equality, and ethical conduct in financial transactions, aligning economic activities with moral and social values. The Islamic financial system or the Islamic banking system offers a sustainable alternative to conventional banking by adhering to ethical principles and promoting financial stability. This interest-free banking system prohibits the payment and acceptance of interest. In its close ties with Islam Islamic banking is either unknown or have been misunderstood by the western world. When Islamic banking was introduced for the very first time with its ethical values, it was simply looked as a unworldly dream, but in recent years its growing popularity and demand has somewhat effected the traditional conventional banking system. People are becoming more aware and are reluctant to engage with banks which invest in unethical and unsocial activities. Islamic banking works on various aspects such as, prohibition of interest, risk-sharing, asset-based financing and etc., it works on various mechanisms like – profit and loss sharing, Mudarabah (safekeeping), zakat (charitable donations) etc. The present study aims at the sustainability of Islamic banking and its study in the middle-east along with some focus on its future in other non-Muslim countries.

2. Literature Review:

Several studies have been conducted by many academicians and researchers on different aspects Islamic banking. Some of them are highlighted below.

Alshater, et al. (2023) carried out a retrospective hybrid review to reveal this literature's influential scientific actors, identify and discuss its most important streams, and finally, present a future research agenda. They identified the influential aspects in the literature and discuss four important research streams: (1) overview, growth, and legal framework of Islamic banks; (2) Islamic banks' performance and risk management practices; (3) customer and marketing perspectives of Islamic banking; and (4) the dynamics of efficiency in Islamic banks.

Boukhatem and Moussa (2018) supported the earlier studies; however, the underdeveloped institutional frameworks might reduce this positive effect of Islamic finance on economic development.

Kassim (2016) examined Islamic finance-growth nexus in Malaysia and found that Islamic finance enhances economic growth both in the long and short run, albeit long-term relationship is more striking.

Abduh and Omar (2012) reported the interconnected relationship of Islamic finance with economic growth in Indonesia with a vital role played by providing financing facilities in the economy.

Al-Harbi (2020) highlighted profitability, credit risk, capital ratios, deposit insurance, and size are the bank-specific factors that can affect liquidity and external factors including GDP, inflation, monetary policy, and banking sector concentration.

Novikov, et al. (2019) found that the connection between the real and nominal economy became more prominent, these sectors were expected to become more significant. Another positive aspect in the Islamic financial industry development was it's refocusing on solving social problems and financial inclusion

Ammar (2023) aimed to assess the performance of Islamic banks beyond traditional yardsticks, to emphasize their ethical, social, and environmental role in accordance with the higher goals of Islamic law namely Maqasid al-Shariah. Based on Imam al-Ghazali's concept of Maqasid al-Shariah, we develop a Maqasid al-Shariah index including the five objectives of Shariah (Preservation of Life, Religion, Intellect, Posterity, and Wealth). Furthermore, when comparing the performance of the sampled Islamic banks across the five objectives, she found that they earned the lowest score in the objective of intellect due to their failure to disclose the required information in their annual reports.

Javaid and Alalawi (2018) examined all the internal and external determinants contributing the profitability of 9 Islamic Banks in the region of Saudi Arabia over a period of 2000-2013, that is a period of 14 years. They found that banking sector in Saudi Arabia is highly competitive. The study further emphasizes optimal policies to bank management that helps the policy makers, bank managers and executives in improving the overall efficiency and maintaining the sound profitability in the Islamic banks in Saudi Arabia.

3. Significance of the Study:

This study on Islamic banking is significant for various reasons:

- It helps to understand other alternative banking models. Islamic banking is very different from conventional banking and this study helps in understand Islamic banking and how does it sustain itself in the long-run.
- The study of Islamic banking is essential to understand its principles, benefits and contribution to the global finance.
- It provides an insight into the methods and products used by Islamic banks to help understand about its functioning.
- It provides a brief data about some countries in the Middle-East that has Islamic banking system.

