Changes in the Islamic Banking Industry Pre and Post the Financial Crisis

التغيرات التي طرأت على المصارف الإسلامية قبل وبعد الأزمة المالية

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Dissertation submitted in partial fulfilment of the requirements for the degree of MSc Finance and Banking

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MSc Finance and Banking

November-2015

DISSERTATION RELEASE FORM

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Abstract

The banking, investment and lending practices adopted by Islamic banks have recently drawn the attention of many researchers and professionals. This is especially after it emerged that these financial institutions that apply the Islamic banking model performed better during the recent global financial crisis in 2008 as compared to their counterparts that employ the conventional banking practices. Islamic banking is a banking system that operates according to Sharia'h laws, which prohibit charging or receiving interests, or investing in products and derivatives that are prohibited in Islam. Instead, the laws encourage profit and loss sharing rather than transfer of risks. The banks provide a number of financial products in different modes that resemble many products in conventional banking. The Islamic banks did relatively well in comparison to their conventional counterparts during the financial crisis. The performance could be largely attributed to the banking system that discourages market speculation and unnecessary risks while advocating for simple financial transactions based on mutual gains from real economic activities. Besides its apparent resilience during the global financial crisis, the Islamic banking model has been associated with the positive economic growth observed in the economies of Malaysia and United Arabs Emirates in the past three decades. There is a necessity for financial institutions, business institutions, regulatory authorities and consumers to look into specific strategies that would constitute desirable features for a stable and effective financial system. The current research sought to trace the development and rationale of the Islamic Banking model as well as identify the most significant and unique characteristics that have facilitated the resilience of the Islamic Banking sector to economic shocks during the recent global recession. Although Islamic banks performed significantly better in the global financial crisis, they were later significantly affected by the depression that hit the real economy for many countries. Certain lending practices

and investment management guidelines following Islamic banking principles emerge as being desirable for improving the resilience and effectiveness of commercial banks for sustained economic growth and stability.

ملخص

جذبت الممارسات الإقراضية وعمليات الإستثمار والصيرفة المتبعة بواسطة البنوك الإسلامية مؤخرا إنتباه العديد من الباحثين والحرفيين. السبب في ذلك، يعود إلى ظاهرة مفادها بأن البنوك التي تتبع النموذج الإسلامي في الصيرفة كان أداؤها أفضل أثناء الأزمة المالية في سنة 2008 بالمقارنة بالبنوك الأخرى التي تتبع الممارسات البنكية التقليدية. النظام البنكي الإسلامي هو نظام يعمل وفقا لمبادئ الشريعة الإسلامية التي تحرم التعامل بالفائدة (الربا)، أو الإستثمار بمنتجات أو مشتقات ممنوعة في الإسلام. وبالمقابل فإن الشريعة تشجع المشاركة في الربح والخسارة بدلا من تجنب المخاطرة كليا. حيث توفر البنوك الإسلامية عددا من الخدمات والمنتجات المالية في عدة أساليب تحاكي في طبيعتها المنتجات المتوفرة في البنوك التقليدية. وكما ذكر فقد كان أداء البنوك الإسلامية أفضل نسبيا من البنوك التجارية التقليدية خلال الأزمة المالية. وهذا الأداء الجيد يعزى بدرجة كبيرة الى النظام البنكي الذي يحد من المضاربات السوقية ولا يشجع على أخذ المخاطر غير الضرورية بينما يسعى للتعامل بعمليات مالية مبسطة مبنية على الفائدة المشتركة وعلى أنشطة اقتصادية حقيقية.

بالإضافة إلى مرونته وقدرته على الثبات خلال الأزمة المالية العالمية، فقد إرتبط نموذج النظام المصرفي الإسلامي بمعدلات نمو موجبة ظهرت جليا في إقتصاديات كل من ماليزيا والإمارات العربية المتحدة خلال العقود الثلاثة الماضية. نرى أن هناك ضرورة لدى المؤسسات المالية والتجارية والسلطات التنظيمية والمستهلكين للنظر إلى إستراتيجيات محددة من شأنها تكوين مميزات مرغوبه لخلق نظام مالي مستقر وفعال. لقد حاول هذا البحث أن يتتبع تطور الأسس والمبررات للنموذج الإسلامي البنكي بالإضافة إلى التعرف والوقوف على أهم المميزات الفريدة التي سهلت عملية ثباته ونهوضه مجددا وحصانة هذا القطاع ضد الصدمات الإقتصادية أثناء الأزمة الإقتصادية العالمية. وعلى الرغم من الأداء الأفضل لقطاع البنوك الإسلامي خلال الأزمة الإقتصادية العالمية إلا أنه تأثر فيما بعد بشكل كبير بالكساد الإقتصادي الذي ضرب الكثير من الدول. إن بعض الممارسات الإقراضية وإرشادات إدارة الإستثمارات التي تتبع مبادئ النموذج البنكي الإسلامي تبدو مرغوبا بها وضرورية لتحسين النهوض المتجدد وكفاءة الأداء للبنوك التجارية للوصول إلى نمو إقتصادي مستدام وإستقرار.

Contents

1. INTRODUCTION

The significant contribution of the Islamic banking model to economic growth for some Asian countries over its short history and its remarkably stable performance during the crisis has created greater recognition internationally for the financial model. While the principles applied in the Islamic banking system date back to more than four centuries ago, the practice got recognition and formalized application in the 1960s with the establishment of the first Islamic bank in Egypt. The major banks that apply the Islamic laws in their operations are mainly found in the region known as Gulf Cooperation Council (International Monetary Fund par. 3). In such countries as Sudan and Iran, all the banks and other financial institutions operate under the Islamic laws of banking (Chenguel 31).

Apart from the provisions of the Sharia'h laws that banks should not charge interests on borrowed money or support investment in activities considered sinful in Islam, there are also concerns about the amount of risk involved in any given investment. The Islamic banks operate on the principle that one should not invest in a risky project, and the banks try to keep away from projects that are surrounded by uncertainties. Indeed, the Islamic Sharia'h laws discourage banks and clients from speculation and investment in non-promising projects (Saymeh and Orieqat 79; Chenguel 32).

During the recent global financial crisis in 2007-2010, banks and lending financial institutions around the world recorded major losses resulting from their lending linkages with the subprime mortgages to the real estate sector in the US. The effect of the credit crisis was particularly devastating for financial institutions in North America and Europe that apply conventional banking practices compared to financial institutions especially in Middle-East Asian countries that apply the Islamic Banking model. Many research findings and industry views by professionals and scholars have indicated that the financial crisis caused asset price inflation for many financial institutions because banks had rushed into buying subprime-collateralized debt instruments without considering the risks associated with such investments.

The resilience of Islamic banks against the global financial crisis was largely a result of the prohibition against risky financial investments and unique banking products that made available surplus liquidity assets. The Islamic banking system gives much protection to capital, and they can just suffer risks emanating from the profits. Nonetheless, the Islamic banks also did suffer some negative effects from the 2008 credit crisis, which has created the need for further adjustments to improve the effectiveness of the financial model and its conformity to Sharia'h laws. The crisis however brought to the forefront the vulnerability of the Islamic banking model to liquidity risk management, and the comparatively small market share and need for rapid growth of the sector in the context of the global banking industry. There has been a gradual shift of Islamic Banking practices from traditional leasing towards a more cash-based lending to fit the economic realities of Western and capitalist economies as well as compete favorably in capturing a larger market share in the international monetary system. A proper analysis of the industry's development focusing on major banks in key countries of the United Arabs Emirates, Bahrain, Kuwait, and Saudi Arabia applying that extensively apply the model is necessary to understand the remarkable qualities that facilitate resilience of the Islamic banking model to economic crises. This knowledge is important in identifying the general lessons from Islamic banking that should inform change in the conventional financial system.

There is a large collection literature on the basic characteristics, historical development, and uniqueness of the Islamic Banking model. There is however a gap in the existing knowledge of Islamic banking with few empirical studies measuring the influence that the unique model has on competitiveness and growth development for financial institutions as well as entire economies that apply the model. This report gives an analysis of the development changes and specific unique practices of the Islamic banks before and after the recent global financial crisis. The research addresses the growing interest in understanding the differences in resilience between the Islamic banks and the conventional banks. While it is evident from the available literature that the Islamic banks were a bit defiant to the outcomes of the financial crunch, it has to be acknowledged that their operations were at least affected in some way and that there are new practices that they introduced in reaction to the crisis. The author gives a particular focus on the changes that occurred at the Dubai Islamic Bank in the UAE. The author finally provides recommendations on the practices that can be adopted in this banking industry to strengthen the banks' elasticity to future probable financial crises.

2. BACKGROUND AND RATIONALE OF THE RESEARCH PROBLEM

The Islamic banking industry has grown over the years and appears to be among the fastest growing segments of the world's financial industry. The first bank of this kind was established in Egypt in 1963 (Noor and Ahmad 9). Islamic banking has since grown to become a global industry with a net worth of hundreds of billions of US dollars. As at the end of 2008, the size of the Islamic banking industry in the world was estimated at $820 billion (International Monetary Fund par. 4). The main differences of the Islamic Banking model from the conventional Western or capitalist model of banking are the fact that Islamic banking is interest-free since selling of money, and debt is prohibited under Islamic law. Financial institutions using the Islamic Banking model instead have to share in the profits or losses realized by borrowers from investing loaned funds. This feature of Islamic Banking has been put in place as a way of reducing the effect of asymmetric information in terms of moral hazard for the lender and adverse selection effect against the borrower that may underlie and influence the success of the lending contract.

The Islamic banks have many products that are comparable to those provided by the conventional banks such as loans and bonds. For instance, the banks have a product called Sukuks that corresponds to the bonds issued by the non-Islamic banks (Chenguel 30). The only difference between Sukuks and the conventional bonds is that in the former, the issuer does not sell a debt but a portion of an asset leased to the buyer. However, these banks differ from the conventional banks in a number of practices.

The real genesis of Islamic banking is the teachings of the religion of Islam (Ali 21). The Quran teaches that the Muslims have to exercise their Islamic faiths in all their life including the economic activities of an individual (Samad 3). Accordingly, in as much a number of other factors have contributed to the growth of the Islamic Banking industry, the core root of the existence of Islamic finance is the desire to live according to the teachings of Prophet Mohamed. The fundamental difference between the two models of banking is that the Islamic banks operate on the standard of justice preserved in the Islamic permissible code of conduct- Sharia'h Laws (International Monetary Fund par. 4). According to this code of conduct, it is immoral, exploitative, and unfair for the banks to charge interests on the money they lend to their clients (Saymeh and Orieqat 79). This provision does not rule out the fact that the Islamic banks can and should lend money to its clients. Rather, the law requires that the banks do not charge interests but instead share in the profits that the clients derive from the investments funded by the banks. With this arrangement, the banks are also required to share in the losses that may be incurred by the clients in their investments. The principle of social justice stipulates that risks are shared by each of the stakeholders (Samad 3). The banks are required to share both the profits and losses with their stakeholders. With this difference in the banking practices between the Islamic and the conventional banks, it was expected that the global financial crisis would have different effects in the bank types.

The global financial calamity that started in 2007 in the United States had far-reaching negative impacts on the conventional banks. Luckily, there are certain indications that the Islamic banks were less negatively affected by the financial crisis compared to the conventional banks (Almanaseer 178). The different results hint to a significant difference between the two systems of banking. In particular, the Islamic banking system does not allow investment in areas of toxic assets, derivatives, and securities exchange (International Monetary Fund par. 6). Economic analysts believe that these are some of the investments on the conventional banks that would later plunge the whole world into a financial crisis.

However, in as much as the Islamic banks survived the financial crisis better than their conventional competitors, they did not escape certain adverse impacts of the crisis. The interplay between the different economic factors caused by the crisis prompted some changes in the Islamic banking system. For a right understanding of the outcome of the financial crisis on the Islamic banking sector to be developed, it becomes appropriate to focus on the financial performance of some of the large banking institutions that operate under the Sharia'h laws. Accordingly, the author makes reference to the performance of the Dubai Islamic banks in the UAE before, during, and after the financial crisis.

3. OBJECTIVE OF THE PAPER

The principle this research study was to provide insights into the effects that the global financial crunch that began in 2007 had on the Islamic Banking Industry in different economies in the world. The author examines in detail the Islamic banking industry before the crisis and the changes that later took place in the industry following the crisis. It is appropriate that the author provides an analogy to the corresponding changes that were seen in the other conventional banks. The writer is more interested in the role that the Islamic Banking industry plays in the UAE's economic growth and development. The paper then proceeds to highlight the effects that the changes in the Banking sector following the financial crisis had on the economy of the United Arabs Emirates. The analyses are carried out with the ultimate objective of getting the whole picture of the Islamic banking industry. The analyses also aid in providing recommendations on how to improve the practices in the industry.

