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INTERNATIONAL ISLAMIC FINANCE

by

David M.A. Firth

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A thesis submitted to the
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Master of Arts

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21 MAR 1991

To my parents

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ABSTRACT

Islamic Banking has both classical and modern connections. Guidelines to acceptable behaviour with regard to money and property were offered in the Quran whilst the compilation of further material and its interpretation is a process that began with the death of the Prophet and continues to the present day.

Upon the establishment of the first Islamic bank twenty-five years ago, Islamic finance passed beyond the realm of jurisprudence and has since gained the respect of Western economists and bankers alike. This period has spawned a considerable volume of theoretical works which detail the wide-ranging benefits particular to an interest-free financial system, and yet, little has been addressed to the experience of Islamic banks themselves.

One of the problems for Middle Eastern banking in general is that an Arab marketplace, similar to the US or European example, still does not exist. By examining the performance of Islamic banks in Bahrain, the Arab world's closest equivalent, it is possible to assess the degree of success that a move to Western markets has allowed.

The introductory chapter investigates the relationship between Islamic economic theory and practice while chapter two considers Islamic banking theory and comments upon the financing methods available in this sphere. The third chapter looks at the Euromarkets in the context of *riba*-oriented finance and the opportunities that exist there for Islamic banks. Chapter four views Islamic financial activity in London and Geneva which contrasts with the experience of Islamic offshore institutions in Bahrain, the content of chapter five. A separate chapter studies the role of the Islamic Development Bank in promoting the spread of Islamic finance and considers how successful the bank has been in Islamic terms. The concluding chapter draws on the experience of *riba*-free financial institutions over recent years to assess the future status and activities of international Islamic banking.

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CHAPTER ONE

INTRODUCTION

1.1 Rationale of Islamic Economics

Islamic economics has recently gained a great deal of exposure through the appearance over the last two decades of banking conducted according to Islamic principles. Although Islamic finance is considered a mould-breaker, right from the outset, it is possible to identify a correlation as well as the more obvious dissimilarity of the strains of thought present in Islamic and Western economic theory. Just as the Bible and the Quran share many characters, events and injunctions, at one time the interpretation of economic thought was a shared one.

A section on *riba* looks more specifically at the pattern of Islamic economic behaviour and highlights its shared background with Christian doctrine. On a broader front, a brief examination of the rationale behind Islamic economics should more quickly illustrate the point at which the two interpretations diverge.

A key to the definition of Islamic economics can be found in knowledge and application of the Islamic Holy Law, the *shari'a*. However, although those minded to conduct their lives in accordance with that of the prophet Muhammad have a number of precedents to follow, in the form of the Quran and the *Sunna*, interpretation and adaptation to new situations is far from easy.

So it is that we can observe that the structure of the Meccan economy during the rise of Islam is still considered relevant today. This fundamental link between moral behaviour and economic theory does however make the paradigm of the Islamic economy very different to the Western model. This has led Volker Nienhaus to observe:

“Islamic economics offers so far, disregarding the critique of western economics and economies, no theories about the empirical world, but only models of ideal, sometimes even utopian, worlds, which do not help us understand realities in Muslim countries and which also do not explain how a transformation from the present day egoism and materialism to the altruistic and value-orientated behaviour could be managed.”¹

To this effect, the same author observes:

“The first experiment in Islamic banking was launched in the 1960s in Egypt, and the initiators drew their inspiration not from Islamic economics, but from the theory and experience of German co-operative and mutual savings banks.”²

Before assessing the effect of the separation between positive and normative economics, it is worth noting that the two strands were interwoven in Western economic thought until recent times. In the West, economics is a comparatively new discipline; prior to the eighteenth century, it would have been clustered together with ethics. In fact, it is possible to class Adam Smith as a moral philosopher and it is only from the neo-classical period that economics can be considered as a neutral, amoral science.

This is a sticking point for Islam which works on a different set of assumptions. The motive of self-interest, for example, is not an attractive one unless it is in the wider context of society or humanity.

