Globalization led to several advancements such as technological innovations, state-of-art communication systems that connect people from around the world, changes in economic activities, reduced cost of business activities, huge profits to the business entities, changes in the standards of living, bringing changes in social and cultural values with an unexpected global cause and effect on relationship. These forces changed the role of financial system; deregulation has allowed free trade across the borders, removed the artificial barriers, free entry of the products in markets and institutions. The augmentation of international trade and fluctuating exchange rates has escalated the development of international currency markets. Financial institutions now have a global presence thereby creating a fierce competition amongst them and paving the path of innovation and development for the market players. Consequently, huge mergers have taken place in the financial services that have changed the scope, size and activities of financial institutions and markets in which they existed and in 1990s, financial market participants struggled to deal with fierce competition and challenges. Finally, the process of change has brought entry to the new institutions and increased the global competition making the financial sector deeper and wider and leading to spread of risk within the economy. In 2008, economic slump has modified the perception of the household sector towards the financial system.

A strong financial system plays a noteworthy role towards an essential and vivacious economy. The presentation of an economy to a significant degree relies on the performance of the banking sector which is regarded to be one of the most predominant elements of the financial service industry (Kumar M and Charles, 2012). The financial system is concerned about money, credit and finance. It is
composed of regulatory authorities, banking and non-banking financial sectors which in turn comprises of banks which are closely related and inseparable. Globally, the banking sector has evolved since the time of its inception with an aim to be more industrious and resourceful by intercession and augmentation of the function of market forces. Financial markets through their participants undertake a dynamic approach to provide improved financial solutions for precise problems and needs of the customers by considering the present condition of technology, finance theory and regulation (Merton, 1995).

The key utility of the ever-evolving fiscal system is to support individuals and establishments to participate through savings. These savings are in-turn transferred to the individuals and institutions who instead invest in new projects, products and services. Financial establishments have a chief role in the economic improvement of a nation through a platform of various services like provision of money for personal borrowings, financing business sectors, investing in government and other big projects, assessment and implementation of economic policies. Proper banking facilities are key players in the economic progress for the nation with the function of intermediation between the surplus units and deficit units. The industrial revolution seeded the demand for planned and well developed financial systems. The acceptance of mass production focused on the growth in international trade to facilitate the industrial productivity and necessary contemporary methods for making payments and gaining credits.

In the previous two decades, modifications in chief peripheral aspects such as the beginning of macroeconomic structural alterations in the financial system, liberalization of capital movement, privatization, and worldwide assimilation of fiscal markets along socio-economic and technological advancements have created the task of financial mediators.

The structure of banking which is mainly deemed to be among the key element of the financial systems has an immense effect on the monetary stability and potency of any economy. The banking system creates links between the basic units in an
economy and acts as the monetary intermediary. Additionally, it aids in creating wealth by establishing interrelated entities. Subsequently, commotion of any kind in the traditional banking system can lead to critical consequences for the economy on the whole, mainly because the conventional banking system relies on the interest rates that are dependent on market or state controlled factors.

Figure 1.1 Globalization-Implications

1.2 EVOLUTION OF BANKING

Banking is among the ancient industries in the world. The term ‘Bank’ was derived from the Italian word ‘Banco’. The Bank of Venice founded in 1157, is considered to be the first institution regarded as a bank. As Germans were influential in Italy the term ‘Banck’ which is the German word for joint stock funds meaning a heap or mound was adapted by the Italians to convert the word into ‘banco’, which denotes an amassing of either stock or money. The establishment of the first conventional bank was nearly 424 years ago. Since then, banking steadily evolved and spread from the classical Greek and Roman civilization into the European nations. The
development of the sea trade routes and developments in the navigation system shifted the centre of the world commerce where banking evolved into one of the leading and dominant facets of development of the society.

Conventional economists recognized a connection between utilization and investment based on supposition that households after consumption have surplus currency and corporations that usually require money. Therefore creating a link at any known point, persons have surplus capital to invest when corporations require borrowing.

Financial markets are involved in creation and transfer of financial assets and liabilities. Financial institutions provide financial services for its members or clients; they act as intermediaries regulated by the government bodies, banks that could provide these facilities grew rapidly. Later, banks in Europe played the role of safe keeping the valuables (such as gold and silver) as people had fear of loss of their assets due to war, theft, risk loss due to pirates and expropriation by government. Then gradually it became more convenient and less risky to carry gold and other valuables. During colonialism in North and South America the old banking practices shifted to the new ones. United States began chartering of the banking companies. Long history of banking and its success has created tough competition and has paved the way to more service competitors to enter into financial services.

The 19th century developed the need of savings banks which offered small savings deposits to individuals who were ignored by the commercial banks. The development of mutual funds and investment firms was divested by the great depression of 1930s followed by World War II. A closely connected capital market rose in 1970s to proffer professional cash management services to the households and the institutions. The insistent competitors of this industry attracted large number of investors which ultimately helped the government in the regulation of the financial system in 1990s which were dynamic and identified as the decade of globalization. Further there was a rise in the increase and trade of information,
cultures and values across the world marked by financial trade and modernization of new products. People had a more unprejudiced approach about new business processes and substitute methods of carrying out business activity. In this varying environment, companies that provided choices that go further than the customary ways simply became ingrained out in new markets (Dicken, 2007). The assertion of Minsky (2008) that solidity breeds unsteadiness in his “financial instability hypothesis” had gained a greater importance. The financial intervention increased at a rapid pace though not reflected in the balance sheets Gorton and Metrick (2010) leading to a financial crisis. Universal macroeconomic imbalances were the chief core reason of the crisis Portes (2009).