The paper's primary objective was to examine the changes that occurred in the Islamic banking industry due to the financial crisis. This objective is best achievable by examining the practices that were adopted by these banks prior to the crisis and the new practices that were later introduced in reaction to the crisis. However, it becomes appropriate first to begin by understanding the genesis of the crisis in order to apprehend why some banks performed well in this period compared to the others (Elsiefy 13) believes that a good understanding of the banks' performance during the crisis can be made by first examining the factors that led to the crisis and the practices that are adopted by these banks. The current study extensively reviewed literature evaluating the development, underlying concept and effectiveness of the Islamic Banking model before and after the global financial crisis, with specific case studies where the banking model has been successfully applied in the economies of UAE and Malaysia, and by the Bank of Dubai.

The current study sought to investigate the sources of financial resilience for the Islamic banking model and their relevance in addressing the particular vulnerabilities in the conventional banking environment that emerged during the recent global financial crisis. This entailed correlating the influence that particular banking practices and products have on the changing resilience and vulnerability of Islamic banking as a better financial model, and thereby provide suggestions for improvement of existing shortcomings in the conventional banking system for modern monetary needs internationally. The study further compared the specific similarities and differences between Islamic banking and conventional capitalist banking models and their products. This evaluated the extent to which the differences between similar products offered by the two models had in influencing the resilience and vulnerability of the banking models to the financial crisis, and in facilitating national and regional economic growth development. The study also compared the resilience and reliability of the Islamic Banking model before and after the 2007-2009 Global Financial Crisis. This involved comparing data on financial performance for Islamic banking and conventional banking models before and after the global depression to identify specific areas of improvement for the Islamic banking model.

4. LITERATURE REVIEW

I. Fundamental Principles Governing the Islamic Banking Model

The principal approach to banking that distinguishes Islamic banking from conventional banking is that of financial intermediation (Ali 4). While conventional banks are debt-driven, and their operation entails transfer of risks, whereas Islamic banks are asset-based financial institutions with intermediations that work on the basis of risk-sharing (Mejia et al. 6). In the conventional banking system, the financial institutions welcome deposits from clients, with the deposited amount gaining interest for an agreed period of time or for the duration which the deposits are held by the bank. The banking institution then lends out the funds to other clients who have their own investment plans, charging borrowers a predetermined interest rate that is higher than that awarded to clients who deposit funds. To facilitate lending, conventional banks require clients to supply collateral to assure the safety and repayment of funds loaned to borrowers. The collateral acts as a risk-management strategy, with the bank not necessarily interested in the investment that the client engages in; the key concern of bankers is that the borrowed money is fully repaid.

The main distinguishing features of Islamic Banking from the conventional banking model is the requirement to operate free of interest charges and cooperative intermediation with clients through sharing of profit and loss from investment ventures utilizing the borrowed and banked funds. These two features are recognized to be the main sources of stability and effectiveness for the Islamic Banking model. It is common practice in Islamic banking for the banks to work very closely with the clients. The Islamic banking system is guided by religious, legal, and economic principles. Islamic banking has the important characteristics of Zakah and Qard-Hasan. These characteristics are derived from the Islamic teaching of a need for a just society in which the wealthier people should strive to uplift the lives of the others. Through Zakah (or poor due), every Muslim and Islamic Financial Institution has to pay some dues from their profits to the poor in the community (Samad 3). Qard-Hasan is also derived from both Hadith and Quran encouraging the financial institutions to provide benevolent funding to the poor. Hadith and Quran teach about sharing out what God has given to an individual to create justice and equality in the society.

There are three main Sharia'h laws that form the fundamental basis in the Islamic banking system. Firstly, the law prohibits charging of usury (*riba*) on borrowed funds (Abedifer et al. 2; Chenguel 31). According to the Sharia'h laws that guide the daily life of a Muslim, it is immoral for an individual to give or receive interest on borrowed money. Rather, Islamic banks are required to participate in the prudent investment of loaned funds without earning a predetermined interest income. The prohibition of interest thus requires Islamic banks to innovate new ways that are consistent with Shariah laws for earning an economic reward on funds loaned to clients. As opposed to interest-based lending, Islamic banks have innovated unique substitutes to conventional financial products, which can be broadly divided into equity-type and mark-up price or debt type products that are unique and distinguishing products developed in the Islamic banking model. In line with the law against usury, the Islamic banking model provides that the performance of a bank should not be evaluated only from its profitability, but should take a more holistic evaluation of a bank's performance seeking to strike a balance between economic and moral considerations. In essence, a bank can be judged to be performing well even when the profits are low provided it conforms to the moral standards stipulated in the Sharia'h laws (Abedifer et al. 2).

Secondly, the laws prohibit investments in activities that are sinful according to the Islamic faith. The banks are thus not allowed to invest in those activities or finance the clients who are involved in these activities. Gambling, pornography, and production of alcohol are some of the outlawed activities that should not be financed by the Islamic banks. This in part explains why it is necessary for the banks to be in close working relationship with their clients lest they fund these activities unknowingly. The management of the banking institutions will strive to ascertain that their clients are engaged in genuine businesses. Representatives from the bank may have to go one by one to check and verify the assets that are financed by the borrowed money.

The other important Sharia'h law is one that governs against wealth accumulation via risk-taking (Chenguel 31). It is out of this regulation that both profits and losses are shared by the customer. The clients who deposit their monies with the Islamic banks are considered important stakeholders who must share in the profits or losses made by the banks. It is also considered immoral for individuals and banking institutions to engage in investments that do not involve real economic activities or those that are considered immoral under Islamic faith. For instance, the banks are not allowed to invest or facilitate the investment in the products that are outlawed by the Islamic teachings such as alcohol, tobacco, and pork or activities like gambling. Financial investments funded by Islamic banks must be connected to real economic activities providing ultimate goods and services that are mot themselves financial investments. Although forward contracts are allowed to some extent, Islamic banks are prohibited from speculative trading in financial instruments and their derivatives for the sake of financial profit through changing prices of such securities (Noor and Ahmad 10). It is also a requirement that the banks will share both their profits and losses with the customers. This practice of distributing risks in investments ensures that the banks will maintain a relatively stable net worth even in situations of economic difficulties.

Financial intermediation practiced in Islamic banking requires that the financial institutions get involved in the investments of the loaned funds by their clients (Ali 4). In particular, a bank will entice agents to deposit money with it. The management of the bank then does thorough checks on the individuals or organizations that have applied for loans to ensure that they only fund investments that are viable. The very principle that Islamic banks cannot charge interest on borrowed money or give the same for deposited funds leaves them with the option of sharing in the proceeds of their clients investments. In essence, any agent that deposits money with an Islamic bank becomes a significant shareholder with the bank. This also applies where the bank has financed an asset on behalf of the client- both the bank and the client have shares in that asset up to the point when the client has fully repaid the loan. Principally, Islamic faith considers a loan as something that should be provided as a charity to an individual in need of the resources in order to make a positive change in the society. As provided by the Sharia'h law, a lender may opt to help a borrower with funds for investment without expecting any proceeds or he can lend out the money on condition that he benefits in the investment's profits (Walton 11). In the first case where a lender opts to provide capital support to the borrower, the former will only be entitled to the principal amount that was lent and cannot claim anything on top. In the second case, the lender and the borrower will have to share in the profits of the investment. Since financial institutions are established as business entities, many of the may find it hard just to lend out money as a charity and so it is the second option that is common in the Islamic banking system.

Further, in the asset financing scheme in the Islamic banking system, a bank will purchase an asset on behalf of it customer. The customer uses the asset while repaying the loan (money spent in buying it) together with a fee charged for using the asset. Upon full repayment of the loan, the bank transfers the ownership of the asset to the borrower (Abedifer et al. 2). The system ensures that profits derived from investing borrowed or loaned funds are shared between the banks and their clients. It also provides a mechanism to ensure that no single party takes unnecessary risks in investment (Chenguel 32). In the given case, risk is distributed between the banks and its client. The laws also require the banks to channel the finances to real economic activities. In some of the banking systems such as Murabaha and Ijrah, the banking institutions are required to have knowledge of the purpose for which a client is borrowing money. The banks should also avail to clients the assets that are in their ownership and held by the banks. This knowledge sharing is necessary to ensure that each of the two parties engage in activities that positively contribute to the growth of the economy without violating the teachings of Islam. The effects of the crisis were thus not felt by the Islamic banks because they did not have collateralized debt obligations when the crisis began (Chenguel 32). Islamic banks are not allowed to invest in trading of financial asset and debt securities or in the stock exchange for speculative purposes to earn gains on capital or interest.

Zakah or charity is an important component of the Islamic banking model requiring financial institutions to demonstrate the compulsory social responsibility under Islam to helping the poor and less fortunate in the community. Similar to individuals, business corporations and financial institutions in Islamic society are tasked with bringing about a just and equitable society, which entails the obligation to pay *Zakah* on profit income corporate returns. Financial institutions are further expected under the Islamic banking model to fulfill their Zakah obligation not only in profit sharing but also through participation in development financing for micro and small enterprises, and for trade and agriculture besides their profit efforts targeting larger corporations and industry. This feature of Islamic banking is referred to as *Qard-Hasan* or benevolence that repeatedly emphasizes the principle of Islamic faith towards supporting the poor in spending the income provided to us by God. Benevolent financing of smaller business entrepreneurs is a cornerstone of Islamic economies and finance and expected of banking institutions under the model.

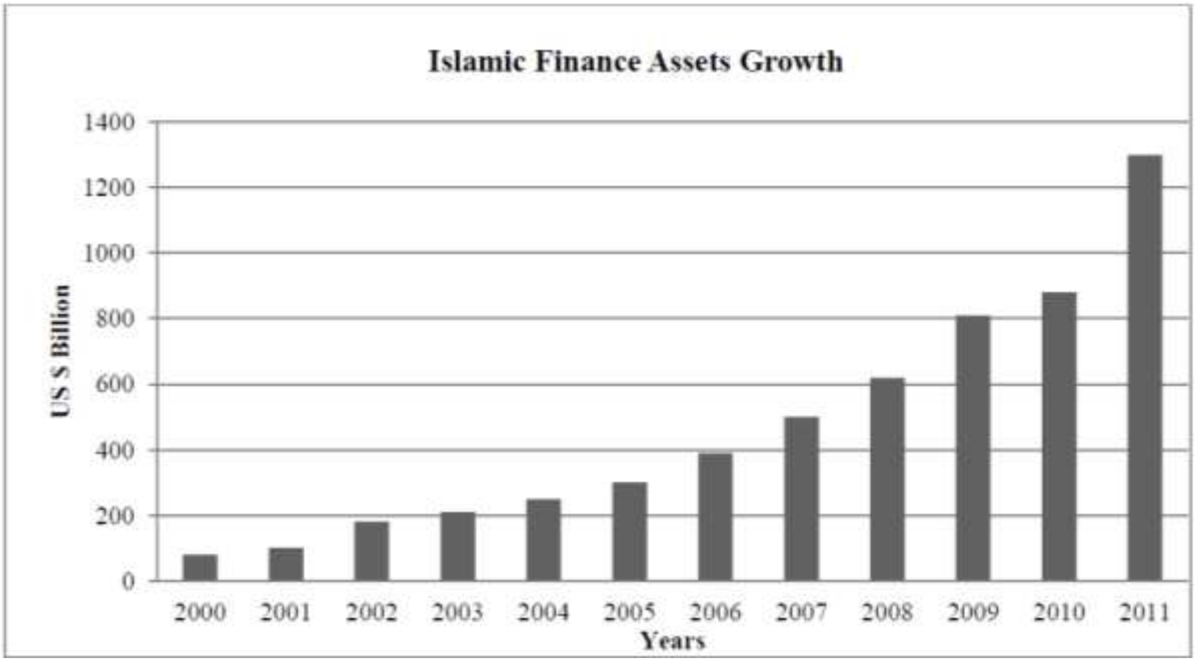
II. Development of the Islamic Banking Sector

Although Islamic banking institutions have operated significantly sophisticated financial institutions since medieval times, the model gained application in modern times beginning in 1962-1963 with establishment of the first Islamic bank in Egypt. Islamic banking came into limelight as a viable alternative to the conventionally used and apparently risky banking and lending model only after the 2008 global financial crisis (Tabash and Dhankar 1070). Since then, there has been keen interest for applying some practices of Islamic banking especially for improving the effectiveness and resilience of conventional banking to recessions and market crises as well as further integration of the banking model as an important component of the global financial system.