Viewed alone, the manifesto of Islamic economic theory makes for comparatively tedious reading for precisely the reasons quoted above. No complete society can be expected to behave entirely in harmony with the elaborate ethical system of a major religion. It is surely too much to expect that social responsibility and altruism should

cast out and replace self-interest and materialism. No such considerations can have passed through the mind of next piece's author:

“ The practice of Islam will not only solve the multiple problems facing the third world Muslim countries but also show the right path for the emancipation of all worldly evils, both economic and non-economic.”³

Statements such as these do little for the theoretical credibility of Islamic finance, given the less than one hundred percent adherence to the Islamic code of ethics worldwide. Nevertheless, this makes the investigation of banking within this sphere considerably more interesting and challenging than it might otherwise be. Fervour and fanaticism for an idea is initially impressive but is not a phenomenon from which much can be learned by the West, at least in the case of financial practice. Pragmatic treatment of religious injunctions on the other hand, makes the experience of Islamic banks in particular, one which may be of interest to conventional banks working in a non-Islamic economy.

1.2 The Prohibition of *Riba*

It is the prohibition of usury that provides the greatest contrast between Western and Islamic finance. Undoubtedly, it restricts the choice of investment methods and instruments that are available to Islamic financial institutions, yet, based upon this prohibition, an important player has joined the field of international finance in recent years. This has been neither a flash in the pan nor an event of small importance to those not directly involved. Considering the problems that conventional banks have encountered through debt financing, the attraction of mutual fund investment and even the shortcomings of the interest rate tool, it would appear that Islamic bank

operations and the implications of usury are of interest to a far wider group than Islamic economists alone.

There is no definitive meaning of the Arabic word *riba*, which has led to a great amount of debate as well as controversy when the different concepts of usury and interest are tarred with the same brush. In the West, we may be prepared to accept that some forms of interest constitute unearned profit. Nevertheless, profit at no risk provided by all manner of commercial bank accounts remains a fact of life and may be considered a reward for delayed consumption. In any case, the tables are turned when one becomes the borrower, which, for the private consumer, is a matter of choice. In a non-Islamic sense, usury and interest are only related when the rate is considered unjustly high.

Translating *riba* from the Arabic produces such innocuous sounding terms as 'increase', 'growth' and 'gain' but, as defined in Islamic jurisprudence, it is interchangeable with interest of the most unattractive sort, namely usury or unjust profit. However, the interpretation of *riba* provided by present-day schools of thought are as varied as the definitions given by dictionaries. At one end of the scale lies those who are convinced that any return on financial transactions constitutes *riba*. The 'liberated' view at the other end of the scale makes a distinction between simple and compound interest, stating that only the latter represents unearned profit and is unfair to the borrower. In between these poles of opinion lie a great many middle of the road, compromise views.

To some, a distinction should be made between interest on loans for consumption and loans for production. Although the definition of *riba* as interest holds fast, a relatively convincing argument in recent years states that the Quranic prohibition of *riba* concerned only the taking of exorbitant interest. Modest interest charges would be acceptable in areas such as the financing of trade, government inducement

to encourage savings and for loans made to finance productive investments.⁴

The permutations appear endless, although a theme of discerning application of interest is becoming evident. Many views on the subject favour the abolition of the interest charge in transactions between individuals whilst viewing it as acceptable between non-human entities such as banks, companies and corporations.

The most insidious interpretation asserts that bank interest is acceptable as banking *per se* was unknown at the time of the Quranic prohibition. Nevertheless, at the same time as calling into question the present-day validity of the Quran, the argument is also self-defeating as it does not allow for interpretation by analogy, a respected Islamic tradition. History clearly shows that *qiyas* and *tafsir* (analogy and interpretation) continued in the centuries following the revelation of the Quran and the death of the prophet Muhammad.

In a comparatively recent commentary on the Quran, Sayyed Quttub illustrates the broad scope of the ban on usury:

“...Having determined the principle we proceed to this description and say that in fact it is not only a historical description of dealings upon usury which prevailed in the Peninsular which was intended by the Prophet (God's prayer and peace be upon him), in this particular place, but is also a description attendant on the hated system of usury, regardless of the rate of interest. The nature of the usury system satisfies always this description; it is not confined to dealings that prevailed in the Peninsular of the Arabs but is a description associated with the system at every time and place.”⁵

From the time of revelation, the Quran itself has been refreshingly unequivocal in its condemnation of *riba* and, as the revealed word of God, its instructions

are considered binding. Numerous references exist both here and in the Prophet's Traditions— the second sura of the Quran gives the most comprehensive treatment to the subject:

