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Understanding the major causes of Islamic Finance Under-development in Tunisia

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Abstract

The main purpose of this paper is to determine the major causes of the underdevelopment of Islamic finance in Tunisia. Indeed, it's surprising to note that Zitouna bank established in May 2010 is the first Islamic Tunisian bank although 99% of Tunisians are Muslim and Islam is the religion of the State according to the Constitution.

So we rely in our paper on the opinions of number of professors of finance and economics as educated people to prove or reject our hypothesis that the underdevelopment of Islamic finance in Tunisia can be explained by the ignorance of its main principles and advantages. Ours findings reveal that this branch of finance is still largely unknown, not only from public but also from professionals. The results obtained surprisingly show that this insignificance of Islamic banking cannot be explained by the fact that Tunisia has been governed since her independence by a secular left-wing party. Indeed, only 3% of respondents believe that legislation and regulation in Tunisia represent an obstacle to the development of Islamic finance. Moreover, respondents are not very optimistic about the future role of Islamic financing.

Keywords: Islamic banking, Islamic insurance *(Takaful)*, Islamic law *(Shariah)*, usury (*Riba)*

1. Introduction

The earliest Islamic bank is the Mit Ghamr established in Egypt in 1963. Islamic banking is developing rapidly around the world and is increasingly recognized as a viable alternative mode of financing. This prosperity of Islamic finance helps to fulfill the needs of Muslims to obtain a financing that respects their religion (*Halal* financing). However, Naser and Jamal (1999) conduct a questionnaire in order to evaluate the degree of customer awareness and satisfaction of products and services offered by Islamic banks in Jordan. They find that respondents are dissatisfied with some of Islamic bank services. Their survey reveals also that customers know Islamic financial products but they do not deal with them.

Recent studies argue that Islamic finance can even survive in non-Muslim countries. Indeed, there are approximately 50 Islamic banks located in western countries and offshore centers. London tends to be the European hub for Islamic finance with 22 fully-fledged Islamic banks and Islamic windows. In 1999, Dow Jones created 'Islamic Market Indexes' to offer *Shariah*-compliant investment portfolios. Several major Western banks such as Citibank, HSBC, ABN Amro, Bank of America, Standard Chartered, and the Union Bank of Switzerland, either have Islamic Banking subsidiaries or have Islamic windows that offer Islamic financial products to their customers (Khan, 2010).

Islamic finance is based on the prohibition of *Riba* (usury). *Riba* is forbidden (non-*halal*) by the *Holly Qur'an* as well as by the *Sunnah* because money itself has no intrinsic value. The Islamic financial system prohibits the payment or receipt of any predetermined, fixed rate of return. The *Shariah* (Islamic Law) forbids making money from money. The wealth can be raised by investing in assets.

The second principle of Islamic banking is the profit-and-loss sharing (PLS). This principle is complementary with the first one. Banks do not charge fixed interest on the loans offered to their customers but they are rewarded by participating in the profit resulting of bank funds. However, Chong and Liu (2009) find that only a negligible portion of Islamic bank financing in Malaysia is compliant with PLS principle. Similarly, Zaman and Movassaghi (2001) conclude that some of the practices and the financial instruments used by the Islamic banks do not respect Islamic principles. Khan (2010) documents evidence that much of Islamic banking and finance still remains functionally indistinguishable from conventional banking.

In this study, we attempt to identify the root causes of underdevelopment of Islamic finance. Our findings indicate that this underdevelopment can be mainly explained by the ignorance of the principles and practice of Islamic finance.

The remainder of this paper is organized as follows. Section 2 presents the financing techniques provided by Islamic banks. Section 3 provides an overview about promising growth of the Islamic finance industry worldwide. Section 4 analyses the results of our questionnaire. Section 5 concludes.

2. Islamic mode of financing

Islamic banks provide several forms of funding *(Tamouil)* that are in line with *Shariah* (Islamic Law)

2.1. Musharaka

The *Musharaka* is a partnership agreement between two or more parties in the capital of a company, project or operation. The profits are distributed according to an allocation formula for allocating predetermined. In the event of a loss, it is supported by the parties in proportion to the capital invested.

By offering this type of contract, Islamic Banks have confidence in their customers and the profitability of the project or transaction.

2.2. Moudharaba

The *Moudharaba* (profit-sharing) is a contract between two parties. A named party "donors" or "*Rab Al Mal"* provides the second part, called "Manager" or "*Moudhareb"* funds. The latter is responsible to manage, while defining a prior allocation of profits to be made.

2.3. Murabaha

Murabaha (cost plus) is a contract of sale at cost plus a margin known and agreed between the bank and the customer. The bank buys the asset chosen by the client and resells it at the buying price plus a profit at a rate agreed between the two parties at the time of entering into the contract.