The Islamic banking sector in Malaysia is recognized for its pioneering practices that have significantly shaped the modern underlying concepts of the model. The country's first Islamic financial institution, Bank Islam Malaysia Berhad, was established in 1983. The Malaysian government later introduced various policies and regulations that were aimed popularizing the Islamic financing system in the country. In 1993, the government came up with the idea of interest-free banking scheme. With this scheme, several conventional financial institutions among them commercial banks, merchant banks, and finance companies applied the Islamic financing systems in their operations. These institutions established Islamic windows providing Islamic banking products and services. There were 31 conventional financial institutions by the close of 2003 operating under the Islamic banking scheme (Furqani and Mulyany 61). Together with two purely Islamic banks, Malaysian Islamic banking system now had 33 participants.

Islamic banking took off rapidly during the oil boom that followed in the 1970's in many Arabian countries. The Islamic financial model recorded considerable growth especially beginning in the 2000s with a renewed interest in Islamic banks that created high savings and strong economic growth especially for predominantly Muslim and oil-exporting countries of the Middle East. In the late 1980s, the global Islamic finance assets were estimated at $5 billion. As illustrated in the below figure, the asset estimate of the assets had grown to about $80 billion by 2000 and the figure had risen to about $1.3 trillion (Tabash and Dhankar 1070).

Fig.1: Global Islamic Finance Asset Growth (2000-2011)



Source: Tabash, Mosab and Raj S. Dhankar, p.1070.

One Islamic banking model that became widespread in the 1960s was a two-tier mudharaba system. In this system, the banks solicited funds from depositors as investment agents. The bank would invest the borrowed money on behalf of the depositors under an agreement that the two parties would eventually share in the proceeds from the investment using a predefined formula (Ali 4). After such an agreement has been made, and the resources obtained, the bank then enters another two-tier mudharaba with the potential investors who will make use of the money to ensure it earns good profits. An important strength of this approach is that it entails distribution of risks to various parties involved. Nonetheless, the model became less popular with time given the amount of information needed about each of the contracting parties. A new model was later developed in which mudharaba is applied in obtaining the funds while both mudharaba and murabaha are used in financing investments as determined by the prevailing circumstances. In a murabaha contract, the funding bank buys some asset that is required by the investor. The asset is then sold to the investment through deferred payment but with a defined fixed price (Ali 5). It is akin to giving loan but in the form of an asset to the investor.

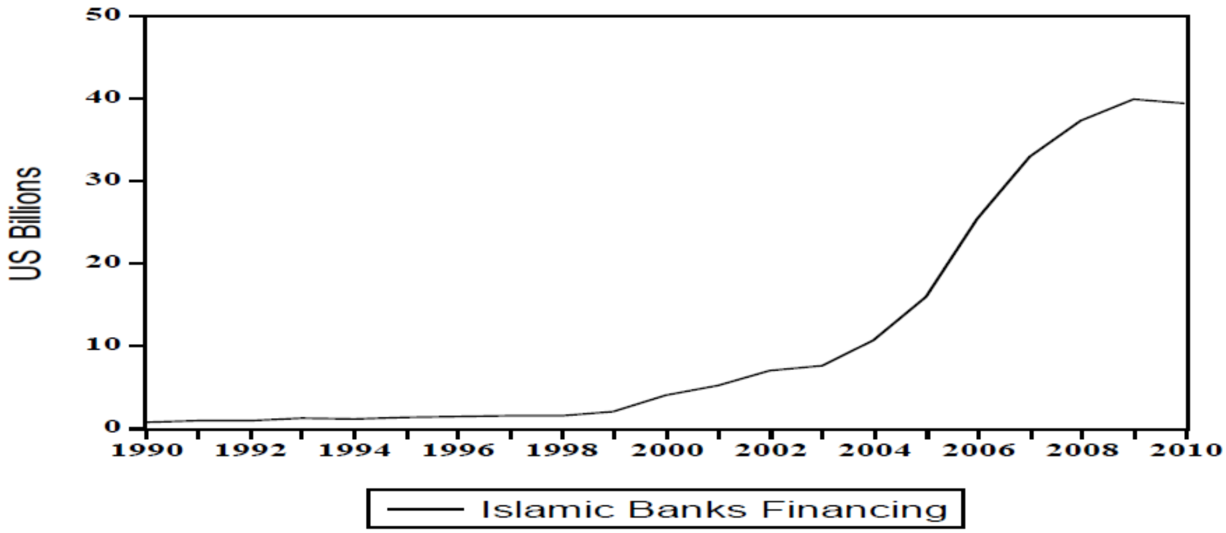
The earlier Islamic banking model involved profit and loss sharing contracts of Musharakah or Murabaha types but recently, the inclination has since changed towards a more sales-based and debt-based financing model (Al Monayea 8). The Islamic finance institutions had to keep pace with these advancements in order to remain competitive in the market. In Musharakah, different partners will bring together financial resources to form capital for some investment. The different partners may take part in the management of the business although it is not a condition. However, the profits will have to be shared between the partners according to the ratio that had been established at the time of making the contract (Samad 2). In case there is a loss, this will be borne by each of the partners in the proportion in which they had contributed to the capital. Today, the Islamic banking provides a number of other financing contracts such as Ijarah (leasing) alongside other banking services such as safe-keeping of money and payments on behalf of the clients. Noticeably, like in the conventional banks, there are small fees levied on such services as withdrawal and funds transfers. There is a gradual shift from traditional leasing towards a more cash-based lending alongside the prevalent equity-like and partnership financing contracts to deal with the excessive liquidity problem being faced by many Islamic banks.

In 2002, it was projected that the number of customers in Islamic banking across the globe would surpass 38 million by the close of 2013. Recent statistics released by Earnest and Young Consultants have indicated that the global Islamic banking sector grew at 19 percent annually in the five years preceding 2012 to reach US$1.55 trillion with more than 435 Islamic banking institutions and 191 conventional banks providing windows to Islamic banking in over 48 countries (Staff Report par. 7). Majority of these customers (two-thirds of them) are found in six countries known commonly as QISMUT, which are Qatar, Iran, Sudan, Malaysia, the UAE and Turkey. Iran and Sudan operate national monetary and banking systems that are fully based on the Islamic banking model. The UK, Bahrain and Malaysia have emerged as key global hubs for Islamic banking, with major Islamic banks being also present in the UAE, Saudi Arabia and Qatar. The United Arabs Emirates is at the center of growth of the Islamic economy, with the tenth World Islamic Economic Forum having been held in Dubai from 28th to 30th December in 2014. The choice of Dubai for this annual function hinted to the country’s potential for growth of

Islamic financing and how that influences both the national and global economy. The 2014 report by the Dubai Chamber of Commerce and Industry indicated that the emirate's recognition of Islamic finance was a vital strategy to become a center for Islamic banking and finance in accordance with the Islamic Economy Initiative of the Dubai capital (Staff Report par. 7).

As the number of Islamic financial institutions increased in the last three decades, some major conventional banks in the west have reacted by establishing Islamic windows and units to serve their Muslim customers who could not engage in interest transactions (Miniaoui and Gohou 3). This reaction even intensified the demand for the Islamic banking products and resulted in many markets in which only such products were allowed. Indeed, after the outstanding performance of the Islamic banks in the crisis, the principles become attractive even to regions that are anti-Islam. The Vatican is among the Christian-dominated regions that were quick to call for the adoption of Islamic principles in banking to thwart future probable financial crises (Hidiyat and Abduh 79). In effect, the Islamic banks are today spread across the globe in both Muslim and Non-Muslim nations. The increasing trend has seen the Islamic banks being established in non-Islamic states such as the United States and the UK. Some of the conventional banks in these countries also provide Islamic windows in efforts to reach out to more clients. At the moment, the financial sector of the UAE is mainly consists of Islamic banks and conventional banks providing Islamic windows products. This implies that much of the remarkable economic growth for the economy in the past three decades is closely linked to the performance of the Islamic banking sector in the country.

Fig.2: Islamic Bank's financing (1990-2010)



Source: Tabash, Mosab and Raj S. Dhankar, p.1073

The global Islamic banking sector is quite diverse and mostly not formalized into uniform banking practice, with many practices being acceptable in one country but not compliant with Sharia'h laws in another. The Islamic Financial Services Board and the Accounting and Auditing Organization for Islamic Financial Institutions are the two most important regulatory and supervisory institutions overseeing the Islamic banking model. A large proportion of the recent expansion in savings amongst Islamic banks has been in the *sukuk* bond contract banking product, with Malaysian infrastructure bonds and financial sector corporate bonds dominating the sukuk Islamic bonds market globally.

III. Previous Research on Islamic Banking Models

Different scholars have shown interest in examining the effects that the global financial crisis had on the performance of organizations in different industries. In the sector of banking, there has been much focus on the effects that the financial crisis had on the conventional banking institutions. The findings from these studies indicate that the financial crisis did have significant negative effects on the profitability of the conventional banks (Almanaseer 176). In the more recent developments, other researchers have had interest in studying the effects that the crisis had on the profitability of the institutions that apply Islamic banking system. Indeed, the financial crisis drew people's attention towards Islamic banking system as it emerged that the banks operating under this system did not suffer huge losses as compared to the conventional ones (Hidiyat and Abduh 79; Elsiefy 13). The resilience is largely attributed by many scholars to the emphasis on trade and asset financing in the Islamic banking system. There have also been different research studies that examine the relationship between Islamic bank financing and the growth and development of economy in a given country.

In one study, Hasan and Dridi (2010) sought to give a comparison between the performance of the Islamic banks (IBs) and the conventional banks (CBs) during the financial crisis. To get a proper insight, the researchers examined the effects that the crisis had on profitability, asset growth, and external ratings of both the IBs and the CBs. They were careful to perform analysis on countries in which both the IBs and the CBs had relatively large market shares. The findings from their study did indicate that there was some significant difference in performance in terms of the above parameters between the IBs and CBs. In particular, the researchers observed that there were better credit and asset growth recorded for IBs than what was observed for the CBs. The researchers noted that the difference could largely be attributed to the different business models applied by the two banking types.

In another study, Beck Demirgüç-Kunt and Merruoche (2010) made a comparison between the performance of the conventional and Islamic banks during the crisis using such parameters as business orientation, cost effectiveness, efficiency, asset quality, and stability. They noted that there were no substantial variations in performance of the two bank types in terms of various indicators. For instance, the findings indicated that the Islamic banks were cost-effective but that such a conclusion was only valid with large sample of countries and it becomes untrue when the analysis is narrowed down to a smaller sample of countries with both banking systems. In the latter case, the findings indicate that the conventional banks are more cost-effective than the Islamic ones. The findings also did not show significant difference in the stability of the bank types. Nonetheless, there was some evidence of a difference in the liquidity holdings of the banks just before and during the crisis. The Islamic banks had increased their liquidity holdings during this period, and it could be the reason their stocks outperformed those of the conventional banks.

Parashar and Venkatesh (2010) carried out their study with a backed understanding that the Islamic banks were safer than the conventional ones when some financial crisis occurs. The researchers understood that the global crisis strongly hit the conventional banks, although the magnitude of the impacts could vary from bank to bank. They also believed that even the Islamic banks were adversely affected in some way by the crisis but pointed out that little research had been carried out in this area. To give more light into the performance of the Islamic and conventional banks during the financial crisis, Parashar and Venkatesh delved more into the different parameters that could describe and provide an excellent comparison of the performance of Islamic and conventional banks. The parameters that were used by the researchers include profitability, liquidity, capital adequacy, efficiency, and leverage. The element of profitability was further broken down and examined in terms of two financial ratios (ROAA and ROAE). The findings from Parashar and Venkatesh's (2010) study showed that the Islamic banks recorded poorer performance in terms of capital ratio, leverage, and ROAE compared to the conventional banks. On the other hand, the conventional banks performed better in terms of return on average assets and liquidity than the Islamic banks.

