A Historical Review of the Development of the Islamic Banking System 
(An Analytical Study)

Novan Fatchu Alafianta 
(Corresponding Author) 
University of Darussalam Gontor 
Email: novan.fatchu@unida.gontor.ac.id 

Muhammad Abdul Aziz 
University of Darussalam Gontor 
Email: mabdulaziz@unida.gontor.ac.id 

Jaya Sahputra 
University of Darussalam Gontor 
Email: jayasp618@gmail.com 

Abstract

This paper tries to investigate the historical development of Islamic banking in the world. The formation of Islamic banking was inspired by the incompatibility between conventional banks and Islamic teachings based on the Qur’an and al-Hadith. Islamic economists are trying to replace and improve the traditional system of banking that has developed rapidly with the Islamic banking system. The establishment of Mit Ghamr marked the emergence of Islamic banking. Since then, many Islamic banks have been established and have proliferated. The primary purpose of this study is to analyze and determine the historical development of the Islamic banking system in various countries. Thus, this research can provide further information for Muslim economic actors as a guide in carrying out economic activities, especially those related to banking. This study using the historical analysis method and at the end of this paper, confirm that the Islamic banking system was preceded by applying a profit-sharing approach to avoid interest in banking. The development of Islamic banks cannot be separated from the efforts made by the Organization of the Islamic Conference (OIC), which since 1970 has issued many recommendations and encouraged its member countries to improve the people’s economy in their respective countries. Then, Islamic banks developed in various countries, including Pakistan, Egypt, Iran, Cyprus, Kuwait, Bahrain, United Arab Emirates, Malaysia, Turkey, and Indonesia.

Keywords: Historical, Development, Islamic Banking
Introduction

*Muamalat* activities are broadly grouped into three major groups, namely political, social, and economical. From an economic point of view, the Qur’an has provided guidance and motivation to encourage the creation of a consumption surplus in the form of savings that are collected and used to finance investment, both trade, products (manufacture), and services.\(^1\) Required a financial institution to regulate and manage it.

In the conventional system, there is an institution known as the central bank. This institution functions to regulate the smooth intermediation process, currency distribution and become the lender of the last resort. Nevertheless, historically the central bank was an institution born of the need to finance military expansion in Europe in the early 20\(^{th}\) century.\(^2\) So some people are starting to worry that banks will not function in an Islamic economy. It is undeniable that current banking is against the teachings of Islam because it is built on usury or interest. So the Muslims began to create an Islamic banking system based on cooperation without involving interest.\(^3\)

The term Islamic banking is a new phenomenon in modern economics. Its emergence is in line with the efforts of Islamic experts in supporting Islamic economics to replace and improve the conventional economic system based on interest. Many kinds of literature written about Islamic banking state that although the performance of Islamic banking almost resembles that of conventional banks in terms of its function, the approach taken by Islamic banking is very different. This difference is because Islamic banking has its uniqueness and characteristics.\(^4\) So this triggers the emergence of Islamic banking in various worlds.

The emergence of Islamic banking was marked by the establishment of Mit Ghamr in the 1960’s. Besides that, its existence was also supported by the oil wealth of the gulf region. With this, the development of banks began to increase sharply, from only one

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bank in the 1970’s, increasing to nine banks in 1980. Furthermore, between 1981-1985, about 24 Islamic banks and other Islamic financial institutions were established in Qatar, Sudan, Bahrain, Malaysia, Bangladesh, Senegal, Guinea, Denmark, New Zealand, Turkey, United Kingdom, Tunisia, and Mauritania. The history of the development of Islamic banking law and its formation will be the subject of this paper.

Methodology

This paper is prepared using historical analysis. In education, historical analysis is critical to research for several reasons. The historical study intends to make a systematic and objective reconstruction of the training period by collecting, evaluating, verifying, and synthesizing evidence to support the facts to obtain firm conclusions.