4. Objectives of the Study:

The objectives of the study are:

- To understand the meaning of an interest-free banking system or the Islamic banking.
- To analyse the role of Islamic banking in the Middle-East for its sustainability.

5. Research Methodology:

The study is descriptive and theoretical in nature. It is purely based on the secondary data. The secondary data have been collected from various articles, journals, research publications, reports and web-based resources.

6. Limitations of the Study:

Limited time, scope, data and resources has caused to the restrain of the research work, and so, only limited aspects about Islamic financial system and Islamic banking system have been covered in this research work.

7. Conceptual Framework:

In order to understand Islamic finance or Islamic banking it is very important to know about the history of Islam. To understand Islam, we need to know its meaning first, **Islam** means **"submission"** which means that a believing Muslim should submit its will to **Allah** and act according to his decree. There are five pillars in the Islamic faith; **Shahada** (the Islamic confession), **Salah** (the five daily prayers), **Zakat** (almsgiving), **Sawm** (fasting the Islamic month of Ramadan), and **Hajj** (pilgrimage to Makkha). Islam preaches justice and brotherhood, which can be simply understood through the concept of zakat. As this project work is based on finance so we will only look into the financial aspects of Islam.

Zakat is one of the five pillars of Islam, which is a charitable contribution made by Muslims, who acquire wealth to the needy and poor. Muslims who possess a minimum amount of wealth are obliged to pay zakat, which is calculated as 2.5% of the excess wealth. It is a way to purify wealth by giving it to the poor and needy, it also helps in reduction of economic inequality by redistributing wealth from the rich to the poor. Zakat is a vital aspect of Islam which promotes social justice, harmony and generosity.

According to Islam "Allah is the owner of all resources and man is only a trustee in their use", and so the way to handle these resources it is necessary to follow the command of the Almighty.

7.1 Islamic Banking System:

In his last sermon the Prophet of Islam, Muhammad (peace and blessing be upon him) stood on the Mount Arafat and addresses the entire humanity with the following words "O' People Allah has forbidden you to take usury, therefore all interest from henceforth be waived", (a small part from the entire sermon) and it is here that the seed of a very new system of finance, banking and economy was sown, which is now known as the Islamic financial system or the Islamic banking system. Islamic finance is very diverse and are broadly classified into several classes according to the service they offer. They are: Islamic banks, Islamic windows, Islamic investment banks and funds, Islamic mortgage company, Islamic insurance institution, Mudaraba company, International Islamic finance market. But as the topic of the project is related to sustainability of Islamic banks and its influence in the Middle-East, we will only be discussing about the Islamic banking system and the Islamic banks. Islamic banking system is a financial framework that works according to the Islamic law known as the sharia law. Islamic banking system is an interest-free banking system which varies a lot from the conventional banking system, but it has also several other aspects which plays very important role in its operation. It basically works on the principle of risk-sharing, which is the most important aspect of Islamic banks, it also uses tools like profit-sharing, partnership, leasing, Islamic bonds etc. The history of Islamic finance is very old but there are several data from the golden period of Islam.

It is said that at the time when "Europe was still in the dark ages, knowledge and culture thrived in the Islamic world'. According to Islamic economist Choudhary and Malik, the elimination of interest followed a gradual process in early Islam culminating with a fully fledge Islamic economic system under the khilafat of Umar Ibn Khattab the second Islamic Calipha.

Islamic banking is a mix of commercial bank and investment bank. Islamic banks work on the basis of profit and not on giving and receiving interest, moreover they should be profitable to secure the depositor and give them an adequate rate of return. The banks advance money for commercial productive activities on the basis of profit-sharing principles.