Almanaseer (2014) studied the performance of 24 banks operating under the Islamic policies in five countries of the Gulf Cooperation Council (GCC). The five nations are UAE, Qatar, Saudi Arabia, Kuwait, and Bahrain. The researcher made use of a linear model to examine the different determinants of profitability of a banking institution. The determinants such as Inflation rates, liquidity ratios, GDP growth rates, capital, risks, and efficiency were used in the linear model to explain the profitability of a given organization. The performance of the selected banks in these countries was examined using pooled data for the period 2005-2012. The findings from the pooled data showed that each of the five GCC countries under investigation recorded a positive economic growth rate during this period, albeit there was some significant variation. The UAE recorded the least GDP growth rate of 3.1% while Qatar recorded the highest growth rate of 13.8% (Almanaseer 178). The countries also recorded varying rates of inflation in the period before and after the financial crisis. In essence, the study by Almanaseer points to the possibility that the Islamic banks were quite resilient to the financial crisis given that no negative trend was seen in the economic growth in these Islamic states.

In another study, Noor and Ahmad (2012) had sought to examine the financial performance of the Islamic banks between 1997 and 2009. The period for which these scholars sought empirical evidence of the banks’ performance is useful in determining the actual impacts of the crisis. It begins way back before the crisis up to the peak in 2009. The authors were interested in the changes that were recorded in the banking practices during this timeframe, which could be ascribed to the crunch. The researchers were interested in the efficiency of some selected Islamic banks in different countries. They derived the efficiency estimates of some 78 Islamic banks using non-parametric envelopment analysis of data. The findings from their study indicated that the Islamic banks have high technical efficiency, which in turn is related positively to their profitability, size, loans intensity, and capitalization. These study findings point to the fact that the banks adopting this system may survive difficult economic situations such as those encountered in the financial crisis. The other important finding from the study was that the efficiency of the Islamic banks had much correlation with the level of economy of a given country.

In their study, Miniaoui and Gohou (2013) sought to examine the performance in terms of profitability and productivity of Islamic banking institutions in the financial crisis with particular interest in the banks in UAE. The researchers obtained financial data from the balance sheet of some 25 banks in the country and made use of a compensational framework to check the difference in performance between the Islamic banks and the conventional ones. The findings from this study were unique and distinct from other related studies. While many research studies have established that the Islamic banks did better than the conventional banks during the crisis, Miniaoui and Gohou observed that the Islamic banks in the UAE performed worse than their conventional counterparts during the crisis. These results were dissimilar from what had been witnessed in the other GCC countries in which the Islamic institutions recorded better performance in terms of credit and asset growth, profitability, and even external ratings. However, the researchers were quick in asserting that following the dismal performance of the Islamic banks in the UAE during the crisis, the banks made adjustments to their practices and began to compete effectively with the conventional banks right after the crisis.

Further, some 2014 report by the Dubai Chamber of Commerce and Industry, developed out of research study by Ernest & Young, indicated that some of the Islamic retail banks in the country had recorded poorer performance in terms of profitability in comparison to the conventional banks. According to the report, the leading Islamic banks in the country recorded lower return on equity compared to the conventional ones (Staff Report para.13). The report attributes such dismal performance to challenges with Islamic banking such as elaborate operation processes, numerous interfaces and high costs associated with provision of a wide array of products.

In a different study, Sarwer, Ramsan, and Ahmad (2013) set out to examine the relationship between Islamic Banking System and Economic development in Pakistan from the perspective of the citizens. The researchers sought the opinions of six interviewees on the role Islamic banking in the country's economic growth and development. The study findings indicated that most of the respondents were of the view that Islamic banking had positively contributed to the country's economic development (Sarwer, Ramsan and Ahmad 63). It was applauded as a more convenient and efficient system of banking as compared to the conventional finance system. The respondents were optimistic that improving the infrastructure for Islamic finance in Pakistan would be an important milestone in promoting economic growth and development in the country.

Overall, the research studies that have focused on the performance of the Islamic banks before, during, and after the financial crisis come to a common conclusion that Islamic banking system is a better strategy than the conventional banking system in mitigating the effects of a financial crisis. With its survival during the financial crisis, the Islamic financial system suffices to be a suitable remedy for similar global financial crises (Saymeh and Orieqat 84). The Islamic principles as applied in the banking context aims at promoting social good for all. This will ensure that no business entities struggle to monopolize given industries and engaging in other money-laundering activities that may plunge the world into a crisis. There are sufficient reasons to believe that much of the problems turning into a crisis emanate from the capitalist approach that is applied in the operations of the conventional banks. There are also indications that Islamic banking may have strong links with the growth of economy given their resilience to various financial difficulties. Nonetheless, the studies also indicate that the Islamic banks were not entirely immune to the crisis. They merely outperformed their conventional counterparts during the crisis, but there are situations in which the conventional banks have outshined them in the financial industry. There are more adjustments to be made in the Islamic banking practices, and this explains some of the changes introduced in the system in reaction to the effects of the financial crisis.

Growth of the Islamic banking sector in developed western countries has been minimal compared to the market size of conventional market as well as in terms of the available demand base for Islamic banking services in these economies. The adoption of Islamic banking internationally notably in developed economies of North America and Europe has been affected by the differing perceptions of the underlying principles that guide the finance model between these economies and Arabian region nations where the model is extensively applied.

IV. Uniqueness of the Islamic Banking model and its Products

Banks operating under the Islamic system provide the banking services just like the conventional ones save for the fact that they do not charge interests on loans borrowed from the bank and neither do they provide interests on money deposited with them. A wide array of banking services and financial contract forms are available under Islamic banking for generating management fees and corporate revenues, and for sharing profits and losses while meeting set conditions for financial transactions under Islam. Fee-based transaction services offered include local and international remittances, online banking and payment, ATM debit cards, safe deposit boxes, and assignment and collection of export and local bills. Ancillary bank services include corporate and public bonds and guarantees, and letters of credit. Islamic banks offer various *Sharia'h* compliant deposit schemes including current and basic payment accounts, saving and safe-keeping accounts, term deposits with various durations of maturity and certificates of investment. Similar to the conventional banking model, depositing customers face a risk-return efficiency frontier in choosing from the range of products available under Islamic banking. Depositors can select whether to allocate funds to safer assets guaranteeing modest return or more risky contracts whose return is contingent on the realization of corporate profit or loss by the bank (Almanaseer 179).

The banks principally operate under the Sharia'h laws that not only prohibit charging of interest on borrowed monies but also guard on the particular investments to be made by the banks and their clients. It may be reasonable for people to question the effectiveness of an economic system that does not allow interests to accrue on capital as practiced in Islamic banking. To fill this gap, there are products in the Islamic banking system that will earn the investors profit on capital and enterprises. Since the Islamic banking model prohibits charging interest, an alternative approach employed by Islamic financial institutions is that of sharing the profits and losses recorded in the banking activities. This approach has given rise to innovative banking products that take the form of equity type and mark-up price or debt type of products that distinguish Islamic banking services from conventional banking products that are interest-based. The *Musharakah* partnership and *Mudaraba* equity-trust financing products are the two equity type contracts in the Islamic banking model, while the *Sukuk* is the main debt-type product under the model. Islamic financial institutions also provide *Murabaha* sale-based financing instruments for asset financing and lease-based *Tawarruq* and *Ijara* instruments where the bank can obtain express ownership of commodity assets (Almanaseer 179).

Under the *Musharakah* partnership equity-type contract, both lending and borrowing parties are required to contribute capital for the particular investment requiring loan financing and share in the risk costs and return accruing from the venture. The sharing of profit derived from the investment is done according to a prearranged agreement that is not necessarily in proportion to the capital contributed by the financing institution and client parties in the venture. The return expected by the financing institution from such a partnership is thus not guaranteed, but in the case of losses, both parties are expected to share the costs in the proportion of their capital investments. The second element in *Musharakah* type of loan contracts is that both parties share and participate in the management control of the investment venture. A third element of such these debt contracts is that liability to the financing institution in the venture is unlimited, therefore both parties remain fully liable for the commitments and actions made in the course of the investment venture.

The *Mudaraba* is a trust financing contract offered under Islamic banking whereby the financing investor provides the capital for the intended venture while the borrowing party provides the entrepreneurial, managerial and labor inputs for the investment. Profits and losses from funded ventures, being a key feature of Islamic banking, are similarly shared by the lender bank and borrowing investor. Profits are shared on the basis of the pre-agreed arrangement and return on funds loaned is thus not guaranteed for the lending bank. The risk of losses is however borne fairly according to the particular stake that each had in the venture, with the financing bank losing capital equity and the entrepreneur loosing management effort and time, the labor force, and market share. Risk and liability is thus limited to the extent of invested capital funds for the financial institution and business management effort and time for the entrepreneur. This is in sharp contrast with the interest-based conventional banking practice where collateral assets usually secure the risk and losses on loaned money and mostly wholly borne by the entrepreneur. Another key element of the Mudaraba contract is the lack of management control in the venture for the financier bank, with the entire management and decision-making role being played by the borrower investor.

The *Murabaha* or cost plus profit margin is another form of debt contract financial service under Islamic banking aimed at facilitating capital financing for asset purchase. In this banking product, the borrowing customer approaches the banking institution for an asset financing loan, and the bank purchases the asset on behalf of the client at the prevailing market price. The bank then sells the asset to the customer at a marked up price. The marked up price thus creates returns for the financing bank in the asset purchase loan venture (Onagun 54). The Murabaha product has however been criticized for its significant costs on the borrowing party and the marked-up price for the asset being equivalent or surpassing the interest costs of loan contracts in conventional banking. This product is nevertheless advantageous for customers in that unlike in asset financing under conventional banking, the eventual acquisition of the asset being financed is assured for the investor since ownership of the asset remains with the bank until the borrower completes repaying the loan amounts. This feature alone makes the product a superior substitute for conventional interest-based asset-financing loan contracts that bear significantly high risk for both financing bank and the borrowing entrepreneur.

The *Shukuk* is a bond product in Islamic banking that denotes debt financing in the form of a certificate of financial securities or order of payment (Onagun 54). A better translation of the word Sukuk would be Islamic investment certificates. In an ordinary bond arrangement, the bondholder has a contractual debt that he is obliged to pay within a specified period. Sukuk, on the other hand, is issued through a unique procedure of Islamic Securitization. The Sukuk are similar to the conventional bonds in that in both cases, there is a fixed maturity period and the holders should receive a regular payment before the maturity date, as well as the final payment at the end (Godlewski et al. 746). In this arrangement, different assets are pooled together, packed into securities then distributed to the potential investors, according to the Sharia'h laws. The banking institutions have much focus on the contents of the Sukuk packages. Sukuk are then issued as certificates of ownership rights to some tangible assets or business venture that are compliant with the Sharia'h laws.

However, Sukuk are not asset-backed securities like the conventional bonds (Godlewski et al. 746). Rather, they are asset-based securities. In effect, one becomes eligible for Sukuk after proper information has been availed on the existence of a tangible asset, service or a project that can be verified by a third party. Sukuk differs from the conventional bonds in that it simply translates to partial ownership of a debt, business or asset, whereas a conventional bond is a commitment by a client to pay for the loan within the agreed period (El-Najar 72). Some of the acceptable assets for which Sukuk can be issued include Mudharaba, Murabaha, Ijarah, and Istisna (Onagun 55). Investments can be made on these assets as single entities or as a combination of many underlying assets.

It is a vital requirement that the Sukuk have to be backed by underlying assets that are compliant with the Islamic laws. This is also a major distinction between Sukuk and conventional bonds. The mere issuance of a document, an Islamic Promissory Note in Sukuk, cannot enable one to obtain funds as is the case with conventional bonds (Onagun 56). There has to be a tangible underlying asset. The securitization guidelines set standards that the certificate has to show that any revenue obtained in the deal must only come from the activities that had been funded (El-Najar 73). Such a standard is necessary to ensure that an income does not emerge that can justifiably be categorized as interest on the invested capital.

Besides, Sukuk are issued to fund investment in tangible assets that have a direct connection to the real economy. This provision has two strengths that are in line with the acceptable Islamic banking practices. Firstly, funding real sector activities implies that the financial institutions will not be involved in unnecessary speculations about the future market trends for a given line of business that may ultimately lead to a crisis (Onagun 56). The bondholders who invest in the Sukuk have the right to obtain information on the underlying assets to increase their confidence. Secondly, dealing in real sector activities implies that the institutions directly contribute to the growth of the country’s economy. It has been reiterated that the Islamic teachings encourage activities that benefit the whole society and not just a few individuals.