The continuing international fiscal crisis was mainly accredited to prolonged periods of exceptionally unfastened fiscal policy in the US over the period 2002-2004. The chief reason of the predicament is an “originate-to-distribute” model of securitizing as monetary institutions didn’t adopt the industry representation of securitization. This securitization also permitted lenders to pass the loan and thereby condensed the motivation to scan and supervise mortgages and loans, thus a decrease in loan worth.

The impact of the financial crisis was that people misplaced trust for the conservative banking structure as a result of which numerous financial markets have experienced a huge slump and this still comprises a massive hazard to the industry. Globally the customers have realized the value that is offered by the banks through their products and services. Therefore, they began to command a further trustworthy relationship from the banks. Even though the customers are still comparatively unwilling to changing banks, they have reached a position where the effort for modifying could be valuable as part of the hunt for a further reliable and secure option (Ernst and Young 2011)

In concurrence with part of fierce competition in the nationwide and global banking markets, modifications were brought in fiscal unions, technological innovations to meet the growing wants and needs of the customers and other challenges of banks.
Opportune preparations in order to enter into the innovative viable financial environment which in turn made the banks to keep pace through wide variety of products and services. The extended phase of “the great moderation” along with credit increase cemented the means for the global financial crisis. Uncomplicated money, unrestrained increase of credit and debt, uncontrolled tax directives and administration, modernization of composite and opaque monetary products, negligence of risks concerned, absence of admission and lucidity, rapacious lending and increased influence among other aspects are recognized as the chief causes behind the crisis (Edib, 2010).

During the financial crisis of 2008, specialists and executives of IBs maintained that such banks were not affected due to their unique nature. In the international financial markets it had earned thrust and is at present attracting a lot of concentration from economists, researchers, policy makers and academicians in addition to being considered a widely accepted alternative mode of banking. According to Ellaboudy 2010, the universal economic crisis has upturned the course in the monetary system of GCC (Gulf Cooperation Council) typically reliant on oil revenue with a great self-governing capital fund to better protect them from the consequences of the financial crisis.

In GCC countries, Islamic banking is identified as an alternate mode of banking in place of the capitalist conventional form of banking; gradually Islamic banks started competing against each other and conventional banks were facing issues of strengths and their development needs similar to their conventional counter parts (Kearney, 2010).

1.3 DEFINITION OF ISLAMIC BANKING

As per the Dubai Islamic bank which is considered as the oldest IB, the definition of Islamic banking is as follows: “Islamic banking, enlightened with the guidance of Islamic Shariah principles, emerged as an alternative financial system that neither gave nor took interest, thereby introducing a fair system of social justice and equality,
while fulfilling the financial needs of people and maintaining high standards of ethics, transparency and a sense of responsibility”. Islamic banking depends on trade which enables to profit making instead of interest, which is prohibited by Islamic religious law.

In the Islamic Encyclopedia, Islamic Banking is defined as: “Financial institutions that give credit and basic business services in the traffic of payment, as well as the circulation of money that its implementation is adjusted with the Principles of Islamic legal principles.”

Muhammad (2000), also defined IB in his popular book called “Financial Institutions of Contemporary People”. According to him, "Financial institutions are businesses primarily providing financing and other services, the traffic and circulation of cash payments adjusted with the implementation of Islamic law”.

The Malaysian IB Act defines IB as ”a company, which carries on Islamic banking business, Islamic banking business means banking business whose aims and operations don’t involve any element which is not approved by the religion Islam.”

1.4 EVOLUTION OF ISLAMIC BANKING

Owing to the end of the Ottoman Empire, Britain and France set up bases in several Arab nations that were previously under their governance and financial institutions in accordance with the general pattern of the west were set up. The lack of Islamic financial institutions led to conventional financial institutions and insurance companies stepping in to meet the people’s financial needs without due consideration to whether or not they were in compliance with Sharia laws (AbdelKarim and Archer 2005). There was, however, a change in the passive nature of the provision of financial services since the 1950s after the Arab countries became independent politically which, in turn, led to the agenda of Muslim identity development.

The foundation of contemporary Islamic finance lies in the years 1962 and 1963 when the Tabung Haji and Mit Ghamr bank were established in Malaysia and Egypt
respectively (Iqbal and Molyneux, 2005). Nevertheless, the emergence of IBs into full-fledged institutions took place in the 1970s through the growth of an international system.

Islamic banking and finance as a discipline is approximately forty years old. The theoretical advancements of IB were cognizant in the late 1940s. After two decades, they reached a position of resulting in a representation which was adapted in the Middle East countries to meet the terms of their objective of possessing banks of their own. Several reputed Islamic banks came into existence in 1970s such as Nasser Social Bank in 1972 in Cairo, the Islamic Development Bank in 1975, the Dubai Islamic Bank in 1975, the Kuwait Finance House in 1977, the Faisal Islamic Bank of Sudan in 1977 and Dar Al-Maal Al-Islami in 1980. In the beginning of 1980s, the budding trade surprised the world as some countries such as Sudan, Iran and Pakistan altered their financial systems on par with the principles of IF. The important players in the fiscal market of the West such as HSBC, Citi bank, and ABN AMRO founded their Islamic windows and also their subsidiaries to draw the deposits of petrodollar from the Middle East countries and Muslim clients from home markets.

The principles that form the basis for Islamic financing activities are deep-rooted in the Holy Qur’an since the past 1400 years. Contemporary Islamic banking merely materialized during 1970s. It rose swiftly all through the 1990s, and in the recent years noteworthy improvements have taken place in the field of IBF. Consequently, the industry has progressed from a local business into a world-wide phenomenon. Subsequently, both Islamic and Western financial institutions diverted their focus towards the increasing customer demand for Shari’ah-compliant products.

Advancement in consumer finance has been unparalleled and diverse consumer finance products have come into existence. Islamic banking, in the present day, is considered to be among the fastest rising sectors of the IF industry which has experienced exponential expansion, incited by the issuance of licenses to new banks,
mostly in home markets, the founding of IWS by key global banks, and fractional or complete alteration of CBs into IBs.