The Islamic finance and banking thrived more at the time of different khilafats throughout the Muslim world. Today the Islamic banking system operates in almost every Muslim country and the countries with dominating Muslim population. In the Middle-East countries like the Kingdom of Saudi Arabia, the United Arab Emirates, Qatar, Bahrain, Kuwait, Iran etc, have Islamic banks while Muslims countries like Pakistan, Bangladesh, Malaysia, Indonesia etc, also have some banks that works on principles of the sharia law.

7.2 Principles of Islamic Banking:

The Islamic law is known as the sharia law and is considered as the Divine Law – the Law of Allah. The sharia law is basically based on the Quran, the Sunnah and the Hadith. The Quran is the divine book revealed by the Almighty to Prophet Muhammad by the Angel Gabrial, and therefore is considered as the true words of Allah. The sunnah consists of the acts of the Prophet Muhammad (pbuh), which transmits and explains the Quran, while the hadith are a collection of sayings, actions etc. of prophet Muhammad (pbuh) which was recorded after the death of the Prophet by his companions.

The key principles of Islamic banking system are:

- Prohibition of Riba (interest): In Islam both payment and receipt of riba that is interest is strictly prohibited. In the Quran it is he taking and giving of interest is mentioned as a grave sin quite a lot of times, but no specific reason for this prohibition is mentioned. But it is said that there are three reasons for the prohibition of riba – interest is unfair and unjust, interest is exploitative and interest is unproductive.
- Risk-sharing: Banks share risk and reward with customers which promotes mutual benefits. Sharing profits and losses is one of the most important examples.
- Investments: Investment is any kind of activity which is prohibited (haram) in Islam. This includes alcohol, pork, gambling etc.
- Asset-backed financing: Transactions are backed by tangible assets, which reduces speculation.
- Sharia compliance: All products and schemes are evaluated by Islamic scholars to ensure with the adherence of Islamic law.

- Social responsibility: Islamic banks prioritize social welfare and community development, and promotes social justice and harmony.

7.3 Islamic Banks:

The history of Islamic banks dates back to the time of early Islam, the second caliph of Islam Umar Ibn Khattab was the first person to establish a fully fledge Islamic economic system during the time of his khilafat between 632-644 CE. But prior to 19th century there was no financial institution recognizable as banks in the Muslim world. The first majority-owned bank emerged in 1920s. in the 1950s the first local Islamic bank was established in a rural area of Pakistan which charged no interest on its lending.

In 1963, the first modern Islamic bank on record was established in a rural area of Egypt by economist Ahmed Elnaggar. This profit-sharing experiment in the Nile-delta town of Mit Ghamr was however was shut down by the Egyptian government, nonetheless it was considered a success by many. The first modern commercial Islamic bank, Dubai Islamic bank was setup in the year 1979. In 1979, the Amana Income fund, the first Islamic mutual fund was established in Indiana.

In 1980 to 1985, Islamic investment went a spectacular expansion throughout the Muslim world, attracting deposits with great gain and religious guarantee. In 1990 an accounting organization for Islamic financial institution namely "Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) was established in Algeria.

By the end of 1995, 144 Islamic financial institution were set-up worldwide, which consist of 33 government-run banks, 40 private banks and 71 investment companies. in 2008 Islamic banking was growing at a rate of 10-15% per year despite the global financial crisis. In 2015, according to the report of the State of the Global Islamic Economy Report $2.004 trillion in asset were being managed by the sharia-compliant.

7.4 Aims of Islamic Banks:

- Corporate in accordance to the sharia law, and to undertake all the financial operation needed by the Muslims in the framework of the principle of Islamic law.
- To support, develop and promote Islamic financial industry.
- To encourage ethical and responsible banking practises.
- To share risk and reward among all parties and enhance customers satisfaction by giving maximum return on investment.
- By promote social justice and well-being of the society.

7.5 Types of Islamic Banks:

Islamic banks can be categorized into different types based on its service, scope etc, few of them are:

- Universal Islamic Banks: It offers a vast range of services and products to individuals, businesses and government.
- Islamic Investment Banks: It focuses on investment banking such as assets management.