Ideally, there are three principal criteria that have to be met by Sukuk in order to be Sharia’h compliant. Firstly, the certificates issued for Sukuk have to represent ownership of tangible assets or services of an organization engaged in a real sector economy (Godlewski et al. 745). Secondly, the payments that are made to the bondholders should come from the profits of the investments after the deduction of the due taxes. Sharia'h compliance will be violated when other payments are made that can appear as interests charged on invested capital. Similarly, it is a requirement that the final balloon payment made at maturity should be commensurate with the current value of the underlying tangible asset at this point of maturity and not the initial value of the asset at the time of investment (Godlewski et al. 745). This provision ensures that none of the parties becomes unfair to the other. There are assets that can depreciate over time while others will appreciate in value. The maturity periods may go for over five years during which several changes might have occurred in the market prices.

One of the major problems with this Islamic banking product is that it is quite hard to attract agents without conditions that violate Sharia'h provisions. It has been observed that many of the banks issuing Sukuk try to twist the Sharia'h laws to enable them issue products that can attract many investors (El-Najar 83). Sukuk should have marked differences with the conventional bonds, but this is not always the case. At the moments, many banks issue Sukuk that have many similarities with the conventional bonds. Moreover, there are numerous risks that are associated with issuance of Sukuk. These include market risk, foreign exchange risks, credit and counterparty risks, and operational risks. There are often no proper mechanisms for the management of these risks and the practice of risk distribution seldom surfaces in Sukuk issuance.

V. Case Studies on the Effectiveness of Islamic Banking in Economic Development

Financial development can be loosely considered as "the surge in the volume of banks' financial services, as well as financial dealings on capital markets" (Furqani and Mulyany 59). In the recent past, development economists have showed some interest in the relationship between this financial development and the growth and development of the economy of a country. It emerges that there is a positive correlation between performance of the financial market and the health and efficiency of the economy (Onuonga 226).

Ideally, the financial system will positively contribute to the growth of a country if it can provide the required financial resources and channel them to the sectors of the economy that require them the most (Tabash and Dhankar 1070). A developed financial system will make it easy for resources to be directed to the most productive activities that will have significant positive contributions towards the growth of an economy. When a financial market does well, it implies that there will be a lot of cash flows and more investments in the economy. Ordinarily, a financial market is healthy when the needs and expectations of both the borrowers and the lenders are met; more people will be willing to deposit their money with the banking institutions and more customers will be willing to borrow money from the banks.

This ease of accessibility of funds translates into better and quicker accumulation of resources that can be channeled to produce the essential products and services in a given market. This is a firm foundation for the growth of the economy, especially when the environment is favorable such as the right government regulations. Besides, a well-developed financial market avails different financial products to the market participants (Onuonga 226). A lender or a borrower will be provided with a variety of opportunities to explore. A potential investor will have the chance to compare the different available opportunities and decide on the one that can give the highest expected returns. Similarly, a client will be able to weigh the offers by various financial institutions and settle on the ones that are quite favorable. Again here, a well-developed market ensures satisfaction by all the participants.

Accordingly, a look at the economic model that links Islamic banking and the country's economic growth can provide a good insight into the general co-integration between these two aspects.

A. UAE

The UAE is among the GCC countries with the economies that are primarily reliant on oil production. Accordingly, the market forces that affect the energy industry will have direct or indirect influence on the country's economic growth and development. The 2008 global financial crisis affected many sectors across the globe among them the energy sector. There were significant drops in oil prices by many producing countries due to reduction in demand for the products. However, the UAE government had various policy responses to the financial crisis and, by 2009, the economy had begun to recover gradually. The government began to restructure various government-related entities (GREs). In the emirate of Dubai, there was restructuring of the Dubai world debt in the efforts to strengthen liquidity in the banking sector (IMF Country Report 2). The emirate of Dubai also obtained financial support from the emirate of Abu Dhabi.

The UAE managed to recover quickly from the crisis due to the diversification that had earlier been effected in the economy. For a long time, the country's economy had largely been dependent on oil exports. The economic growth had been boosted by the good oil prices in the Asian region and the potential for growth. In the later developments, though, the economy became more diversified, and the country was now a potential focal point for different services in the MENA region (IMF Country Report 2). The economic recovery in the UAE after 2009 was well supported by the stable hospitality and services industries. The developments in these industries then strengthened sectors such as transportation and logistics, as well as tourism that enhanced economic growth hence quicker recovery from the crisis. As more and more expatriates moved into the country, there was increased demand for property.

The process of economic recovery strengthened and continued in 2011 fueled by the political factors in the other oil producing countries. During this period, there was civil unrest in Libya, one of the oil producers in the MENA region. The production of oil in the country was disrupted resulting in some increase in fuel prices (IMF Country Report 4). The United Arabs Emirate responded to the shortage by increasing production. There was also considerable growth in the export of non-hydrocarbon products. The net effect was a GDP growth of about 4.9% in 2011.

However, inflation could still be felt owing to the poor performance of the real estate sector following the financial crisis. By 2011, the real estate sector still suffered decreasing housing rents. As of 2012, it was estimated that the real estate prices in Dubai had reduced by 60% from the prices that had been recorded in mid-2008 before the financial crisis had effects on the economy (IMF Country Report 5). Nonetheless, Dubai began to record some impressive recovery in the hotel and retail segments of the real estate as their prices began to rise in 2011. The market vacancy rates for retail and hotel sector were 20% and 25% respectively by the end of 2011. The rate was expected to remain stable or even decrease since there were no new projects that would increase the supply. The vacancy rate for offices in Dubai in 2011 was 30%, but this was expected to increase given that several constructions were underway that would increase their supply. The situation was the same in Abu Dhabi where the commercial and residential rents were still steadily decreasing. The office market vacancy rate in Abu Dhabi stood at 23% by the end of 2011 while that of the hotel segment was the highest at 35% (IMF Country Report 5). These rates were even expected to grow as many projects were underway. With this stalemate in the real estate, the growth and development in the financial sector would certainly be affected negatively. The Islamic banks have much focus on the real sector economy, and real estate is among the assets upon which many Islamic financing products are based.

In the past few decades, banks and the other financial institutions have played important roles in the development of various economies across the globe. The UAE is among the current fastest developing economies in the world characterized by its export of oil products. The country's banking sector is supported by the low-interest rates and high oil prices that boost the economy. The banks in the country can be grouped as national, foreign and Islamic. As of 2010, there were 23 national (local) commercial banks, 22 foreign banks and 10 Islamic banks (Miniaoui and Gohou 4). The banks can alternatively be grouped as conventional banks and Islamic banks. Besides, like in many other countries, there are also conventional banks that have begun to provide banking using the Sharia'h principles through the Islamic windows and products. The national banks are largely controlled by government, private merchants, and the families in government. The earliest Islamic bank to be founded in the UAE in 1975 was Dubai Islamic bank. Several other banks have since been established in the country as the Islamic products gain fame in the global financial industry. As at December 2011, the total assets of the Islamic banks in the UAE were estimated at 200m Dirhams (Miniaoui and Gohou 4). A report by the central banks GCC in 2009 indicated that the UAE had the largest banking system in the region followed by Saudi Arabia.

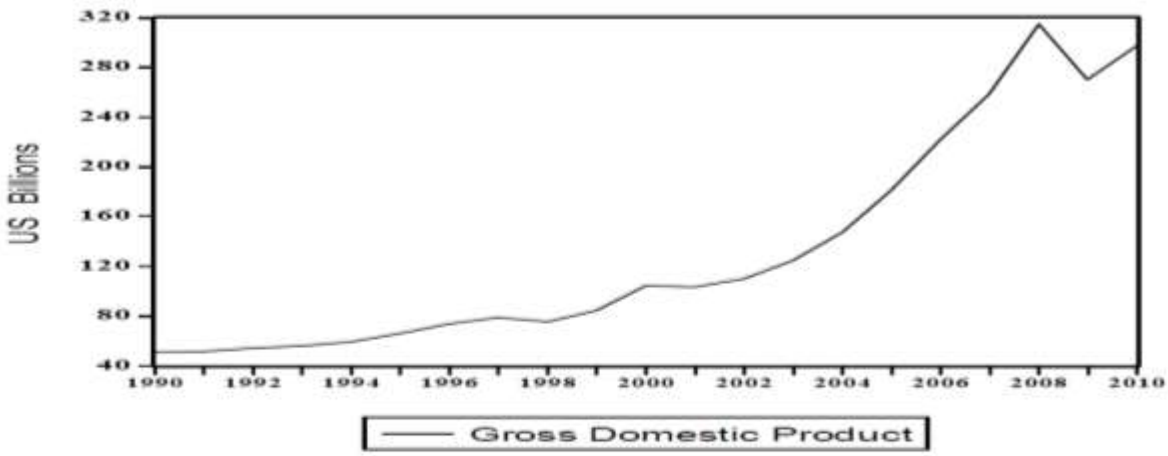
The excellent performance of the country's banking system may be attributed to the established regulations and adherence to international standards. The Central Bank of the UAE (CBU) handles much of the monetary regulations in the industry. For more than a decade, the banks in the country have been using the established International Accounting Standards in their operations (Miniaoui and Gohou 4). The CBU ensures that all the banks implement the Basel I, Basel II, and Basel III Accords and other provisions such as the UAE corporate governance code of 2010. The banks are in the forefront in meeting the capital requirements as required by the Basel III Accord. The Central Bank was instrumental in its policy responses that enabled the banks to avert the adverse effects of the financial crisis in 2008. It has been pointed out that the banking industry of the UAE significantly suffered from the financial crisis compared to many of the other GCC or MENA countries. Fortunately, by 2009, the UAE financial sector was performing better than some countries such as Kuwait and Bahrain (Ali 28). This excellent performance could be pegged on the CBU with its response initiatives to the financial crisis. The central bank reacted by providing liquidity support to the banks in the country whose operations were adversely affected by the crisis.

However, the financial crisis did have some negative impact on the banking industry of the UAE. The growth rate of Assets in the banks in UAE was 40.28% in the period 2006-2007, and that of customer deposit was 46.16% in the same period. However, these figures decreased to 17.07% and 19.56% respectively in the period 2007-2008 denoting the adverse impacts of the financial crisis (Ali 13). Interestingly, except for Kuwait, Egypt, and Bahrain that recorded some similarly decreasing trend in growth rate of assets and deposits, the other countries of the MENA region recorded significant increase in the growth rate of these indicators. For instance, the growth rate of the Assets of Islamic banks in Yemen increased from 7.29% in 2006-2007 to 20.08% in 2007-2008 (Ali 13). However, the economic growth of the country did not receive substantial shock despite the sharp decrease in asset growth rate in banking. In a wider timeline, the available data indicate that the country recorded an average positive growth rate of GDP in the period 2005-2012 (Almanaseer 179) as shown in the figure below. The implication is that the country's economic growth rate did not change significantly following the global financial crisis. This could imply that the overall negative impacts of the crisis on Islamic banks were insignificant or that the banks reacted promptly to prevent prolonged adverse impacts.

A proper analysis of the interaction between financing and economic growth in the UAE can be achieved by applying models in which the financial systems influence economic growth factors such as capital investments and in which economic growth, in turn, calls for a more strengthened financial system. In particular, the very model that Furqani and Mulyany (2009) used in analyzing the relationship between Islamic financing and economic growth of Malaysia has recently been applied by Tabash and Dhankar (2014) to examine the same relationship in the United Arabs Emirates. Like in the previous study, Tabash and Dhankar (2014) used Islamic bank financing to the private sector as the variable representing development in the Islamic finance system. The variables representing economic growth were Gross Domestic Product (GDP), Gross Fixed Capital Formation (GFCF), and Foreign Direct Investment (FDI). The researchers obtained time series data between 1990 and 2010 pertaining to these variables.

The UAE has recorded impressive economic growth over the past two decades or so especially in the provision of financial services. The good market environment has attracted both local and global investors as has been witnessed in the growth of local and international financial institutions (Tabash and Dhankar 1071). The country recorded a relatively steady growth in its GDP until the increasing trend was disrupted in 2008 following the financial crisis. The GDP growth then resumed and was on the rise by 2010 as shown in the following figure.