1.5 HISTORY OF ISLAMIC BANKING

1.5.1 The era prior to World War II

The concept of Islamic finance traces back to the initial days of Islam, during which Prophet Mohammed himself was a merchant. Yet, back then the concept of Islamic finance was not wholly developed and merely involved settling trades between the Arabian Desert and other merchants from Damascus. The religious obligation of performing *Hajj* at least once in a lifetime also provides an opportunity for the pilgrims who were mainly merchants and traders to trade products in the course of their trip. Consequently, scope for economic transactions such as lending, borrowing etc. also became widespread.

![Figure 1.2 Trade routes in the early era of Islam](http://mrgrayhistory.wikispaces.com/)
1.5.2 The era after World War II

The period after Second World War is called the interest-free era by Gafoor (1995). Accordingly, the period is divided into 2 stages; the first period where the interest-free banking concept was merely existent in theory and the second period when the concept was put into application by Islamic banks and financial institutions.

Figure 1.3 Trade Routes during the Golden Age of Islam

Source: http://mrgrayhistory.wikispaces.com/

1.5.3 Summary of the substantial timeline of the advancement of Islamic banking and finance achieved since its inception:

Table 1.1: Historic timeline of advancements in IBF

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-1950s</td>
<td>• The Suez Canal construction in the 1890s led to Barclays Bank opening its branch in Cairo for facilitating financial transactions. The activities of the bank were challenged and criticized by Islamic scholars for collecting interest. This disapproval spread to other countries in the Arab world and</td>
</tr>
</tbody>
</table>
to India, which was home to a significant number of Muslims.

- Interest in all forms was declared to amount to the prohibited *riba* by the majority of *Shari'ah* scholars.

| 1950s–60s | Preliminary academic work in Islamic economics begins. The concept of interest-free banking reliant on *mudarabah* or *wakala* was put forward by 1953.  
|           | *Mitghamr* Bank in Egypt and Pilgrimage Fund in Malaysia were set up. |

| 1970s     | The Dubai Islamic Bank which was the first Islamic commercial bank was set up in 1974.  
|           | The Islamic Development Bank (IDB) was founded in 1975.  
|           | There is an increased demand for products in compliance with *shariah law* due to the building of revenues in oil sector and petrodollars. |

| 1980s     | The Islamic Research and Training Institute was set up by the IDB in 1981.  
|           | Banking systems were transformed into an interest-free system in countries like Pakistan, Iran and also Sudan.  
|           | Improved demand invites Western organizations intermediation.  
|           | Some nations such as Bahrain, Malaysia etc promoted IB corresponding to the CB system. |

| 1990s     | Due consideration was given to the requirement for accounting standards and a regulatory framework.  
|           | A self-regulating agency, the Accounting and Auditing Organization of IF Institutions was set up in Bahrain.  
|           | Islamic insurance was initiated. (*Takaful*)  
|           | Equity funds based on Islamic principles were founded.  
|           | The Dow Jones Islamic Index was devised. |
1.6 ISLAMIC BANKING – A WORLDWIDE PHENOMENON

The core concept of IBF essentially involves providing banking and financial services that are in accordance with the Shariah principles. Though Islamic banking and finance, as the name suggests, works on Shariah principles, the services provided are equally beneficial to all community groups. Initially, Islamic banking and finance was established and fostered in the Islamic countries. Gradually, and owing to factors such as globalization and modernization, which led to a liberal exchange and adaptation of cultures, policies etc. between nations, Islamic banking has come to grow and spread to Non-Muslim countries as well.

The growth in Islamic banking has been rapid and widespread in the past decade, with a growth rate between 10% and 12% annually. It had evolved into an effective tool for worldwide development financing. As per the report of Ernst and Young, “latest World Islamic Banking Competitiveness Report”, the growth rate of IB assets during the period between 2008 and 2012 was around 17% per annum. One of the distinctive features of IB is that it acts as a liaison between the real economy of the country and the financial sector. The focus is primarily on financial inclusion and social welfare and advancement. Additionally, economic consideration takes a back

Source: Greuning and Iqbal (2008: 13)
seat and moral consideration is of highest priority and profitability is not an independent criterion for assessing a bank’s performance (Al Omar and Abdel-Haq, 1996). The fundamental difference of IBs when compared to CBs is that they symbolize an exceptional financial process as a comprehensive solution for building solid customer relationships and being unconditionally accepted.

Prime financial hubs are recognizing the effectiveness of Islamic banking in terms of how it has mainstreamed with the worldwide financial framework and its potential towards addressing the challenges of dealing with poverty and promoting shared growth and prosperity. Consequently, Non-Islamic nations such as UK, Hong Kong and South Africa have also expressed interest in Islamic banking.

Currently, Islamic banking is commonly found, though in varying degrees and modes of practice, in most of the countries. According to Lewis and Algaoud (2001), there are two basic expansion forms of contemporary IB. In the first form, the complete financial system of a nation is altered from the conventional system to a wholly Islamic system. Iran, Pakistan and Sudan are the only countries which adopted this form. The second form involves purposeful attempts being made both by market regulators and participants to set up Islamic banks that contend with established CBs. In this form, a dual, mixed system where there is co-existence between IBs and CBs is established.

Owing to their presence on a global level, across different continents, Islamic banks are now regarded as business entities whose focal point is to attract and retain customers and fulfill their social responsibility, other than merely fulfilling religious obligations.