- Islamic Commercial Banks: It focuses on commercial activities such as business, trade etc.
- Islamic Microfinance Banks: It provides financial services to low-income individuals and small businesses.
- Islamic Treasury Banks: It focuses on treasury management such as foreign exchange.

7.6 Products or Services of Islamic Banks:

Islamic banking system has its own products and services that differs from conventional banks. These products include – Mudharabha (profit sharing), Wadiah (safe-keeping), Musharakah (joint venture), Sukuk (Islamic bonds), Takaful (Islamic treasure).

- **Mudharabha:** It is a type of Islamic financial contract, which is also known as profit-sharing. It the most popular mode of investment in Islamic banking. It consists of two-parties the investor (Rab ul Mal) and the entrepreneur (Mudharib). The mudharib manages the project. The profit is shared between the two according to a predetermined ratio. The losses are borne by the investor, except in case of mishandling or misconduct.
- **Wadiah:** It is also known as safekeeping or custodial agreement. In this contract one party (depositor) entrust their assets or funds to another party (the custodian) for safeguarding. The custodian is not entitled to use or invest the assets for their own benefit. The ownership of the assets remains with the depositor. The custodian is liable for any losses or damage to the assets except in case of unforeseen circumstances.
- **Musharakah:** It is a popular mode of investment in Islamic banks also known as joint venture. To or more parties collaborate to finance a business or a project, where each partner contribute capital to the partnership. All parties are involved in management and decision-making. The losses or debts are borne by all parties in the venture.
- **Sukuk:** Sukuk also known as Islamic bonds that complies to the sharia law. It prohibits riba (interest) and promote ethical banking practices. It works on the structure of paying shared profit instead of interest.
- **Takaful:** It is also known as Islamic insurance, is a kind of corporative system of repayment or reimbursement in cases of loss. Under this system people or businesses concerned to risk make donations and pays funds to provide financial protection. It offers various products such as health, life, property insurance etc.

8. Role of Islamic Banking in the Middle-East Countries:

Almost all the Muslim countries in the Middle-East have Islamic banks which are fully fledge and fully functional. Here are some of the major countries with their recent data.

8.1 The Kingdom of Saudi Arabia:

In Saudi Arabia, Islam is the ideology and sharia is the law of the kingdom. Rules andregulations are strictly based on the Islamic law and son does the rules of banking sector which totally prohibits riba (interest). The largest Islamic bank in Saudi Arabia is Al-Rajhi Banking and Investment was founded in the year 1957 and today it has 600 branches all spread over Kuwait, Jordan and Malaysia. Al-Rajhi bank offers various services such as deposits, loans, investment, credit cards etc.

All other banks working in Saudi Arabia are by definition Islamic, Saudi Arabia does not officially recognize Islamic banking, if one bank is considered Islamic then all other banks without an Islamic bank would we considered as un-Islamic.

8.2 Qatar:

Qatar is the fourth-highest GDP per capita in the world. Islamic banks in Qatar represent 28 per cent of Qatar's total banking sector. Qatar Islamic bank is the safest bank in the Islamic banking sector. Dukhan banks is of the largest Islamic bank of Qatar and the third largest bank in the country. The bank has QAR 75.4 billion ($19.2 billion) in assets from which 43 per cent is owned by the government. Assets of Islamic banks in Qatar reached QAR 563.7 billion ($143.9) in the year 2023. Assets in Islamic banking sector grew by 3.6 per cent last year. Foreign assets in Islamic banks were recorded to be $9.2 billion while local assets increased by 4 per cent reaching QAR 509 billion ($132.1 billion).