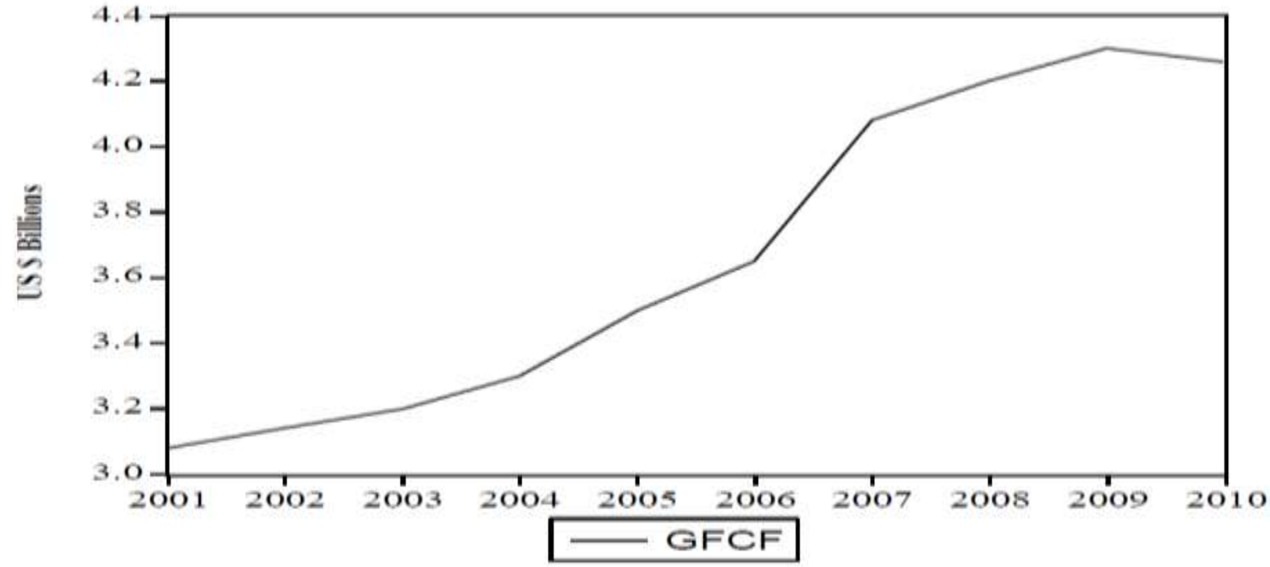
Fig.3: GDP growth for the UAE (1990-2010)



Source: Tabash, Mosab and Raj S. Dhankar, p.1072.

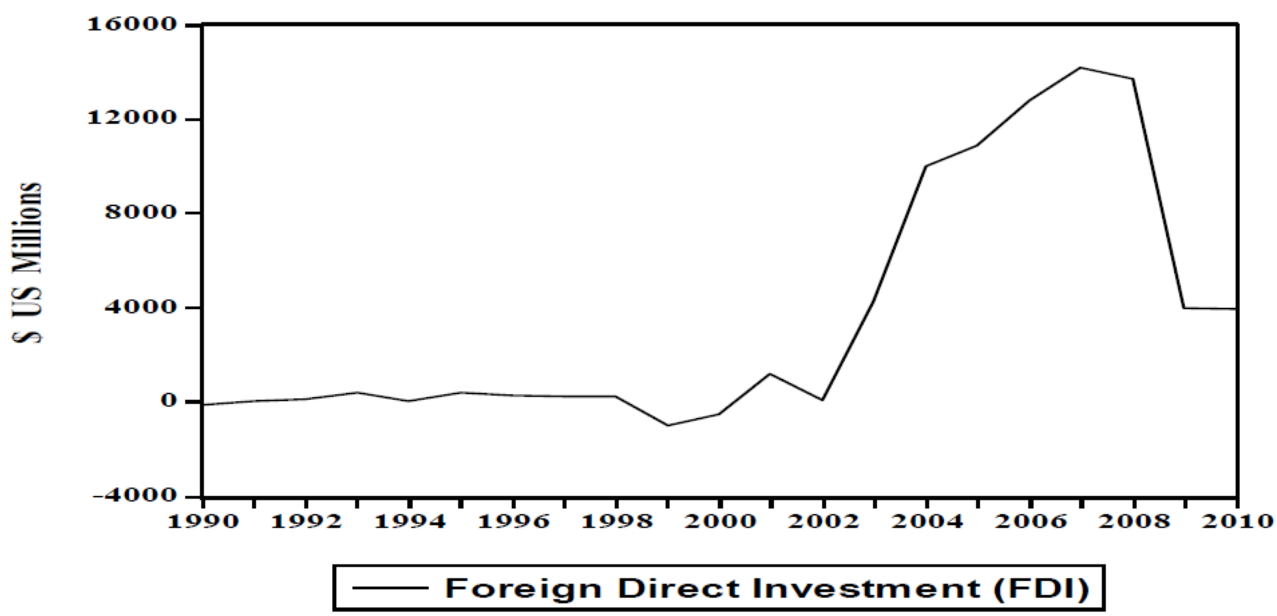
The other economic variables also showed some increasing trend in the long run. The available data between 2001 and 2010 showed that there was a general increasing trend in Gross Fixed Capital Formation up to 2009 when it slowed down. Further, the Foreign Direct Investments were relatively stable throughout the 1990s beginning to fluctuate up and down towards the end of the millennium and in the early 2000s. The FDIs then began to rise in 2002 reaching the peak in 2007. There followed a steep fall in FDIs between 2008 and 2009 from about $14 billion back to around $4 billion (Tabash and Dhankar 1074). The growth patterns in both GFCF and FDIs are shown below.

Fig. 4: Gross Fixed Capital Formation in the UAE (2001-2010)



Source: Tabash, Mosab and Raj S. Dhankar, p.1073.

Fig.5: Foreign Direct Investment in UAE (1990-2010)



Source: Tabash, Mosab and Raj S. Dhankar, p.1074.

The Islamic banking sector in the United Arabs Emirates has recorded a similar impressive performance. The UAE banking sector is the largest in terms of total assets in the GCC region. As of 2010, the Islamic bank assets accounted for 17% of the total bank assets in the UAE (Tabash and Dhankar 1072). The banking sector recorded increasing penetration in the period before the crisis. In 2006, the ratio of credit deployment to GDP was 80.5% while the ratio of deposits to GDP was 83.1%. These ratios increased to 95.4% and 98.1% respectively in 2007 (Tabash and Dhankar 1072). This increased penetration into the banking sector implied that the Islamic Banks in the country had to face stiffer competition from the conventional financial institutions some of which had opted to establish Islamic windows. The following figure shows the trend in Islamic bank's financing in the UAE.

B. Malaysia

Malaysia is in the league of fastest flourishing economies in the world. The country has consistently recorded high economic growth rate since the early 1980s. The country has maintained a Per capita GDP of $3000 as from 1995 and had reached GDP growth rate by 2005 (Furqani and Mulyany 60). It is also one of the top six countries in the world with the largest number of Islamic banking customers (Staff Report par. 6). Some researchers have, indeed, shown interest in studying the relationship between Islamic finance development in Malaysia and the growth of the economy of the country. Furqani and Mulyany (2009) used co-integration techniques and Vector Error Correction Model to study the relationship between Islamic bank financing and economic growth in Malaysia both in the short and long run. The researchers used quarterly time series data from 1997 to 2005 relating to Islamic bank financing and various economic indicators in Malaysia. For this study, Islamic Bank total financing was the variable relating to financial development whereas economic growth was represented by real GDP, real gross fixed capital formation (GFCF), and international trade activities (imports and exports).

Furqani and Mulyany used Johansen and Juselius (JJ) co-integration tests to check co-integration between the variables. The findings from this study showed that, in the long run, there was some significant positive correlation between Islamic bank financing and economic growth, as well as capital accumulation in the country. In particular, the JJ co-integration test showed that Islamic banking positively influenced both GDP and investment in Malaysia in the long run (Furqani and Mulyany 68). However, there was no significant relationship between

Islamic bank financing and international trade activities. In essence, Islamic bank financing positively contributed to the economic growth in Malaysia by boosting its GDP and fixed investment. The growth pattern in GDP is shown in the graph below:

Fig.6: Malaysia GDP Growth Rate (2007-2013)

Source: http://www.malaysiapropertyinc.com/market-intelligence.htm

Further, having established some co-integration between Islamic bank financing and both economic growth and investment, it was necessary to determine the causal relationship. The researchers made use of Granger's causality test in this case. In the short run, the test indicated that Islamic bank financing and economic growth in Malaysia did not have a causal relationship; neither of them led to the other (Furqani and Mulyany 69). Considering each of the variables, however, the tests showed that there is some unidirectional causal relationship between financing and investment. By increasing fixed investment, financing then contributed to the growth and development of the country's real economy. In the long run, there is strong evidence of causality. For investment, there was a unidirectional causality observed in the short run. For the GDP, there was also evidence of some causal relationship but this time it is the GDP that is observed to promote development of the financial systems (Furqani and Mulyany 69). In either case, there is a positive association between Islamic bank financing and economic growth.

Essentially, from the study, Furqani and Mulyany noted that Islamic banks in Malaysia are highly reliable and have largely contributed to the real economic sectors in the country. Interestingly, though, the study found no significant correlation between Islamic banking and international trade. Conversely, the investigators were of the view that non-integration, in this case, could be due to the developing Islamic banking system that still had a small share of the international trade activities at that time. Furqani and Mulyany were optimistic that there was a serious commitment by the Malaysian government to develop an all-inclusive Islamic banking system that is liberal and can easily be integrated into the international financial system. When such a system is developed, then there would be no doubt that Islamic bank financing would also show co-integration with international trade activities.

C. Dubai Islamic Bank

Dubai Islamic Bank (DIB) is among the prominent Islamic banks in the UAE. The bank has recorded considerable growth in the past decade or so and currently has more than 400 branches in the UAE and across the globe (El-Najar 80). It still has a potential for growth and expansion as the banking system gain fame across the globe. The Dubai Islamic Bank was the first modern commercial Islamic bank in the UAE in 1975 (Johnes et al. 2). The bank then started developing its products such as the Islamic bonds in 1978 and equity funds later in the 1990s. One of the banking products offered by DIB is Sukuk- Islamic bonds. Indeed, the bank has risen to become the global leader in management of the Islamic bonds covering a wide array of assets (El-Najar 81). The bank manages the Sukuk through different arrangements among them Murabaha, Istisna, Ijara, Musharika, and Mudharaba. In 2013, the bank issued tier 1 Sukuk that amounted to about $1 billion in the efforts to strengthen its market in Dubai and make use of the available investment opportunities. This Sukuk was issued in the structure of Mudharaba in preference to Ijara that had been traditionally applied. In such an arrangement, a Mudharaba agreement is made between the bank and the Trustee on the investment to be made. None of the parties engages in purchase or sale. In issuing the Sukuk, the Trustee makes an agreement with DIB on behalf of the investors to engage in the general banking activities. In the arrangement, the bank will eventually receive just 1% of the profits derived from the bond investment.

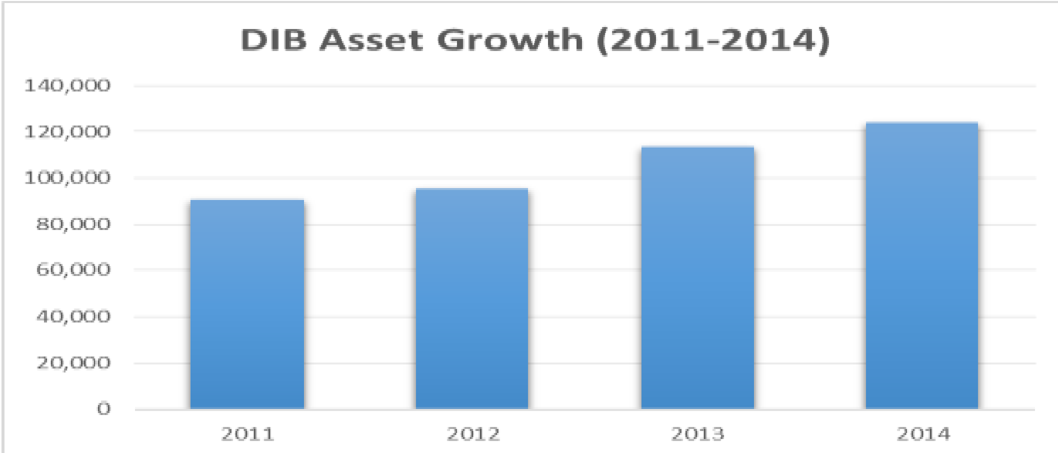
Following the financial crisis, the Dubai Islamic Bank has had considerable concern on the liquidation of the Mudharaba. Several Islamic banks do not have formal liquidity management systems (Paldi 174). Therefore, proper liquidity management becomes a strong competitive edge for this banking institution. There can be instances in which the profit turns out to be more than what was to go to the Trustee as per the agreement. In such cases, the bank will have to retain and transfer the surplus to their reserves. In the event that the Mudharaba capital exceeds the amount that should be returned to the Trustee, the bank will have to continue with the Mudharaba capital to do away with final liquidation. In either case, the bank takes an objective initiative that it deems fit for the initial agreement.