In this section, an attempt has been made to highlight how Islamic Banking has grown to become a worldwide phenomenon.
1.6.1 Islamic banking in Asia

Increasing consideration for extensive and principled monetary products has been noticed lately. In common, it is imperative that consumers seek monetary products that provide revenues and the chance to make a good act and the sense of investment are turning into something more valuable than real profit. The reasons mentioned have been identified to contribute towards the expansion of Islamic banking, almost an unidentified financial structure 30 years ago which has evolved into an exceptional and mounting section in the worldwide banking sector (Elgar, 2007). All through the expansion of Islamic banking, the system has been modified in a different way in different countries.

The most favorable pace of capital and wealth formulation and a resourceful use that could lead to sustainable financial expansion and fair opportunities for everybody is provided by the Islamic financial system. It is value-based and mainly focuses on the assurance of morals and ethics for the material security of the personal and the public as a whole (Naqvi, 1982; Zarqa, 1983; Ahmed, 1994; Siddiqi, 2000).

IB activities are largely centered in three sections of Asia: South Asia, Middle East Asia and Southeast Asia. The region of Middle East Asia, that’s mostly inhabited by Muslims, is the place of birth of IBF. IBs have the backing of the affluent patrons, state level establishments along with support from government bodies in that region of Middle East. A major share of authoritarian and other sustaining bodies of the IBF industry are based in the Middle East. The GCC countries were determined to combine their financial and fundamental banking systems by 2010. Such advancements are prone to have intense impact on the IBF sector in the Gulf and abroad. In South Asia, IB is restored in Pakistan under the dual-banking system. In Bangladesh, thorough Islamic banking policies are in place to meet the rising market and public needs. In Afghanistan, the central bank has recently licensed the Islamic Bank of Afghanistan (IBA), the primary lender in the country to incorporate the interest-free principles of Islamic finance across its operations. In India, Islamic
banking principles based products are found in the non-banking finance companies such as co-operative societies and chit fund companies which are not regulated by the Reserve Bank of India. In the recent past, co-operative banks guided by Islamic banking principles were established in two states of India. The “Cherman Financial Services Ltd” was set up in Kerala. The “Lokmangal Cooperative Bank” was opened up in Maharashtra.

Among the Southeast Asian countries, Singapore, Malaysia and Indonesia are foremost at fostering a highly inclusive and sophisticated adaptation of IBF in their respective regions for attracting IBF from Middle East. The concept of IBF is attaining impetus in European countries apart from USA that are presently more eager to make modifications in their tax and banking related legal framework in order to accommodate the adaptation of IB into their markets. In spite of the advancement of IB on an international level, the Middle East remains the nucleus of IBF industry. The institutions related to Islamic finance continually make efforts at individual and communal level to provide a varied range of pioneering, customer-centered and competitive products and services. Gaining a strong hold over the aboriginal oil-wealth and dampening its outgoing to financial institutions in the European countries and the Western world forms the primary objective of the financial institutions.

New market trends put forward the notion that the IBF industry is highly successful and receives tremendous regional backing. A rising amount of conventional finance institutions in the Middle East are diverting operations partly or wholly towards Islamic lines, which could threaten the longstanding legacy of conventional banking in the region.

1.6.2 Islamic Banking in Europe

Bosnia and Herzegovina

This is situated on the Balkan peninsula of South Eastern Europe and has transitioned from a socialist to an economy based on markets. As per the 2013
census, Islam is the majority faith in Bosnia and Herzegovina, totaling up to 51% of the population. In spite of an enthusiasm of the Muslim population towards the introduction of Sharia compliant banking services, due to the long-standing unrest between different ethnic groups and substantial political reasons, the scope for Islamic banking has remained restricted and limited. Sarajevo-based, Bosna Bank International (BBI) is jointly owned by the most powerful IF institutions from the Middle East, the Islamic Development bank holding 45.46% and 54.54% held by the Dubai Islamic Bank and Abu Dhabi Islamic Bank (Capital shared equally among the two). The financial dealings of the shareholders and the operations of BBI are Sharia compliant and hence, BBI is considered to be the first IB established in Europe.

Implementing Mudarabaha in any form is not possible for BBI as banks in Bosnia and Herzegovina are not permitted to do trade which is a huge hurdle for BBI (Islamic Finance Asia, 2009). BBI, therefore, had to devise a different structure that was acceptable to Sharia as well as Bosnian legislation. In spite of the worldwide financial crisis, BBI reported an increase in its operations up to the 3rd quarter of 2009. Thus, Bosnia and Herzegovina is a potentially viable market for Islamic banking and finance though conventional banks setting up Islamic finance windows in compliance with Sharia laws.

**Azerbaijan**

Azerbaijan, a major oil-based economy located in the Caucasus region of Eurasia, reported a GDP growth of 41.7% in the 1st quarter of year 2007 (higher than any country worldwide) The population consists of over 8 Million Muslims. It is a member of the Islamic Development Bank (IDB) based in the Kingdom of Saudi Arabia. Independent Islamic banks are not yet in established in Azerbaijan, however, banking products in accordance with Islamic finance concept are offered by some banks. The Kauthar Bank, which claims to be an Islamic bank, offers, Mudaraba, Musharaka and sells bank bills similar to Sukuk. The bank is regarded as the first and second in Azerbaijan and the Commonwealth Independent States Countries (CIS
Countries) respectively, to have been working in accordance with Islamic banking concept.

**Switzerland**

Switzerland is the world’s leading financial center for private banking and offers a comprehensive range of financial products and services that are *Sharia* compliant (Qatari Daily, 2009). IBF has been under the spotlight in Switzerland since the advent of the global financial crisis of 2008. Two major banks, UBS and Credit Suisse set up Islamic windows at that point of time to accommodate the entry of funds from the Muslim population who were keen on investments in compliance with *Sharia* Laws. Yet, this lost its pace and the Islamic products and services were more often than not left out by 2013. The interest in *Sharia* compliant financial services and products was, however, rekindled, but with emphasis on the insurance sector. In 2016, the Zurich Insurance Company bought Malaysian MAA Takaful in order to further their insurance in Malaysia.