Result and Discussion

A. The Beginning of the Emergence of the Islamic Banking System

Banks are intermediary financial institutions or commonly called financial intermediaries, meaning that bank institutions are institutions whose activities are related to money matters. To avoid operating banks with an interesting system, Islam introduced the principles of *muamalah*. One form of the principle of *muamalah* lies in Islamic banks, born as part of the solution to the problem of conflict between bank interest and usury contained in Islamic economics.

Islamic banking in Islamic economics is an institution based on Islamic requirements based on the Qur’an and Hadith. Islamic banks are certainly different from conventional banks, which tend to be secular, where their economic activities are separated from religion. Refreshing Islamic thought by resurrecting a wave of *ijtihad* is very necessary, which is used as a means of obtaining relevant ideas from the Qur’an and as-Sunnah and then trying to formulate legal requirements based on principles. Therefore, Islamic economics

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makes efforts to understand that interest is usury and replace interest with a profit sharing system. These two movements became one of the influences of the birth of Islamic banks.\(^8\)

Initial efforts in implementing a profit-sharing system were recorded in Malaysia in the 1940’s and in Pakistan in the late 1950’s, namely the efforts to manage pilgrims’ funds unconventionally.\(^9\) Other Institutional pioneers were the Islamic Rural Bank in Mit Ghamr Village in 1963 in Cairo, Egypt, and the Nasser Social Bank in 1971.\(^10\) After the initial pioneering, which was quite simple, Islamic banking grew very rapidly. Following the analysis of Prof. Khursid Ahmad and reports from the International Association of Islamic Banks, until the end of 1999, there have been more than two hundred Islamic financial institutions operating worldwide, both in Muslim populated countries and in Europe, Australia, and America.\(^11\)

The Asia Pacific region is also not left behind in contributing and making a very valuable contribution in this pilot trial of interest-free banking. An interest-free bank was established under the name Philippine Amanah Bank (PAB) in 1973 through a presidential decree as a special banking intuition, although without reference to the Islamic character in its bank charter. This banking is specifically designed to serve the needs of the Muslim community.\(^12\)

One thing that should also be noted is that currently, many big names in international finance such as Citibank, Jardine Flemming, ANZ, Chase Chemical Bank, Goldman Sachs, and others have opened branches and subsidiaries based on *sharia*. Even in the world of capital markets, Islamic funds are now heavily traded, which has prompted the world capital market lion, Dow Jones, to publish the Islamic Dow Jones Index. Therefore, it is not surprising that Scharf, the former president director of the Danish Islamic Bank, a Christian, stated that Islamic banks are new partners of development.\(^13\)


Efforts to realize the establishment of Islamic financial institutions only materialized in the 1940’s, namely with the establishment of the first financial institutions that were established as follows:14

1. **Mit Ghamr Bank**

   Islamic banking pioneers began to exist in Egypt in the 1960’s and operate as rural social banks (such as financial institutions of village units in Indonesia) along the delta on the Nile. The institution under the name Mit Ghamr Bank, which Prof. Dr. Ahmad Najjar fostered, operates in rural Egypt and is small in scale.15 This bank received a warm welcome in Egypt, especially among farmers and rural communities. Mit Ghamr’s success was marked by the opening of 9 branches in four years with a total of one million customers.16 Although small in scale, this intuition can become a very meaningful trigger for developing the Islamic financial and economic system.17

   Unfortunately, due to political turmoil in Egypt, Mit Ghamr began to decline, so its operations were taken over by the National Bank of Egypt and the Central Bank of Egypt in 1967. This takeover caused the interest free principle of Mit Ghamr to be abandoned. In 1971 the practice of no interest was reapplied during the Sadat regime by establishing the Nasser Social Bank. This bank aims to re-run the business based on the concepts that have been practiced by Mit Ghamr Bank.18

   Mit Ghamr has inspired Muslims around the world, thus raising awareness that Islamic law can be applied to modern business. When the Organization of the Islamic Conference (OIC) was formed, many international conferences began to be held. Namely, one of the economic agendas was the establishment of an Islamic bank.19

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2. **Islamic Development Bank**