8.3 The United Arab Emirates:

The United Arab Emirates has one of the most diverse economies among the members of the Gulf Cooperation Council. UAE was the first country to setup a modern commercial Islamic bank in Dubai namely the Dubai Islamic Bank in the year 1979. In recent years, the total value of deposit at the Islamic banks in the UAE was recorded at AED 539 billion in the year 2022. In the year 2023 UAE's Islamic banking assets surpassed, AED 700 billion ($190.61 billion). By the end of 2023 increase in Islamic bank credit was recorded to AED 428.9 billion. By the end of 2023 increase in deposits and investments were also recorded to AED 495.5 billion and AED 132.7 billion respectively. Islamic banks in the Emirates have recorded significant growth in credit, investments, deposits and assets in the year 2023.

8.4 Kuwait:

Officially known as the State of Kuwait, is the fifth richest country in the world by gross national income per capita. Kuwait finance house is Kuwait's first Islamic bank. Boubyan bank of Kuwait is the second safest Islamic bank in the region. In the year 2017, the Kuwait finance house recorded for 44.7% of the total Islamic banking market in Kuwait, whereas Boubyan banks accounted 19.7% of the total Islamic banking market in Kuwait. It is estimated that by 2025, the number of commercial banks in Kuwait will be 186.

8.5 Egypt:

The first sharia-compliant bank in Egypt was the Faisal Islamic Bank. It provides retail and corporate banking service both in Egypt and internationally. The Abu Dhabi Islamic Bank Egypt has the highest return on equity share at 33 per cent. There are two more Islamic banks being operated in Egypt today are the International

Bank of Investment and Development (IIBIB) and the Egyptian-Saudi Investment Bank (ESIB), these two banks are said to be private Islamic banks.

8.6 Bahrain:

Bahrain is a major financial centre and has the fourth-freest economy in the Middle-East. Bahrain Islamic bank is the first Islamic bank in the Kingdom of Bahrain which is based in Manama and was founded on 7th of March, 1979. In the year 2017, Bharain Islamic bank sold assets worth 14 million dinars as part of its five-year growth plan. The national bank of Bahrain offered to acquire Bahrain Islamic bank for 124 million dinars in the year 2019. Bahrain Islamic bank launched its future leaders' youths' program in the year 2021, it won the best the best Islamic bank in Bahrain award from Euromoney in 2022. Bahrain Islamic bank announced its plan to create first AI platform for Islamic banking in the year 2023 and also won the best Digital Banking Initiative at the Mena Banking Excellence Award in the same year.

8.7 Iran:

Iran is a Shia Muslim majority country, which is a different school of scholars and varies a little with other Middle-Eastern countries in reference to the Islamic law. The Iranian revolution also known as the Islamic revolution which was headed by the supreme leader of Iran Ayatullah Sayyid Imam Ruhollah Khomani in the year 1979 led to the transformation of Iran's banking system to run on an Islamic interest-free basis. Since 1984 Iranian banks have been operating under the sharia law. The second stage started in 1982 in which the legislation ordered to adopt Islamic model of banking and the third stage started in the year 1986 in which banking was considered to be an integral part of the Islamic government. In 2009 Iran's bank accounted 40 per cent of total assets of the world's top 100 Islamic banks. By the year 2014, Iran's banking assets were estimated at $523 billion, which was over a third of the total Islamic banks globally. The economy of Iran is still dominated by the state, and the capital market is still in the second stage of development.

8.8 Sustainability of Islamic Banking:

The system of Islamic banking is not a new concept, it's been there in the Muslim world from a very long time. As the world becomes more aware of Islamic banking and Islamic banks because of its growing success and popularity, it becomes necessary to clear their doubts and to provide them with information about the sustainability of Islamic banking system. Islamic banks sustain themselves through various techniques, such as:

- Sharia compliance: The most important point is the compliance of Islamic banks with the sharia law. As Muslims want themselves to be governed by the sharia, they also want their financial transaction should align with the sharia law. This attacks Muslims customers.
- Risk-sharing: Islamic banks neither gives nor takes interest, as interest is prohibited in Islam, so they encourage partners and customers to share risk. It works on profit-sharing models such as mudarabah (profit-sharing) Musharakah (joint venture), sukuk (Islamic bonds) etc.
- Asset-backed financing: Islamic banks require transactions to be backed by tangible assets, this asset-backed approach leads to a more resilient banking.