**Spain**

Spain, a sovereign state, situated on the Iberian Peninsula in Europe, is among the several countries that expresses interest in IF industry. The Saudi-Spanish Center for Islamic Economics and Finance (SCIEF) is a result of the collaborative efforts between the Islamic Institute at King Abdulaziz University in Jeddah, Saudi Arabia and the IE Business School based in Madrid, Spain and has been operational since 2009. In accordance with the World Savings Banks Institute (WSBI, 2009), “La Junta Islamica” (wich is Spain’s National Islamic Institute), has initiated the process for setting up Islamic banks in Spain, the first phase of which would involve setting up an Islamic window in the Spanish bank, Bancorroses.

**Luxembourg**

After the US, the second major investment fund centre is Luxembourg. It is the foremost reinsurance captive marketplace in the European Union. The largest
contribution to the economy comes from its financial sector. Luxembourg was the first chosen country in 1983, for setting up *Sharia* compliant insurance “*Takaful*” in the European region. Additionally, its stock exchange was the first to step into the Europe stock market to trade in *Sukuk* in the year 2002 (Flatter and Pie-Pierron, 2009). Luxembourg, in September 2014, issued its first sovereign *Sukuk* and is predicted to host its full-fledged Islamic bank.

**Ireland**

Ireland is one of the European countries to facilitate the issuance of *Sukuk*. As per the Price water house Coopers, the Ministry of Finance in Ireland had introduced important amendments to enable Islamic financial transactions. In April 2017, Saudi Arabia listed its *Sukuk* (biggest-ever *Sharia* compliant bonds) on the Irish Stock Exchange.

**1.6.3. Islamic banking in USA**

The Amana Mutual Funds Trust, the Dow Jones Islamic Fund and Azzad Funds are some of the financial intermediaries in the USA which offer *Sharia* compliant mutual funds and financing services. The growth of Islamic financial institutions ranging between small community banks to countrywide investment banks and brokerage firms had gained a fair amount of attention during the presidential elections. There are roughly 25 financial establishments providing Islamic financial services in the US. The American Islamic Finance House, University Islamic Financial which is a subsidiary of University Bank and the Harvard Islamic Finance Program began offering Islamic financial services since 2013.

**1.6.4 Islamic banking in Australia**

Australia, with a considerable Muslim population and Muslim entrepreneurs’ investments in different sections of the Australian economy, has great prospects for IBF services. According to the Islamic Financial Services Council of Australia's
(IFSCA) survey in 2016, Australian Muslims possess a high level of wealth and purchasing power. There are an extensive number of financial service providers who provide an extensive variety of Sharia compliant financial products and services. Hejaz Financial Services, Islamic Cooperative Finance Australia, Amanah Islamic Finance Australia, MCCA Islamic Finance and Investments, Iskan Finance, Crescent Wealth, and Islamic Financial Divisions of the National Australia Bank and Westpac Banking Corp are some of the major IF service providers in Australia. In 2008, analysts, in response to a report commissioned by Canberra, put forward recommendations on how Australia can be positioned as a Asia-Pacific financial hub in the region which also included the promotion of IBF in Australia.

1.7 KINGDOM OF BAHRAIN- A KEY PLAYER IN THE GCC

1.7.1 The structure of GCC

The Gulf Co-operation Council (GCC) is the political and economic association of six Middle Eastern countries— Three constitutional monarchies (State of Qatar, State of Kuwait and Kingdom of Bahrain), two absolute monarchies (Kingdom of Saudi Arabia and Sultanate of Oman) and one federal monarchy (the UAE, which consists of seven member states, each of which is an absolute monarchy with its own emir). On 25th May 1981, the Charter of the Gulf Cooperation Council was signed in Riyadh, Saudi Arabia, formally establishing the institution. The primary rationale of the GCC is to attain harmony between its members on the basis of objectives, identical political and cultural identities which are ingrained in Islamic beliefs.

1.7.2 History of Bahrain

Bahrain is home to the early Dilmun civilization. It has remained eminent for antique pearl fishing which is deemed to be the finest on a global level in 1900s. Bahrain, among the initial regions to convert to Islam (AD 628), was occupied by the Portuguese in the year 1521, who were ousted in 1602. In the late 1800s, after
entering into consecutive treaties with Britain, Bahrain became independent in 1971. Previously an emirate, Bahrain was affirmed a Kingdom in the year 2002.

1.7.3 Bahrain’s geography

Bahrain is officially known as the Kingdom of Bahrain. It is an Arab legal realm in the Persian Gulf. It is an island country that consists of a small archipelago located around Bahrain. It is located amid the state of Qatar and the north-east coastal region of KSA and is linked by a Causeway which is 25 kilometer long. It is 765.3 square kilometers in size and thereby, the 3rd smallest country in Asia preceded by the Republic of Maldives and Singapore. The present population of Bahrain is 1,558,040 as of May 2018, based on the latest United Nations estimates. Bahrain's population corresponds to 0.02% of the total world population. Bahrain's rank is 152nd in the listing of countries in terms of population.

1.7.4 The economy of Bahrain

In Persian Gulf, Bahrain is the first economy which discovered post-oil era. Ever since the late 20th century, it has been incessantly investing in and promoting the banking and tourism sectors. Manama is the country’s capital and hosts several huge financial institutions. With a high Human Development Index, Bahrain has been recognized as a 'high-income economy' by the World Bank.

The economy of Bahrain has been considered as a fast growing in the Arab world, in accordance with a report published by United Nations Economic and Social Commission. In addition, it has the most liberal economy in Middle East Asia. London’s Global Financial Centers Index quoted Bahrain as the world’s most rapidly raising financial center. The provincial boom resulting from the oil demand specifically led to added benefits to the banking and finance sector of Bahrain.