At the foreign ministerial session of the Organization of Islamic Conference (OIC) countries in Karachi, Pakistan, December 1970. Egypt submitted a proposal to establish an international Islamic bank for trade and development (International Islamic Bank for Trade and Development) and a proposal to establish a federation of Islamic Banks. (Federation of Islamic Banks), which experts from eighteen Islamic countries reviewed. The bank uses a profit and loss sharing system. The proposal was accepted, with approval of the plan to establish an International Islamic Bank and a Federation of Islamic Banks.\(^{20}\)

After the establishment of the International Islamic Bank, at the foreign ministerial sessions of the OIC member countries (the organization of the Islamic Conference) in Pakistan (1970), Libya (1973), and Jeddah (1975), the OIC Finance Minister’s Session in Jeddah in 1975 approved the draft for the establishment of an Islamic Development Bank (IDB) with an initial capital of 2 billion Islamic dinars and using a profit sharing system. In the early years of its operation, the IDB encountered many obstacles due to political problems. However, the number of its members has increased from 22 to 43 countries. The IDB can also meet the needs of the Islamic state in the field of development by providing interest-free loans.\(^{21}\)

3. **Islamic Research and Training Institute**

IDB plays a role in assisting the establishment and development of Islamic banks in various countries. This institution also builds research and training institutes to develop research and training in Islamic economics, both in banking and general finance. This institution is called IRTI (Islamic Research and Training Institute).\(^{22}\)

B. **Establishment of Islamic Banks**

Many Islamic countries are motivated by the existence of the IDB to establish Islamic financial institutions. Therefore, the IDB expert committee established guidelines on the establishment, regulation, and supervision of Islamic banks. In the late 1970’s and early 1980’s, Islamic banks in Egypt, Sudan, the Gulf States, Pakistan,

\(^{22}\)Ibid.
Iran, Malaysia, Bangladesh, and Turkey emerged. These banks are divided into two categories, namely commercial Islamic banks and investment institutions.

Banks in the commercial Islamic bank category are Faisal Islamic Bank in Egypt and Sudan, Kuwait Finance House, Dubai Islamic Bank, Jordan Islamic Bank for Finance and Investment, Bahrain Islamic Bank, Islamic International Bank for Investment and Development. The second category is investment institutions consisting of Daar al-Maal al-Islami in Geneva, Islamic Investment Company of the Gulf, Islamic Investment Company (Bahama), Islamic Investment Company in Sudan, Bahrain Islamic Investment Bank in Manama, Islamic Investment House in Amman.\(^\text{23}\)

The first commercial Islamic bank was established, the Dubai Islamic Bank, established in March 1975. Then in 1975, the Dubai Islamic Bank was established, a little private business with an initial capital of 50 million dirham’s. The Kuwaiti government contributed 20% of the total capital. Since then, many Islamic banks have been established in various countries.\(^\text{24}\)

In 1984 there were about 38 Islamic banks in the world and about 20 Islamic financial and investment institutions conducting their activities based on Islamic sharia. Of these 38 Islamic banks, 28 are in Islamic countries, Arab countries have 20 Islamic banks, while eight other Islamic banks are in non-Arab Islamic countries. The development of Islamic banks cannot be separated from the efforts made by the Organization of the Islamic Conference (OIC), which since 1970 has issued many recommendations and encouraged its member countries to improve the people’s economy in their respective countries.\(^\text{25}\)

C. Development of Islamic Banks in Various Countries

1. **Pakistan**

Pakistan is a pioneer in the field of Islamic banking. In early July 1979, the interest system was abolished from the operations of three institutions, the National Investment (unit trust), House Building Finance Corporation (financing the housing sector), and the

Mutual Funds of the Investment Corporation of Pakistan (investment cooperation). In 1979-1980, the government socialized an interest-free loan scheme to farmers and fishers.