Asset growth at DIB before, during and after the crisis

The Islamic banks are principally asset-based rather than asset-backed financial institutions. Accordingly, one of the effective ways of examining performance of an Islamic bank is to check the trend in its asset growth. In terms of revenue growth, the available data indicate that DIB showed some increasing trend in its total revenues as well as net incomes as from the year 2011. The Bank's total revenues in billions of United Arabs Emirate Dirham (AED) were 2.531, 2.591, 3.324, and 4.718 for the years 2011, 2012, 2013, and 2014 respectively. The net incomes for the bank in billions of AED were 1.010, 1.150, 1.611, and 2.661 for the years 2011, 2012, 2013, and 2014 respectively (Bloomberg Business). The company's gross profits also increased from 2.4228bn in 2011 to 4.616bn in 2014. In terms of total assets (putting together total cash and short-term investments, total receivables, total current assets, and net property plant and equipment), the bank recorded (in billions of AED) 90.5885bn (2011), 98.6112bn (2012), 113.2884bn (2013), and 123.8874bn (2014) (Bloomberg Business). In the previous years, the bank's total assets in billions of AED were 84.3600 (2007), 84.7566 (2008), and 84.3043 (2009) (Dubai Islamic Bank PJSC 3). These data show that DIB has recorded considerable asset growth in the aftermath of the financial crisis. However, there was some stagnated asset growth (a decrease) between 2008 and 2009, which would most likely be attributed to the financial crisis.

But even after the financial crisis DIB has shown consistent asset growth in there balance sheets which is shown in the table below:

Fig.7: DIB Asset Growth Rate (2011-2014)



Source : Dubai Islamic Bank Investor relations

Changes in Practices at DIB following the Crisis

It is important to point out that DIB has adjusted its products in line with the changes that have occurred in Islamic financing in many other countries. It has been observed that the Islamic financing is done through different modes. In the earlier times, Ijarah (leasing or hire purchase) was the commonest mode of Islamic financing. However, in the more recent developments, there has been a shift towards other financing modes such as Murabaha and Mudharaba. At the moment, the former (Murabaha) is the most commonly used mode of financing in the MENA region. In the UAE, Murabaha currently accounts for about 95% of the Islamic financing in the country (Tabash and Dhankar 1073). Ijarah remains as the second most used mode of Islamic financing in such countries as Bahrain, Kuwait, and Jordan. Conversely, Mudharaba is the second most used mode in Saudi Arabia. Istisna remains as the third most used mode of Islamic financing in the MENA region. With these developments, DIB has opted to apply a mixture of different financing modes, the Sukuk above being issued through Mudharaba. There is a host of other products offered through Murabaha or a combination of the two.

With the increasing trend in both Islamic financing and Economic growth in the UAE, Tabash and Dhankar (2014) used JJ co-integration and Granger causality tests to determine whether or not there is some significant relationship and if some causality can be deduced from the relationship. The GDP of a country is a good indicator of economic growth and is a commonly used variable in a finance-growth relationship (Tabash and Dhankar 1077). It is a good measure of the level of Income in a given country. The GFCF measures the degree of investment for a particular accounting period. The increase in new investments implies that the economy is expanding. Similarly, inflow of FDIs pumps in more capital, technologies, and skills into the economy and thus also promotes economic growth.

VI. Impact of the Global Financial Crisis on Islamic and Conventional Banking Models

The financial credit crisis and ensuing economic recession that began in the US in 2007 had far-reaching and lasting negative effects on many economies around the world. The genesis of the financial crisis was a market boom in the American real estate sector caused by low mortgage lending rates during the 1990s. A credit crisis resulted from the excessive pricing above real value and the unexpected market correction that caused drastic reduction in the value of real estate property. Many borrowers could not clear their mortgages, causing widespread mortgage foreclosures. The loan financial securities that were guaranteed using these subprime properties were greatly affected and underwent great reduction in price, causing massive losses and non-serviced loan assets that could not be written off or diversified away in the books of many financial institutions across North America and Europe.

Common lending practices adopted by the conventional banks are often based on speculations of what the market could be in the future. The players in the market make their projections of the future price patterns, thereby creating an element of a virtual market that parallels the real one. Some of the projections may be made based on asymmetrical and sometimes entirely wrong information as happened in the booming subprime mortgages and real estate investment markets in the US prior to the credit crisis. Many studies have pointed out factors such as financial engineering and innovation techniques for banking debt products as well as excessive executive compensation that were applied by many conventional financial institutions in the western developed economies to have largely contributed to the global financial crisis. These approaches to lending, which apparently had short-term goals of increasing market share, eventually ended up in excessively leveraged debt and highly risky investment securities that were intended to diversify risks away from the creators of those financial instruments (Elsiefy 12).

Financial firms were principally hit hard by the crisis, with many financial institutions including some major banks notably Lehman Brothers, Wells Fargo and Citi banks filing for bankruptcy due to the losses incurred in 2008 and 2009 at the height of the crisis. In the US alone, over 140 banks reported for bankruptcy by the end of 2009, with large-scale bank failure that saw 157 banks face insolvency and eventual collapse by the end of the financial crisis in 2010 (Almonayirie and Dubey 92; Hidiyat and Abduh 79; Almanaseer 176). The economic devastation caused by the credit crunch to financial institutions around the world is unprecedented in the more than half a century period following the Great Depression in the 1940s. Conventional banks were able to offer attractive debt and deposit products to ventures that are less optimal in terms of risks since risk, costs and outcomes are hard to ascertain using the model and risk bearing is fully transferred to the borrower controlling the venture. Islamic banks operate as universal financing institutions owing to their equity-like financial products requiring the banks to take ownership of commodities, real estate and capital assets alongside accepting deposits and issuing loans. As such, the banks are required to be cognizant of the storage, maintenance and management requirements for such assets as well as supervise the execution of these responsibilities by their customers. This is unlike conventional interest-based contracts that contain complex provisions for collateral but reduced responsibility for verification, monitoring and control for banks.

The prohibition against taking or charging interests on borrowed money and restriction on the products to be traded were among the factors that insulated the Islamic Banks from the financial crisis. Since the banks are not allowed to charge interests, they were unable to engage in activities that were thought to be the major causes of the crisis such as Collateralized Debt Obligation and credit default swap (Chenguel 29; Almanaseer 180). The Islamic banks had the advantage that they operate under laws that discourage any form of market speculation. The fact that each of the parties (the banks and the clients) has to share risks in the ensuing investment was another characteristic of the Islamic banking system that proved useful in the long run. The Islamic teachings consider risk sharing as an acceptable social justice that should be practiced by the banks (Chenguel 30). Many investors do not wish to take risks, and they find ways of insulation against such eventualities. Lack of hedging was seen by many as one of the major weaknesses of the Islamic banking system as it discouraged investors (Almanaseer 180). However, after the crisis, this practice emerged as one of the strengths of this system. The practice of risk sharing implied that the banking institutions were not all alone in bearing the losses. The Islamic banks did not also suffer much from the financial crisis because they do not rely on funds borrowed from the interbank markets for their operations (Chenguel 31). The banks derive the investment funds directly from their deposits. While the Islamic banks contribute significantly to the global economy, they hardly make considerable investments with the conventional banks. Accordingly, they were insulated from the losses suffered by the conventional banks following the crisis.

Fig.8: The GDP growth rate and Inflation rate of five GCC countries, 2005-2012

Countries	GDP growth rate % (GDPGR)		Inflation % (INF)	
	Mean	S.D	Mean	S.D
Bahrain	5.4	2.2	2.4	1.1
Kuwait	3.5	4.9	5.1	2.5
Qatar	13.8	4.5	5.3	7.5
Saudi Arabia	6.3	2.1	4.5	2.7
UAE	3.1	3.5	5.1	4.7

Source: Almanaseer, Mousa, p.178.

VII. Lessons that were learned from the financial crisis

In spite of the better performance during the crisis, there are some challenges associated with the Islamic banking system that had to be addressed to increase its stability in financial crises. The Islamic banks, like many other financial institutions, provide a broad array of other financial services that contributed to the adverse effects that they felt from the financial crisis. These services include funds mobilization, risk transformation, and asset allocation, among others (Noor and Ahmad 10). An April 2010 report by Islamic Financial Service Board, which was informed by what happened in the financial crisis, pointed out a number of challenges with the Islamic banking system that need to be addressed. These include lack of proper infrastructures and tools for management of risks, a poor legal framework that has not been put to test, insufficient contract harmonization, and lack of supervisory expertise in the industry (Hasan and

Dridi 30). The necessary changes to be made are aimed at improving the efficiency and effectiveness of the operations of the banks in this industry so that they can remain stable in times of financial difficulties.

The financial crisis did point out to the policy makers that management of liquidity risk was an important concern for the Islamic banks. The Islamic banks could boast of the fact that they are stable in terms of funding given that they mainly deal with retail deposits. However, liquidity management in the system has often faced stumble blocks since the system does not allow for tools that can be used as collateral and neither are instruments that encourage huge deposits with anticipation of good returns (Hasan and Dridi 31). The global reform agenda on the monetary policies then needs to focus on coming up with some liquidity infrastructure that works for all the available bank types and can withstand the dangers of the financial crisis.

The other change initiative that was necessary was the harmonization of the accounting and regulatory standards to be adopted by the Islamic banks. After the crisis, regulators expressed concerns that financial institutions, even within the same countries, did not engage in standard financial contracts with well-recognized financial products due to the laxity that was evident in the system (Mejia et al. 21). The Auditing Organization of Islamic Financial Institutions (AAOIFI) and the Islamic Financial Service Board did come up with some international accounting standards to be applied in the industry (Hasan and Dridi 32). However, the Islamic Banks still operated under uneven standards. The banks made use of a mixture of the local and international accounting standards making the operations even more complicated than in the past. Some of the Islamic banks in certain countries were even reluctant to adopt the international standards in their operations. It is imperative to acknowledge the point that it may be difficult to have completely harmonized standards of accounting. Nonetheless, efforts had to be made to ensure that the standards applied by any bank are recognized globally.

The financial crisis also pointed to the weakness that the level of expertise in the Islamic banking industry was not at par with the growth and development that the global financial industry was experiencing. It is necessary that the experts in Islamic banking be conversant with the conventional finance practices, as well as the provisions of the Islamic laws on financial transactions (Hasan and Dridi 32). More and more institutions are being added into the Islamic banking industry yet there is shortage of banking professionals with both conventional and Islamic banking practices.

5. RESEARCH METHODOLOGY

The study mainly aims at explaining the Islamic banking practices before and after the financial crisis. It, therefore, becomes quite necessary first to examine the performance of the Islamic banks in comparison to the conventional banks during the financial crisis. It is then necessary to examine the reactions that the Islamic banks had towards the effects of the crisis. Even if they did better than the conventional banks, the Islamic banks must have also been hit by the crisis. Accordingly, this research employs secondary research methods utilizing data from existing government and corporate databases on the Islamic banking sector. The author relies on different research studies that have been carried out relating to the Islamic banking practices and how they influenced the performance of the banks during the crisis. The key principles that are used in the Islamic banking system are examined in details. There is an explanation of some of the products and financial instruments that define the Islamic banking system. Further, the author makes use of a case study on Dubai Islamic Bank, in the United Arabs Emirates. The financial reports, balance sheets in particular, of the bank are examined beginning in the year 2007 to 2014 to shed light on the impacts that the financial crisis could have on its financial health. The trends shown in the assets and the liabilities sides of the bank's balance sheet at the end of each financial year may provide useful information as to whether or not the financial crisis had some significant impact.

The research approach adopted for this study is an explorative research design utilizing observational methods to collect information from historical statistical data on the banks and economies selected. This study compared empirical data on the performance of Islamic banks compared to that of conventional banks in the UAE and Malaysia to determine the significance of specific unique characteristics in creating resilience against recessions and economic shocks for banking financial institutions. The study utilized two sample groups comprising of 40 conventional banks and 45 Islamic banks pooled from the UAE, Bahrain, Kuwait, Quatar, Saudi Arabia and Malaysia to analyze their performance before, during and after the global financial recession. For the case study research on a specific financial institution, the Dubai Islamic Bank has been chosen because it was the first Islamic bank in the UAE and is one of the largest and pioneering financial institutions in the global Islamic banking sector. A case study on the performance of this bank before, during, and after the crisis and the change in practices can offer understanding into what transpired in the other banks. There is an extended discussion on the relationship between the growth in financial institutions and the health of an economy of a given country. Specific focus is given to the growth and development of banks in the United Arabs Emirates and the country's economic growth.