Economic circumstances have been oscillating with the varying oil prices since 1985. Having initiated the Middle East region’s oil manufacturing since 1932, Bahrain has established the fundamental structure for the oil industry in the region. This led to modernization of its economy and diversifying into finance and tourism
in addition to the conventional pearling and fishing industries with a highly appreciated regulatory structure.

### 1.7.5 Islamic Banking in Bahrain

Recently, Bahrain emerged into an international leader in the field of Islamic finance. Bahrain is home to the biggest cluster of institutions of Islamic finance in the region of Middle East.

Bahrain has nearly 400 approved monetary institutions, presenting a prosperous combination of multinational, provincial and regional names. They provide a complete assortment of monetary services, with specific focus in wholesale banking, asset management and insurance. The banking sector is currently the most significant segment of the financial system, occupying up to 27% of total GDP of the country. The financial and monetary sector is also the main solitary employer in Bahrain, with the work-force comprising of 80% of Bahrainis.

The sector is synchronized and monitored by CBB, which has operated as the sole supervisory body for the complete monetary system since 2002. Bahrain’s banking system has both CBs and IBs and is the chief constituent of the monetary system, totaling for more than 85% of the total monetary assets. The conventional section constitutes 19 banks in the retail banking section, 69 banks in the wholesale section, two specialized banks along with thirty six offices of Overseas Banks. The Islamic sector offers a range of Shariah Compliant products and services and includes 6 IBs in retail wing and 18 IBs in the wholesale section and the figures are rising continually. The banking segment contributed significantly to the surfacing of Bahrain as the foremost financial center in the GCC.

### Basel Committee on Banking Supervision (BCBS) and BASEL III

BCBS was set up by Governors of Central Banks of 10 countries in the year 1974. The key purpose of the establishment of the BCBS is encouraging convergence in terms of common standards and approaches for banking. It offers a forum to enable cooperation in banking supervisory issues. The main objective of the BCBS is to
achieve enhanced understanding of primary issues related to supervision and improved worldwide quality of banking supervision.

The regulations issued by BCBS are not binding but function as an informal forum where the development of policy solutions and standards happen. These international guidelines include the main principles for effective supervision of banks, the capital adequacy standards etc. which are put forward by the BCBS.

Post financial crisis, the reforms of regulatory requirements to be met by banks in terms of capital adequacy (known as BASEL III) were introduced by the BCBS. Buffers, leverage ratio and liquidity risk in international harmonization and requirement were introduced through BASEL III. In doing so, the specificities of Islamic banks were not taking into consideration. According to Boumediene (2011), a study based on Al Rajhi Bank under the revised framework revealed that the reform in BASEL framework is on par with the Islamic banking business model. The reforms put forward the instruments from debt-based to equity-based. Additionally, the surplus liquidity maintained by Islamic banks is an added benefit under the BASEL III framework.

In the case of Bahrain, both IBs and CBs are presently needed to apply capital adequacy ratio of 12% in compliance with BASEL III.

Islamic banks in Bahrain offer a wide range of products such as Mudaraba, Musharaka, Murabaha, Ijara, Al Salam and Istitsna'a and other structures employed in conservative finance, suitably customized in accordance with Shariah principles. Adding up to the many Islamic finance institutions actively involved in its monetary segment, Bahrain is home to numerous organizations crucial to the growth of IF, including:

i. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)
ii. Liquidity Management Centre (LMC)
iii. International Islamic Financial Market (IIFM)
iv. Islamic International Rating Agency (IIRA)


Ever since the 1970s, Bahrain has remained a popular hub for IF owing to the lawful offshore banking and globally established regulations. In 1979, Bahrain Islamic Bank is established in Bahrain which is the first-ever Islamic commercial bank in Bahrain and the third bank in GCC. The Central Bank of Bahrain has obligated an all-inclusive prudential and authoritarian structure for IF institutions. In addition, the CBB has set up a special fund (Waqf fund) to support the financing of research, in the field of IF along with education and training. Grigorian et.al 2005) opined that the banks in Bahrain are far more efficient technically than many other banks in and around GCC.

1.8 INDIA-THE EMERGING SUPERPOWER

India is one among the two of the earliest civilizations that date back to almost 5,000 years, which withstood testing times and survived. The number system, the theory of zero, geometry, fundamental logics, algebra, probability, calculus, astronomy etc. were all invented in India. India has an extensive history of cultural interaction with several regions of the world. Many religions with their roots outside India such as Christianity, Judaism, Islam, Zoroastrianism, Bahá’í Faith have established supporters in India. The culture of India has spread to other foreign lands through nomadic traders, theorists, relocation and less through invasion.

The Republic of India is counted among one of the rising superpowers of the world. This is attributed to more than a few indicators, the prime ones being its demographic development and a swiftly growing economy and in terms of Gross Domestic Product India became the fastest rising economy in 2015 with 7.3% of GDP rate.

India is a home to multi-religious civilization along with multi-lingual and multi-ethnic groups existing collectively. The nation’s lengthy and varied history has
bestowed it with a unique diverse culture. It is mostly related to spirituality. Owing to its history of both aboriginal and overseas influences the early Indian religions. The current Indian civilization is budding into a composite combination of them, thus leading to the conception of several synchronized mingling of faiths such as Sai Baba of Shirdi.

The public in India is more open to adapting contemporary influences from the west into their civilization and media, as a result a convergence of its historic home culture with the innovative western culture (Social Globalization).

1.8.1 Economic growth

The Indian economy is a mixed economy developing continuously. It occupies the sixth position in the world as per the GDP. When considered the Purchasing Power Parity, it is the third largest. As of 2018, it got 122nd rank in per capita GDP (PPP) and 139th rank in per capita GDP (nominal). After 1991 economic liberalization, India has achieved 6-7% average GDP growth per annum. After the financial Year 2015, the Indian economy emerged into the fastest growing foremost economy leaving behind China.