In 1981, in line with the enactment of the Mudharabah and Murabaha Companies Act, it started operating seven thousand branches of a national commercial bank throughout Pakistan using a profit sharing system. In early 1985, the Pakistan government converted the banking system in Pakistan into an Islamic banking system.26

2. Egypt

The first Islamic Bank to be established in Egypt was Faisal Islamic Bank, and this Bank was operational in 1978. This Bank managed to record impressive results with total assets of around 2 billion US dollars in 1986 and a profit rate of 106 million US dollars. Apart from Faisal Islamic Bank, another bank, the Islamic International Bank for Investment and Development, operates using Islamic financial instruments with an extensive network. The bank operates as an investment, trade, and commercial bank.27

3. Iran

The idea of developing Islamic banking in Iran started during the Iranian Islamic revolution led by Ayatollah Khomeini in 1979, while development in a real sense only started in January 1984.28 The first step taken by the new rulers was to take over all commercial banks in Iran. According to Mehdi Barzagan, the Prime Minister of Iran, the takeover process was inevitable because the banks were not making a profit and showing signs of being unhealthy. This policy is taken to protect the country’s rights and wealth and for the country’s economic progress. As a result of the takeover and reorganization of these banks, the banking system was represented by only six commercial banks and three specialized banks.29

Following the promulgation of a law in August 1983 as the Law for Usury Free Banking, it obliges banks in Iran to completely change their business activities following sharia principles and change

26Antonio, Bank Syariah, p. 22.
27Ibid., p. 23.
28Ibid., p. 24.
29Sutan Remy Sjahdeini, Perbankan Syariah (Jakarta: Jayakarta Agung Offset, 2010), p. 80.
outstanding interest based customer deposits within three years deposits into interest free deposits within one year from the date, the Law is enacted. As a result, since March 21, 1984, depositors are not allowed to place their money into usury based accounts, and banks are not allowed to provide credit facilities based on interest. Starting in March 1985, Iran changed the entire banking system to an Islamic banking system. Thus, since the promulgation of the 1983 Islamic Banking Law, the entire banking system in Iran has automatically run according to sharia under the full control of the government.

4. **Cyprus**

Faisal Islamic Bank of Kibris (Cyprus) started operations in March 1983 and established the Faisal Islamic Investment Corporation, which has two branches in Cyprus and one branch in Istanbul. In the first ten months of its operation, the Bank has financed a *murabaha* scheme worth approx TL 450 Million (Turkish Liara/Turkish currency).

This bank also carries out financing with *musyarakah* and *mudharabah* schemes with profit levels that are competitive with non-Islamic banks. The presence of Islamic banks in Cyprus has moved people to save. This bank operates by visiting villages, factories, and schools using mobile cash offices to collect people’s savings. In addition to the above activities, they also manage other funds such as *al-qardhul hasan* and *zakat*.

5. **Kuwait**

Since its inception, the Kuwait Finance House was founded in 1977 and has been based on an interest free system. This institution has dozens of branches in Kuwait. The development was fast. In just two years, the public funds collected increased from KD 149 million to KD 474 million. In 1985 the total assets were KD 803 million, and the profit was KD 17 million (one Kuwaiti dinar is equivalent to 4-5 US dollars).

6. **Bahrain**

Bahrain is the largest off-shore banking haven in the middle east. In a country with only 660,000 people (December 1999), there

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30Ibid., p. 80-81.
are around 220 local and off shore banks. No less than 22 of them are based on sharia. Among them are Citi Islamic of Bahrain, Faisal Islamic Bank of Bahrain, and al-Barakah Bank.32 Bahrain has become a global Islamic finance leader by primarily hosting middle eastern Islamic financial institutions. In the end, September 2007, all the banks’ assets in Bahrain reached the amount of US 20.1 billion. In addition, Bahrain has occupied a significant market for sukuk (sharia bonds), including short term government sukuk. Currently, there are 29 Islamic banks, 50 Islamic mutual funds, and 18 tafakul (Islamic insurance companies) in Bahrain. It is estimated that the Islamic finance industry in Bahrain will grow by 20%.