- Market demand: Islamic banks also offer product that comply with the Islamic law. There is a growing demand of Islamic product both among Muslims and non-Muslims.
- Zakat: Zakat plays an important role in the sustenance of Islamic banks. Zakat is a charitable contribution of 2.5 per cent of an individual's excess wealth. Islamic banks receive and collects zakat and manage them. By managing zakat it contributes to social welfare, poverty alleviation aligning with the Islamic financial values.

8.9 Sustainable role of Islamic Banking System in the Middle-East Countries:

Islamic banking system prioritize ethical practices, economic stability and social responsibility by adhering the sharia law which serves as a catalyst for sustainable economic growth in the Middle-East, as well in other parts of the world.

- Islamic banking plays an important role in growth and development in the Middle-East Asia.
- Islamic banking accounts for a major proportion of total banking assets in many Middle-Eastern countries.
- Islamic banking helps promote inclusive growth, reduce poverty and inequality by using Islamic finance and instruments. It also has the potential to support the United Nations' Sustainable development goals.
- Islamic banking promotes green finance by supporting green and sustainable investments through the use of Islamic financial instruments such as sukuk.
- Islamic banking has emerged as a potential driver of climate finance in the Middle-East Asia.
- Islamic banking has shown resilience against global economic shocks, including the 2008 global economic crisis and the COVID-19 pandemic, in 2020.

9. Conclusion:

Islamic banking is a very wide subject. There are many other countries in the Middle-East and other parts of the world which has Islamic banks and are being profitably working for years other than the countries mentioned in this paper, countries like Lebanon, Iraq, Jordan, Turkiya, Pakistan, Malaysia, Indonesia, Sudan etc cannot be covered in this project report because of its limitation. All these countries mentioned earlier have different history, culture, politics, topography etc, but still these countries share some similarities between them. The most important and highlighting similarity of these countries is religion. Islam is the common religion in this region and the majority population of these countries are the followers of Islam, which plays an important role in these countries to opt for Islamic banking instead of conventional banking. As Islam prohibits riba (interest), and is considered haram for the Muslims. Islamic banking has established itself as a viable alternative to conventional banking. The financial conditions differ largely among the countries having Islamic banking system. In some countries the whole banking system has been nationalized through government action. This is a step toward the Islamization of the entire society through banking system. These banks can be private, state owned or a mix of two. For example, the third largest Islamic bank of Egypt is said to be private while in reality 20-80 per cent is state owned. But country like the Kingdom of

Saudi Arabia has strongly disliked the establishment and development of Islamic banks. The central bank of Saudi has refused the license of two banking group, Ai-Baraka and Al-Faisal, practically owned by Saudis, whereas in countries like Egypt Islamic banks compete with conventional banks. While country like Kuwait Islamic banking system has received enormous support from the government and receives special privileges and rights that conventional banks cannot have.

In conclusion the sustainability of Islamic banking is because of it risk-sharing, interest-free mechanism and because of its ethical principles. However, the roles of the banks keep changing according to the religious, financial and political environment. Islamic banking is well-positioned to contribute to the global economy and finance and its growth and development is yet to be seen.

10. Recommendations:

Some suggestions for the betterment of the Islamic Banking system in middle-east counties have been given below:

- Sharia compliance and governance should be enhanced. Sharia principles and guidelines should be strictly implemented.
- New products should be developed so that customers need can be diversified.
- Risk-management framework should be robust to reduce risk.
- New technologies should be adopted to reduce cost and enhance customer experience.
- Customers and public should be educated about Islamic banking and finance and about its benefits.
- Collaboration with International Cooperations should be done to promote Islamic banking and finance.

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