1.8.2 Banking and finance sector

The finance service industry added $809 billion which is 37% of the Gross Domestic Product and engaged 14.17 million people amounting to 3% of the total workforce in 2016. In the same year, the banking industry supplied $407 billion which is 19% of Gross Domestic Product and created 5.5 million jobs amounting to 1% of the workforce. The Indian capital market is organized into public, private and foreign-owned commercial banks and cooperative banks, collectively called 'scheduled banks'. It also has the individual or family-owned native bankers or money lenders and non-banking financial companies. The unorganized sector and micro-credit are favored over CBs in many sub-urban and rural areas, particularly for reasons such as issuance of short-term loans or advances for special occasions, rituals and ceremonies.
The gross domestic savings in India for 2006–07 in terms of fraction of GDP accounted to 32.8%. From the personal savings, more than half was invested in assets such as gold ornaments, residential and commercial buildings, houses, lands, cattle etc. More than 75% of total value of assets is held under the control of public sector banks whereas the share of private and foreign banks together is around 24.7%. Due to liberalization, noteworthy developments in the banking sector are permitted by the government.

1.8.3 Islamic banking in India

Though India is the world's second largest Muslim population country, Islamic means of finance are not yet established as an institution in the nation. In India, the setting up of financial institutions in compliance with Shariah principles happened way prior to the organization of a small number of most major Islamic finance institutions universally. But owing to the legal and other obstacles, their growth did not continue for a longer time. Ever since the commencement of contemporary Islamic banking, several attempts towards establishing a Shariah compliant banking sector in India, but, financial laws have restricted the entry of Islamic banks into India. In the previous years, the deliberations on the requirement and viability for modifications and amendments to the prevailing legal structure are raised in specific to the “Banking Regulation Act 1949”.

The merits of Islamic banking for India will be better appreciated if considered in conjunction with the demographic profile of the Indian population. The Muslim population in India at present is roughly 14 percent of the total population (2011 census). The introduction of IBF in India will augment the financing opportunities available for Muslims as well as other communities. The system of Islamic banking which functions on the Sharia principles provides a viable unconventional alternative to the conventional banking system.
1.8.4 Islamic financial products permissible under present regulations

The de-regulation of interest rate in the current regulatory framework has allowed access to banking and financial services in compliance with Sharia principles. In accordance with the current banking regulations in India, the following banking products/services fall under the latently Sharia-compliant category offered by subsidiaries in the banking sector:

A. Deposit type products and services

i. Savings deposits at zero interest
ii. Current Accounts
iii. Safe Deposit Lockers
iv. Online Trading
v. Internet banking services for receiving, paying out and transferring funds at a fee.
vi. Consultancy Services (on a commission basis) for customers who seek Sharia compliant Investments in Mutual Funds/Equities/Preference shares

B. Finance and investment type products and services

i. Investment in Equities/Mutual funds of a listed company (chosen after Sharia Screening)
ii. Leasing
iii. Hire purchase business
iv. Bills of discount
v. Factoring of debts
vi. Foreign exchange Services
vii. E-Freight Services
viii. E-Taxation services
ix. Issuance of Bank drafts
x. Letters of credit by charging a fee
xi. Sale of Gold Coins on a retail basis
xii. Gift Cheques
1.9 INDIA AND BAHRAIN- WHAT THEY HAVE IN COMMON

Bahrain is a cosmopolitan country with an ethnically diverse population. Though being an Islamic state, Bahrain is immensely tolerant towards other religions. There are Hindu temples, Catholic and Orthodox churches in the country. The population of Bahrain is ethnically diverse and consist at least 8 to 9 diverse ethnic groups.

![Religions of Bahrain](image)

**Figure 1.4 Religions of Bahrain**

Though Islam is the official religion in Bahrain, the population consists of people from different ethnicities, religions and cultures. The outlook of the people is highly secular and people from various ethnic and/or religious groups are free to practice their religion within reasonable limits. Freedom in terms of conscience, freedom to perform religious practices and holding religious parades and meetings within the limitations set by the Government are provided by the Article 22 of the Bahrain constitution.

Bahrain sets a noble example in terms of religious tolerance in a time where Islam and Islamic countries are often treated with skepticism. While ensuring that all the
due respect is given to Islam, Bahrain is a country that stands for treating all other religions with equal respect.

India, on the other hand, does not have an official religion. The Republic of India, often referred to as the “Indian Subcontinent” is home to people from different religions and cultures.

The diversity of ethnic and religious groups that constitute the population of both India and Bahrain is one of the most significant characteristic that both the countries have in common. Additionally, the tolerance and religious freedom that both the countries stand for, in spite of the population consisting of one major religious group is commendable.

The relevance of these characteristics to the research is that when Islamic banking has achieved and continues to achieve notable growth in a country like the Kingdom of Bahrain where there is a sturdily established conventional banking system and the population consists of people from different religious groups, it may be safe to infer that the Islamic banking system could make a significant contribution to a country like India which is home to roughly 10% of the world's Muslim population.
Islamic banking in India could cater not only to the Muslim population in the country, but to people from other religious faiths. The success of IBF products and services in other countries stands witness to the point that IB is for people of all religions.