2.4. Ijara

If the customer does not want to buy the asset and prefers to rent it, this transaction can be undergone in the Islamic framework as *Ijara* (leasing). Under the *Ijara* transaction, the bank (referred as *Mu'jir*) purchase the property as requested by the customer (referred as *Must'jir*) and gives him the right to use and benefit for a period of predetermined time and the customer pays an agreed rent (referred to as *Ujrah*). The property is owned by the bank since only the right to use is transferred to the leaseholder. The *Ijara* can be defined as the enjoyment of the usufruct determined with a known rent for a period of time.

2.5. Istisna'a

The *Istisna'a* is defined as a contract of sale between the "final buyer" or "*Al Mustasni'"* and "seller" or "*Al Sani'"*. The seller is committed to buy raw materials, and provide the necessary work to deliver the goods manufactured in accordance with predefined description of the characteristics required by "*Al Mustasni'"*. The sale price and payment terms are agreed and set at the contract signing. Payment can be done at the conclusion of the contract, in installments or on a specified date in the future.

2.6. Bay' salaam

Bay' salaam can be defined as a contract of sale with deferred delivery. The price is paid in advance at the time of contracting while the delivery of the purchased goods or services is postponed to an agreed future date.

3. Overview on Islamic banking

Islamic banking is currently practiced in more than 50 countries worldwide (Chong and Liu, 2009). There are more than 300 Islamic financial institutions around the world, including banks, mortgages companies, *Takaful* companies and investment funds. There are many indicators that reveal the increasingly importance of Islamic finance. The value of assets of Islamic financial institutions (IFIs) was roughly five billion U.S. dollars in 1985 (Iqbal, 1997). At the dawn of the third millennium, it was estimated at 100 billion dollars, which, represents nearly the quarter of short-term external debts of developing countries (World Bank 2000, p. 79). In 2008, the value of the world's "Islamic assets" became about US $700 billion (Economist, 2008) and it is estimated that by 2012, Islamic assets will reach about US $1,600 billion, with revenues of US $120 billion (Islamic Financial Services Board, 2010).

Figure 1 shows that Shariah-compliant assets have exceeded US $1 trillion in 2010 with an annual growth rate of more than 10% even during the financial crisis of 2008.

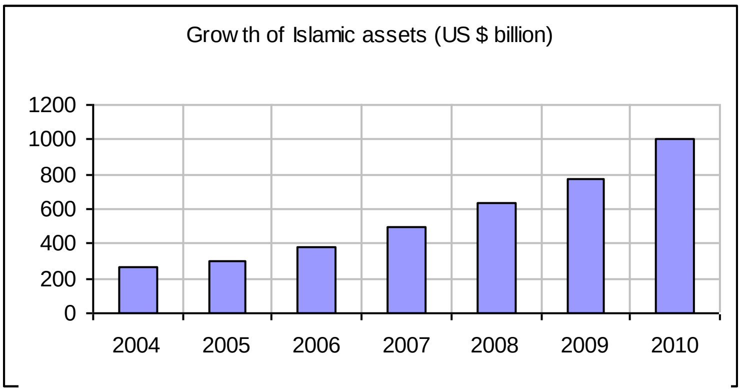

Fig. 1. Growth of Shariah-compliant assets

Source: The Banker, Celent, Moody's, Bloomberg

The reason of the tremendous progress of Islamic banking is due to their rationality and effectiveness experienced by Muslim as well as Non-Muslim countries (Ebrahim and Safadi, 1995). Gambling and Karim (1986) suggest that if the individuals are Muslims so their personalities are Islamic and their culture is Islamic. However, Ariss (2010) notes that Islamic finance is not limited to stakeholders with common religious backgrounds.

Figure 2 shows the repartition of Islamic finance assets for the year-end 2008. It reveals that commercial banks have the largest portion of Islamic assets.

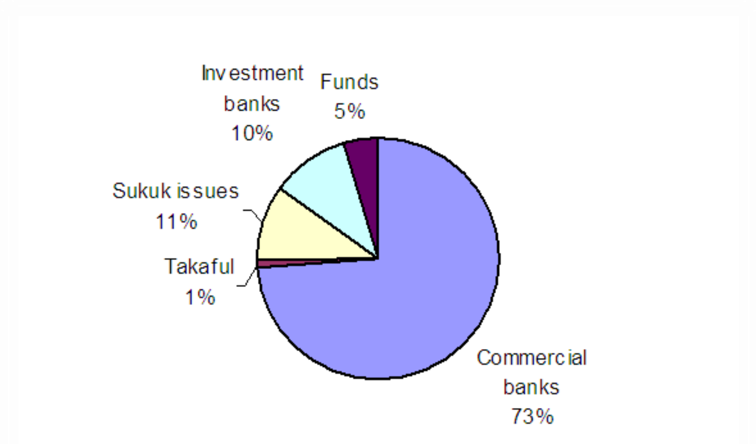

Fig. 2. Market share of Islamic finance assets ─ 951 billion at end 2008
Source: IFSL estimates based on The Banker, Ernst & Young