The study utilized both quantitative and qualitative types of data to investigate the impact that specific qualities of Islamic and conventional banking companies had in determining the performance of these institutions before, during and after the 2008 financial crisis. Data was also collected for three case studies on the extent of saving and investment in the Islamic banking sector in the Gulf Cooperative Council economies, and on the performance of the Islamic and conventional banks selected in the model as well as the Dubai Islamic Bank. The data on performance trends and differences was collected by obtaining the annual financial statements of these banks for the ten years period beginning 2002 to 2012. The performance dependent variable for this study was measured using profitability ratios for the banking institutions. The main independent variables for the study were measured using financial ratio analysis for liquidity and capital structure from the financial statements of the banks studied. Data on the independent variables of total outstanding savings and loans in individual and pooled groups of the banks under study was also collected. The data was analyzed using correlation and regression comparing the relationship between certain qualities of the banks and their financial statements against their performance. The analysis also used statistical measures to compare the effect that certain macroeconomic factors in the economies had on the performance and the asset and capital structure of the Islamic and conventional banks during the period being studied.

6. RESULTS AND FINDINGS

The results obtained from the analysis of results confirmed the findings of many previous studies in Islamic banking model that although Islamic banks were affected by the impact caused by the financial crisis, the effect was significantly lower than the devastating losses suffered by many banks utilizing conventional western models of banking. The differences in the impact of the financial crisis on the Islamic financial model compared to the conventional banking model could largely be attributed to the differences in their operation models that make the later inherently more vulnerable to economic shocks than the former. The prohibition from participating in speculative financial markets shielded Islamic banks from having significant investments in debt derivative instruments for subprime mortgage markets in North America and Europe, thereby insulating Islamic financial institutions from the 2008 credit crisis.

The findings from the study affirmed the theoretical perspective that a well-performing financial system advances economic prosperity in a given country- the data showed strong positive relationship between the Islamic bank financing and the economic growth of the UAE. The JJ co-integration test showed that there was significant co-integration between Islamic bank financing and each of the three economic growth variables: GDP, GFCF, and FDI. In causality, the findings revealed one-directional causal relationship; that is, it was the Islamic bank financing that led to economic growth and not vice versa. The understanding developed thus far was that a well-developed financial system will function like a supply that will prompt transfer of resources from the traditionally non-productive sectors to the most productive sectors of the economy. There will be increased investor interest in these modern productive sectors and hence an enhanced economic growth. The causal relationship between Islamic Bank’s financing and foreign direct investment was found to be bi-directional. In other words, growth and development in Islamic financing attracts foreign direct investments and at the same time expansion in FDIs will call for a more enhanced financial system.

Some shortcomings of the Islamic banking system, which include asymmetrical information and excessive liquidity issues, were confirmed from analysis of the data collected in this study. The requirement for Islamic financial institutions to closely analyze and monitor the investment of loaned funds offsets the disadvantage of lacking fixed interest contracts that fully transfer risk on loans to the borrowers. The costs associated with more involved control and the preference of short-term financing contracts over long-term loans has resulted in Islamic banks concentrating on sale-based and lease-based products, and lower-risk *sukuk* contracts rather than partnership-based and equity-based financing contracts. This is because in the latter two, banks may suffer asymmetrical information that may expose them to higher lending risks and the lack of ready mechanisms for offsetting such risk in partnership ventures. Customers depositing into Islamic banks also face a significant informational burden especially for remunerated accounts since the return is not predetermined and the lack of control in the management of the bank, which creates a strong incentive to analyzing the management and investment activities of banks.

The data on the total customer account balances in different deposit plans reveals the difficulty faced by Islamic banks in managing excessive liquidity and its short-term fluctuations. The rapid development of Arabian oil exporting countries and the macroeconomic conditions that prevail in these economies over the last decade have created a surplus of deposits amid a shortage of suitable compliant monetary investments for Islamic banks. The current level of maturity for Islamic financial system in terms of short-term deposits and loans market is not matched by a similar maturity in long-term financing opportunities to channel pooled short-term deposits funds. Deposits and other short-term funds make up more than three-quarters of the assets held by Islamic banks. This excessive liquidity indicates a lower investment return for customer funds held compared to that achieved by conventional banks.

The excessive liquidity was, however, instrumental in shielding Islamic banks from the credit crisis that affected conventional banks following the collapse of the real estate market prices, especially in the US. The requirements for Islamic banks to link their loan investments to real and viable financial ventures prevented arbitrage trading in financial assets that contributed to credit market bubbles in the west as well as excessive leveraging on non-tangible debt instruments trading practiced in the conventional western financial system. The abundant and mostly liquid financial assets held by the Islamic financial system also shielded the Arabian economies from the impacts of the global financial crisis with the continued availability and provision of credit.

Data on the loan products offered by Islamic banks shows that Murabaha cost-plus and deferred sales markup price products for short-term financing made up an overwhelming 49.5 percent and *Ijarah* financing products taking up 25.4 percent, while longer-term Mudarabah and Musharakah partnership financing constituted only 5.2 percent of the investment portfolio at the end of 2012. The mismatched proportion of short-term loan investments against longer-term channels for funds creates substantial surplus liquidity earning very low return in the balance sheets of Islamic banks. In some countries where the Islamic financing model is well developed, banks can place excessive liquidity funds with the central bank on an *Al-Wadiah* safekeeping basis. The more advanced Islamic banking economies have a *Sharia'h* compatible facility in the form of a financial assets pool valued on a daily basis offered by the central bank for commercial financial institutions to invest their customer's excessive funds.

Despite their immunity from the credit crisis affecting conventional system banks in the western developed countries, Islamic banks were significantly affected by the widespread economic corrections experienced by countries around the world in the great recession in 2009 and 2010 that followed the 2008 financial crisis.

7. SUMMARY AND RECOMMENDATIONS

The future appears bright for Islamic banking as many individual investors and organizations get attracted towards the practices. In the earlier times, there were doubts as to whether or not an economy could run without interests. The operations of conventional banks had largely attached economic growth to interests. However, the flourishing of Islamic banks and different economies has proved that indeed an economy can run on trade and profits as opposed to deficit budgeting as required in Islamic finance. The banking system just requires certain adjustments to ensure that it contributes to real economic growth as was envisioned by the pioneers of such a banking system. The fact that Islamic banking focuses on the economic, as well as social growth of a society, makes it a noble way of eliminating various vices in the society. However, there are improvements that still need to be made to the system. Adoption of the Islamic banking model and resultant development of the sector internationally is still at the infancy stage and thereby certainly facing challenges in terms of product development and market share, and in the formalization of management practices. Islamic commercial banks in many of the less advanced jurisdictions have no access to central bank services as lender of last resort and safeguard of cash reserves. The low formalization of standardized banking practices across the Islamic banking system.

Firstly, there is a need for proper regulatory framework in the Islamic banking industry. It is necessary that governments and other policy developers come with succinct regulations, guidelines, operations manuals, and procedures to ensure the banks operate in line with Sharia’h laws, as well as laws of the countries. The banks have to ensure that they operate under the established international regulations such as Basel I, II and III Accords. The Islamic banks have to adopt the international accounting and reporting standards to put them at par with the other players in the international financial system. It has also emerged that there are a number of Islamic finance products that are slightly out of the way of the Islamic laws. It is necessary that some Sharia’h supervisory board is established in every country to approve the products availed to the customers. There is need for clear operational and supervisory guidelines to ensure that all the products are Sharia’h compliant.

Secondly, the level of growth in financing contracts was positively correlated to the level of economic growth in the countries studied. Islamic banking had instituted modalities for channeling resources to the more productive sectors of the economy. The contributions that small businesses make towards economic growth cannot be overemphasized. Unfortunately, these businesses may not have proper access to the finances. The Islamic banking system is one that is asset based implying that finding will be easily obtained when there is some underlying asset. While this practice can be seen to be advantageous in minimizing risks, there are chances that a substantial proportion of small and mid-sized enterprises (SMEs) may be locked out of these financing products. It then becomes necessary for the Islamic banks to reconsider restriction on investment financing, trade financing or lending based on some underlying asset. The earlier practices of Islamic finance such as Zakah and Qard-Hasan that were aimed at helping the poor have to be strengthened to improve small businesses.

It is also important to note that Islamic banking can remain active if it receives proper government backing. The first Islamic banks such as the Dubai Islamic Banks were established by individual businessmen. In order to promote economic growth, the governments should inject a lot of resources towards this industry and increase access to interest-free loans by different categories of investors.

Capacity building is another important step in strengthening Islamic banking for sustainable growth in the future. Professionals should be developed who can operate in the dynamic market environment and timely and accurately foresee the future demand of the customers. There is no doubt that changes have occurred in the Islamic banking models with earlier modes of financing gradually giving way for the more recent ones. The changing environmental factors unquestionably bring about more changes in the Islamic banking, and these should be easily noted by the professionals and the necessary adjustments made in good time. The use of IT, for instance, cannot be ignored if operations have to be efficient in any given industry.

Besides, conventional banks still provide stiff competition to the Islamic banks in different economies across the globe. Some of these banks mainly compete by adopting some

Islamic banking practices in some of their products- through the Islamic windows. In order to compete in such an environment, the Islamic banks have to continue with research and development to come up with counter-products that can make up for their interest-free loans. Strengthening the profit-sharing schemes is a worthy move to adopt. Alternatively, the banks may also opt to provide conventional products, especially when operating in economies in which there are non-Muslims as well. With the trend that has been witnessed in this industry, the banking institutions whose future survival is guaranteed are those that are flexible and allow customers to choose on the banking model to adopt.

8. Limitations of the Research

This research has not been without challenges that now point to some of its weaknesses. Firstly, the key objective was to examine the possible changes in the Islamic banking practices that could be deduced to be the consequences of the global financial crisis. This is best achieved by examining the financial practices adopted by the Islamic banks before, during, and after the financial crisis. Unfortunately, much of the available literature focuses on the comparative analysis of the performance of conventional and Islamic banks before and after the crisis. It is quite difficult to obtain proper documentation of the succinct responses that the Islamic banks had to towards the financial crisis.

Secondly, much of the available data pertaining to the performance of the financial institutions during and after the crisis only extend up to around 2010. The Islamic financial system is predominantly a private sector industry, and thus information on development and performance is not readily available on a regular basis. The economic recovery process from the crisis has been different in various countries, with information on western countries being more readily available than that in middle-income and underdeveloped economies, thereby affecting the availability of information on the Islamic banking sector globally. By 2010, some of the economies were still struggling to recover from the effects of the crisis. More recent data on the performance of the financial institutions would help provide a better picture of how the Islamic banks reacted to the crisis and the efficiency and effectiveness of these new practices.

9. Conclusions

Islamic banking is a financial system that blossomed particularly after the 1960s following the establishment of one such banking institution in Egypt. This banking practice follows the teachings of Koran on God's laws that should govern the daily life of every Muslim. The key principles in Islamic banking include prohibition of interest (*Riba*), sharing of profits and losses, avoidance of excessive risks, and investments in products or services that are considered sinful in Islam. An important feature of the Islamic banking system is the moral obligation bestowed on the banks and the agents so that the performance of an Islamic financial institution is not only deduced from its profitability.

The worldwide financial crunch of 2008 negatively affected different industries and sectors across the globe. Many large financial institutions, especially in the United States, were pushed into bankruptcy following this crisis. Fortunately, given the nature of their operations and the associated products, the Islamic financial institutions performed relatively better than the conventional banks in many parts. Following this outstanding performance during and after the crisis, Islamic finance practices were quickly integrated into the financial system. Many conventional banks also began to offer Islamic finance products through Islamic windows.

The contributions that Islamic financing has made towards economic growth in different countries cannot be ignored. Malaysia is one example in which Islamic bank financing proved to be strongly positively correlated with economic growth. The same economic model in Malaysia explains the relationship between Islamic bank financing and the economic growth in the United Arabs Emirates. Following the financial crisis, the Islamic banks in the country such as the Dubai Islamic Bank and the government have made proper adjustments in operations and policies to mitigate for future similar financial predicaments. There has been considerable emphasis on investments in real economy sector with limited uncertainties. The system discourages investment in sectors that are highly risky and less productive. This is the direction that all Islamic banks should take to remain sustainable in future.

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