1.10 SIGNIFICANCE OF THE STUDY

Conventional banking possesses an extensive history of augmentation through the participants like shareholders, lenders, creditors, regulators, investors etc. These banks are involved in transactions by levying interest on the advances made to the needed people who are borrowing and also paying depositors some interest for extending sources of funds with the motive of securing a profit. To meet the rising needs of customers, ground-breaking products were presented and markets were unstable leading to a crisis. The sternness of the crisis led to the appraisal of capitalist financial system and exploration for idyllic alternatives. The financial crisis experienced in the worldwide financial system has drawn attention to Islamic banking which is likely to be an alternate source of banking based on the principles of Shariah and works through PLS model (profit and loss sharing). Islamic banking accentuates transparency, undue risk avoidance, exclusion of interest (riba) and ambiguity (gharar). Islamic banking, is parallel to conventional banking in terms of the intermediation process, but the approach is based on Islamic economic and legal values established. These values are created in the beginning period of Islam based on risk-sharing methods of finance against the other financing which is interest-based (Van Schaik, 2001). Due to the principle of prohibition of interest Islamic banks avoids investments in subprime mortgage based securities like conventional financial institution. Hence they did not incur any losses due to sub-prime loan but they were not wholly unmoved from the crisis but acted as shock absorber during the crisis.

The worth of Islamic banking has risen greatly in recent years, with many of the world’s largest banks presenting financial products based on Islamic interest-free models with the exception of a few. Several countries have adapted Islamic banking
while, in few of them, *Shariah* compliant products are offered by conventional banks through Islamic windows.

Numerous academic journals and periodicals have reported research on comparison pertaining to the origin, growth of conventional banks and Islamic banks along with their performance.

![Figure 1.6 Focal points of the current study](image)

### 1.11 Scope of the Study

The scope of the research is to categorize the similarities and distinction of conventional and Islamic bank in terms of their operational framework. The scrutiny of internal variables from the financial statements reveals the trends and ascertains the parameters of growth; point out financial performance of IBs and CBs in Bahrain. Another significant dimension of the current study is to gauge the perceptions of Expatriate Indians towards the futuristic prospects of Islamic banking in India. The underlying purpose of such exploration is to acquire the opinion of respondents who have had the experience of being customers to both
conventional and Islamic banks as against respondents who have only had the experience of conventional banks alone.

1.12 RESEARCH OBJECTIVES

In this study, a thorough evaluation of the comparative growth of IBs and CBs was carried out along with their performance comparison. The financial statements of the banks selected for the study for the period of 2007 to 2016 have been analyzed. Through this research an effort is made to present the aspects that, both similar and distinct, between IBs and CBs. The following are the specific objectives considered in this study.

1. To explore the principles and products of Islamic banks and compare the similarities and distinctive features of IBs and CBs.
2. To compare the growth of IBs and CBs in Kingdom of Bahrain.
3. To evaluate the comparative financial performance of IBs and CBs in Bahrain.
4. To ascertain the perceptions of the Expatriate Indian community (Customers of Islamic banks in Bahrain) towards the future prospects of IB in India.
5. To highlight the benefits of IB to India.

1.13 RESEARCH METHODOLOGY

The methodology used for the study comprises of three distinct phases.

The first phase focuses on a comparative analysis in terms of principles, similarities and products of both the types of banks. It also covers the operational differences of IBs and CBs and is descriptive in nature.

The second phase involves applying quantitative and analytical techniques to financial statements of banks obtained from secondary sources for measuring and comparing the growth and performance of IBs and CBs in terms of acknowledged growth variables and financial performance parameters.
The third phase involves the use of questionnaires for obtaining data from selected respondents to gauge the perceptions of Expatriate Indians who have experience of Islamic bank services towards the prospects of Islamic banking in India.

**1.14 OUTLINE OF THE THESIS**

The proposed thesis will comprise six chapters.

Chapter 1 will shed light on the background, evolution, history of IB and also its global scenario. There is a write-up on the state of Islamic banking around the world which also overs in detail about the position of IB in Bahrain and India. The significance of this study, research objectives and brief note on methodology are also covered in the first chapter.

Chapter 2 will include the literature review in a two-fold plan: review of literature available about Islamic banking in GCC/ Bahrain/Other countries and review of literature available on futuristic scope/prospects of Islamic banking in India.

Chapter 3 will comprise of the methodology adopted for the current research with details about the variables of growth and financial performance indicators used for the study. It also covers the research design, sources of data, sampling method, size of the sample, statistical techniques used for analysis.

Chapter 4 will highlight in-depth description of the principles of Islamic banking, the important modes of Islamic finance, its characteristics, similarities and distinctive features from conventional banks. In addition, a SWOT analysis of Islamic banking and prospective benefits of IB to India will be included.

Chapter 5 will provide the analysis of data collected from primary and secondary sources. The comparative analysis of IBs and CBs with regard to their growth and performance in Bahrain is covered in the first section whereas the next section deals with the data analysis and interpretation of the sample respondents collected through the questionnaire in terms of their perception towards the future prospects of Islamic banks in India.
Chapter 6 will include the key findings of the study, recommendations and scope for future research on the topic.

1.15 SUMMARY

This chapter highlights the significance of a financial system in an economy. The financial system continuously strives to facilitate the provision of different products and services to the household sector though its financial institutions in return for investments and sharing of risk. A summarized depiction of the origin, evolution and the systematic role alteration of the banking system are given. The scope of this chapter is basically to throw some focus on the emergence and the continuous growth of IB globally with focus on GCC and especially the Kingdom of Bahrain.

The altered function of financial intermediation was to meet with the requirements of household sector with a consideration of growing demands towards savings and investment purposes. Many players emerged into the market with the diversification of products which seemed diverse but functionally stayed constant. The implications of this tendency led to globalization and through liberalization and deregulation creating strong competition throwing new challenges and new realities into the monetary system and lastly, through innovation, an uninterrupted flow of cash, gaining impetus and assurance in the market among the people. Since two decades’ lot of changes were noted parallel to swift developments in field of Information and Communication Technology with the trends in finance theory. The general circumstances of crisis can be perceived as one of the aspects that lead the banking sector to look for innovative solutions which could envelop the new needs of the community with singular financial requirements of the household community who lost confidence.

The research design and methodology are briefly outlined; brief description of the organization of the research work is also shown.