Figure 3 shows that 36 percent of these Islamic finance assets are located in Iran. This evidence can be explained by the fact that in this country whole banking system has been transformed to Islamic banking. Indeed, the Iran's Islamic revolution of 1979 had been followed by a government initiative for the establishment of interest-free banking. Gambling and Karim (1991) explain that this Islamic revolution was a result of the dissatisfaction of the less wealthy social classes with the West backed politico-economic system that governs Iran under the Shah.

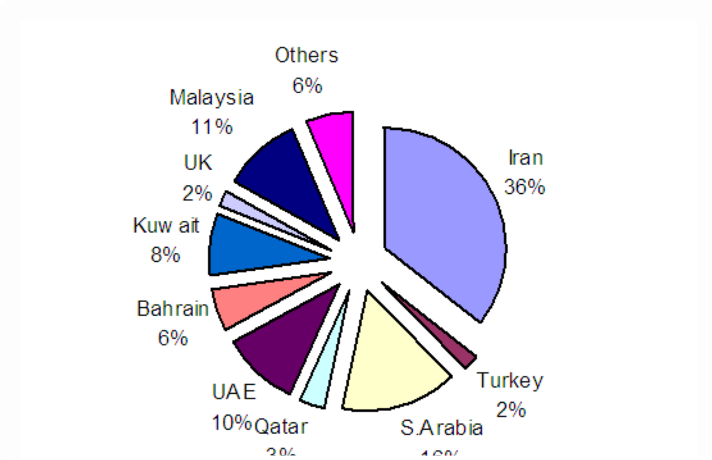

Fig. 3. Geographic breakdown of Islamic finance
Source: IFSL estimates based on The Banker, Ernst & Young

Table 1 shows the number of Islamic banks and financial institutions by country, their total assets, and the repartition of assets between each Islamic sector for the year-end 2008. Of the 302 financial institutions operating over the world, 118 are located in five countries of the

Gulf Cooperation Council region[1]. Following the events of September 11, 2001, a considerable amount of Arab money flowed out of western countries back to the Middle East. This has further increased the dominance of the GCC region in Islamic banking world-wide (Olson and Zoubi, 2008).

Table 1. Islamic banks and financial institutions at year-end 2008 (in US $ billion)

Countries	Number of firms	Total of firms	of which Banks	Takaful	Others
Malaysia	37	86,5	84,4	2,1	---
Bahrain	34	46,2	44,2	0,4	1,6
Kuwait	30	67,6	57,4	0,2	10
Iran	23	293,2	290,6	2,6	---
Sudan	22	7,2	7	0,2	---
Indonesia	20	3,4	3,2	0,2	
S.Arabia	20	127,9	127,1	0,8	---
UAE	18	84	83	1	---
Pakistan	18	5,1	5,1	---	---
Qatar	16	27,5	25,3	0,4	1,8
Bangladesh	15	7,5	7,5	---	---
UK	6	19,4	19,4	---	---
Jordan	6	4,6	4,5	---	0,1
Turkey	4	17,8	17,8	---	---
Egypt	3	6,3	6,3	---	---
Syria	2	3,8	3,8	---	---
Iraq	1	3,8	3,8	---	
Brunei	1	3,2	3,2	---	
Other countries	26	7,1	6,5	0,4	0,2
Total	**302**	**822,1**	**800,1**	**8,3**	**13,7**

Source: International Financial Services, London, (Islamic finance 2010).

In Tunisia, Islamic banking was implemented in 1983 by the arrival of Albaraka Bank which holds currently nine branches. It provides a large range of products and services that are *Shariah*-compliant. The experience of Noor Islamic Bank belonging to Dubai Holding Group in Tunisia was very short since it retired after only one year. Thus, Islamic banking is still underdeveloped in Tunisia. Indeed, it's surprising to note that Zitouna bank established in May 2010 is the first and sole Islamic Tunisian bank although 99% of Tunisians are Muslim, the Islam is the religion of the State according to the Constitution, Kairouan is the Islam's fourth holiest city, and Tunisia is the native country of several great Islamic scholars such as *Ibn-Khaldoun (1332-1406 AD)* and *Imam Sahnoun (776-854 AD)*. In the following section, we attempt to determine the major causes of this Islamic finance underdevelopment.