It is estimated that the Islamic finance industry in Bahrain will grow by 20%. 27 The Central Bank of Bahrain (CBB) is in charge of regulating and supervising the entire financial sector in Bahrain, both conventional and Islamic banking. Both conventional and Islamic banks are subject to the same provisions, including the conditions set out by the Basel agreements. CBB was the first central bank to implement the Accounting and Auditing Organization Standards for Islamic Financial Institutions (AAOIF) for the local market and later adopted by Sudan, Jordan, and Qatar.33

7. The United Arab Emirates

Dubai Islamic Bank, founded in 1975, is one of the pioneers in developing Islamic banking. Its investments include housing, industrial projects, and commercial activities. For several years, its customers have received greater profits compared to conventional banks.34

8. Malaysia

Bank Islam Malaysia Berhad (BIMB) is the first Islamic bank in southeast Asia. The bank was founded in 1983 with 30% of the capital owned by the federal government. By the end of 1999, BIMB had more than 70 branches spread across almost all cities in Malaysia.35 Meanwhile, the Islamic financial system was first introduced
in Malaysia in 1963, establishing the Pilgrimage Board or the *Tabung Haji* institution. However, the *Tabung Haji* Institution is not a bank. After establishing the *Tabung Haji* Institution, a movement arose in Malaysia, which was influenced by the revival movement of its intellectuals in the 1970’s to establish an Islamic bank in Malaysia. There have been many calls by various people, groups, and government agencies for an Islamic bank to be established in Malaysia to meet the needs of Muslims in Malaysia. \(^{36}\)

Finally, the Malaysian government created a steering committee called the National Steering Committee on Islamic Banking on July 30, 1981. The committee was chaired by Tan Sri Raja Mohar bin Raja Badiozaman. The secretarial function is entrusted to the *Tabung Haji* Institute. And to pave the way for the establishment of Islamic banks, the Islamic Banking Act 1983 has been promulgated, which will take effect on April 7, 1983. This law emphasizes the rules that Islamic banks must comply with that will operate in Malaysia and the authority of Islamic banks to operate in Malaysia. The state of Malaysia in supervising and regulating Islamic banks in Malaysia. At the same time, the Malaysian government also issued the Government Investment Act 1983, which authorized the Malaysian government to issue Government Investment Certificates based on *sharia* principles until the establishment of BIMB. \(^{37}\)

The Malaysian government’s commitment to advancing the Islamic banking system can be seen from the ongoing plans that have not been implemented until now. Malaysia has not only developed a dynamic Islamic banking system at home but has also begun to export Islamic banking models to neighboring countries. 

9. **Turkey**

As a secular ideology, Turkey is one of the first countries to have Islamic banking. \(^{38}\) The issuance of a special law, namely Decree 83/7506 on December 16, 1983, promulgated in Official Gazzate No. 18256, has paved the way for establishing Islamic banks in Turkey. In 1984, the Turkish government permitted *Daar al-Maal al-Islami* (DMI) to establish a bank operating on the principle of profit sharing. According to the provisions of the Central Bank of Turkey,

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\(^{36}\)Sjahdeini, *Perbankan Syariah*, p. 68.


Islamic banks are regulated in a special jurisdiction. After DMII was established in December 1984, the Faisal Finance Institution began operating in April 1985. The development of Islamic banking continues to be considered from year to year, especially during the reign of the Prime Minister of Turkey, Turgut Ozal, who was very enthusiastic about realizing his promise to the public. Its followers are devout Muslims. Even though there are many criticisms from hard line secular parties, special laws governing the operational system of Islamic banks continue to be legalized.

At the end of 2008, there were four participating banks in Turkey, namely Albaraka Turk, Bank Asya, Kuvyet Turk, and Turkiye Finans. In 2007, these banks jointly controlled 4.2% of total deposits and 3.3% of total loans in the Turkish banking system.\(^{39}\)

10. Indonesia

As an initial step in the development of Islamic banking in Indonesia, in the mid 1970’s, discussions were held on Islamic banks at the Indonesia Middle East Relations seminar held in 1974 and 1976 at a seminar held by the Institute for the Study of Social Sciences (LSIK) and Unity in Diversity Foundation. Since then, the development of broad thinking regarding the need for Indonesian Muslims to have their Islamic banking began to blow. However, efforts to realize the idea of Islamic banking were hampered by several reasons, namely operations of Islamic banks based on profit sharing principles have not been regulated. Therefore they are not in line with the applicable banking principal law, namely Law No. 14 of 1967.

In the early 1980’s, discussions about Islamic banking as a pillar of Islamic economics began to be carried out with the parties involved, in 1983 with the release of the December 1983 Package (Pakdes ‘83), which contained regulations that allowed banks to provide loans with 0% interest (zero interest). In 1988, the idea of Islamic banks re emerged, motivated by the issuance of the October Policy Package (Pakto), which contained banking liberalization. The banking liberalization allowed the establishment of new banks in addition to the existing ones.\(^{40}\)

Based on the MUI National Conference IV mandate, MUI

\(^{39}\)Sjahdeini, Perbankan Syariah, p. 66.

\(^{40}\)Dewi, Aspek-Aspek Hukum dalam Perbankan dan Perasuransian Syariah di Indonesia, p. 53.
formed a working group to establish an Islamic bank in Indonesia, which was named the MUI Banking Team. The team is tasked with approaching and consulting with all relevant parties. As a result of the work of the MUI Banking Team, Bank Muamalat Indonesia was born on November 1, 1991. At the signing of the Deed of Establishment of PT Bank Muamalat Indonesia, a commitment to purchase shares of eighty four billion rupiah’s was collected. Then on November 3, 1991, in the presidential gathering at the Bogor Palace, it was fulfilled with a total initial commitment of Rp 106.126.382.000,00 which with the initial capital, Bank Muamalat Indonesia began operating.\textsuperscript{41}

In the reform era in Law No. 10 of 1998, banking law policy in Indonesia adopted a dual banking system. This policy essentially provides an opportunity for conventional commercial banks to provide sharia services through the Islamic window mechanism by first establishing a Sharia Business Unit (UUS). As a result, after this law, many conventional banks took part in providing sharia services to their customers.\textsuperscript{42}

At the beginning of the birth of Islamic banks in Indonesia in 1992 to 1998, there was still one Islamic bank, and this is because the legal system in Indonesia does not recognize the existence of a sharia banking system and only recognizes a profit sharing system in its banking business as reflected in Law No. 7 of 1992. Finally, in 2008, Law No. 21 of 2008, the law on sharia banking brought a new wind to the Islamic finance industry in Indonesia. During this period, Indonesian Islamic banking had a separate arrangement from conventional banking.\textsuperscript{43}

Conclusion

Sharia financial institutions in Islamic economics are institutions that are based on Islamic requirements based on the Qur’an and Hadith. Early attempts to establish Islamic financial institutions in implementing a profit and loss sharing system were recorded in Malaysia in the 1940’s and in Pakistan in the late 1950’s. Other institutional pioneers were the Islamic Rural Bank in Mit Ghamr

\textsuperscript{41}Antonio, Bank Syariah, p. 25.
\textsuperscript{43}Ibid.
Village in 1963 in Cairo, Egypt, and Nasser Social Bank 1971. After the initial pioneering is quite simple, Islamic banks multiply in Muslim populated countries and Europe, Australia, and America. The establishment of the Islamic Development Bank (IDB) motivated Islamic countries to establish Islamic financial institutions. Therefore, the IDB expert committee established guidelines on the establishment, regulation, and supervision of Islamic banks. The first commercial Islamic bank established was the Dubai Islamic Bank established in March 1975, which was a limited private venture with an initial capital of 50 million dirham’s. In 1984 there were about 38 Islamic banks in the world and about 20 Islamic financial and investment institutions that carried out their activities based on Islamic law and were spread in various Islamic countries, Arab countries, and non Arabs. The development of Islamic banks cannot be separated from the efforts made by the Organization of the Islamic Conference (OIC), which since 1970 has issued many recommendations and encouraged its member countries to improve the people’s economy in their respective countries. Sharia banks are developing in various countries, including Pakistan, Egypt, Iran, Cyprus, Kuwait, Bahrain, United Arab Emirates, Malaysia, Turkey, and Indonesia.

References