[1] The Gulf Cooperation Council includes six members: Bahrain, Kuwait, Qatar, Oman, Saudi Arabia, and the United Arab Emirates.

4. Empirical analysis

4.1. Methodology

In this paper, we study the perceptions of university teachers interviewed about the causes of underdevelopment of Islamic finance in Tunisia through a questionnaire.

The population consists of 80 respondents. The questions range from the most general items to those most associated with our specific problem, i.e. from the analysis of the concept of Islamic finance to the relevance of its principles. The questionnaire sent online includes 29 questions.

4.2. Results

The use of qualitative data collected through the questionnaire conducted led to several results. Noting in this regard that a test of reliability of measurement scales through statistical Alpha Crombach generated a value of 0.89 (questionnaire exceeding the threshold of 0.72 which shows a high degree of homogeneity, consistency and coherence (Nunnaly, 1978)).

Our findings reveal that despite their knowledge of the number of existing Islamic banks in Tunisia (this result can be explained by the small number of Islamic banks in Tunisia), the majority of respondents ignore the concept of Islamic finance and its main principles (65%). Indeed, only 22.9% affirm that Islamic finance can be viewed as a solution to the problems of conventional finance while only 8.4% see that Islamic finance has no role in solving these problems. 42% of respondents denounce the utility of Islamic finance for Tunisians against 38% who see otherwise. It's the same logic that 37% state that Islamic finance can satisfy the needs of Tunisia citizens. The rest of the population surveyed rejects the idea.

A minority of respondents (3%) argues that legislation and regulation in Tunisia represent an obstacle to the development of Islamic finance. Given the potential importance of Islamic Finance in Tunisia, 80% of respondents state that the government must make an effort to encourage the establishment of new Islamic banks.

In response to the question: to create your own business, you want a loan of an Islamic bank or conventional banking? More than 96% of respondents say they will prefer Islamic financing. Indeed, more than 42% of respondents believe that the *Musharaka* (partnership) may encourage them to set up their own businesses.

We find also that 68.7% of respondents have obtained a loan from conventional banks to buy a house because the majority of them (66. 3) ignore the loan called *"Tamouil Menzel"* provided by the sole Tunisian Islamic bank *Zitouna*. In the same context, more than 77% of respondents have purchased cars through conventional bank loans because 92.8% of them were not aware that Islamic banks provide a loan called *"Tamouil Sayara"*.

It should be noted that ignorance of Islamic finance is not only an ignorance of the terms of bank financing but also an ignorance of the concept of Islamic insurance *"Takaful"*. In fact, 96% of those surveyed state they have no idea about this concept and only 2.4% of them believe that Islamic insurance will be preferred to conventional insurance.

49.4% of respondents are optimistic about the growth of Islamic finance in Tunisia and believe that the Tunisian Islamic banking system can reach the same level of the enormous development of modern Islamic finance in GCC countries and Malaysia. Similarly, 96.2% think that the development of Islamic finance in non-Muslim countries demonstrates the relevance of the principles of Islamic finance whereas the remaining respondents say that this development reflects the need of diversification of existing services. 67.5% of professors emphasize the utility of Islamic banking to deal with problems faced by conventional banking while 28.9% of them think that is not necessary to have Islamic economics.

We find also that 96.2% of respondents are aware that the interest *(Riba)* is prohibited by the *Quran* and the *Sunnah*. They were divided into two groups: 36% state that Islamic products and services are really interest-free, while 60.2% disprove this idea. More than 50% of respondents say that the most important principle of Islamic finance is the prohibition of interest while 28.9% think that the interdiction of transactions involving speculation is more important.

Opinions differ in the answer to the question if the existence of a *Shariah* board is sufficient to ensure that Islamic products are interest-free. Indeed, 40% of respondents have confidence in the role of the *Shariah* board to help Islamic banks to offer exclusively interest-free products. By contrast, 32.5% of responses disprove this idea and argue that some practices and the financial instruments used by the Islamic banks do not respect Islamic principles.

5. Conclusion

Islamic finance study represents an interesting and fascinating domain of research. Previous empirical studies are mainly reserved to the GCC region and some other countries where Islamic banking industry is sufficiently developed. Therefore, we chose a Muslim country, Tunisia, to investigate the main causes of Islamic finance underdevelopment. To the best of our knowledge, our paper is one of the rare studies of Islamic finance in North Africa, and the first one that is interested in Tunisian context. In this paper, we analyze the opinions of professors in Tunisia about the current role and perspectives of Islamic finance. We document a strong ignorance of the concept of Islamic finance in Tunisia dominated by conventional banking. There is also dissatisfaction of the majority of the interviewees on conventional finance that can play well for the proliferation of Islamic banks in Tunisia.

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