“Those that live on usury shall rise up before Allah like men Satan has demented by his touch, for they claim that usury is like trading. But Allah has permitted trading and forbidden usury.”⁶

The issue of usurers trying to compare their behaviour with that of legitimate traders bears a close comparison with the continuing assessment of new financial practice by the Islamic banks' *shari'a* boards. Islamic bankers would be the first to admit that they trail the West in banking development and that any progress towards closing the gap will be as a result of consultation and co-operation with Western experience. Consequently, new investment procedures tend to be in some way related to the practice of non-Islamic banks. Yet whilst the newcomers to the financial scene are eager to broaden the range of services they provide, it is imperative that financial instruments derived from the West should not simply be a *riba* scheme under an Islamic name. Thus, both the spirit and the letter of Islamic law must be followed. However, this still leaves room for interpretation; what constitutes Islamically acceptable behaviour and what does not has been the subject of considerable debate. The difficulties that this has created are explained throughout this work and are a major theme within it.

1.3 An Investigation Into The International Role Of Islamic Banks

In order to study the operational experience of Islamic financial institutions competing alongside conventional banks, this work has involved a continuous comparison

between the two parties. To state that Islamic banks are newcomers to the international banking arena hints that the established players dominate an unchanging market. This is far from being the case and it makes the task for Islamic banks to compete successfully even more difficult; in effect, they are aiming at a moving target. No investigation into the specific problems that Islamic banks encounter in entering this market has been undertaken before and would now seem logical as many important considerations are involved. Primarily, there is the religious factor: how much of a restraining influence does this have over entry into a market dominated by *riba* institutions? Moreover, is it possible to argue that a stress on competition is un-Islamic? Considering the power and influence of the established market players, is it not likely that Islamic banks will be forced to deal with *riba* of some description? There is after all, little room and even less cause to make allowances in a market of this sort for another man's religion. However, the increased Western interest in ethical investment makes the Islamic contribution to financing procedures in the market relevant to others than the Islamic banks themselves.

Chapter three examines the fast-changing environment of international financial markets and highlights the demands of potential clients in terms of the flexibility and competitiveness that they expect as investors and borrowers. Later chapters look at the extent to which selected institutions have penetrated the market and the point at which it becomes unacceptable for them to operate. A further and similarly important point of contact with the West is the status of Islamic financial institutions abroad, in particular their relationship with central banks. No Islamic bank operating in England for example, can claim the status of a licensed deposit taker. An interview at the London office of Al-Baraka discusses the reasons behind this restriction and the resultant focus of this bank's activities. A section is devoted to the future of Islamic finance in the West and the circumstances that would surround institutions such as Al-Baraka competing with conventional banks on an equal footing.

So far, this introductory chapter has very briefly examined the broader aspects of Islamic finance from the point of view of its connection with Islamic thinking on economic matters. Consideration has also been given to the religious background that helps form its foundation. Further themes that are particularly relevant to Islamic financial practice are highlighted here before being studied more closely in later chapters.

1.3.1 Liquidity Constraint

The problem of managing liquidity has been a long standing one for Islamic banks; it is also one of the major questions to be examined in this work. Many other issues are connected with this one, amongst which is the absence of a central bank for Islamic financial institutions. This has two main results: the prohibition on borrowing at interest prevents firstly the raising of funds via the central bank and secondly, the inability of that institution to act as a lender of last resort. No preferential treatment is given to Islamic banks in their country of origin and so this is as much an issue in the Middle East as it is in Europe.

Inevitably, the extraordinarily high level of liquidity that Islamic banks are required to maintain has a profound effect upon their investment policy. Unless a competitive means of investing and borrowing short term funds can be found, the problem of finding and maintaining an equilibrium between incoming and outgoing funds will continue to eat away at the profitability and the attraction of Islamic banks.

This subject is studied from different angles in separate chapters; from an investigation into the shortcomings of what is presently available, an overview of the conventional interbank market, to the criteria for developing an inter-Islamic bank market. It appears that such major structural developments rely not only on co-operation amongst the commercial banks but also on the technical and financial

impetus of a truly international institution such as the Islamic Development Bank. An assessment is made of the IDB's contribution to the growth of Islamic finance as a viable alternative to *riba* banking and the part that it has yet to play as the motivation behind projects that are beyond the reach of institutions of a smaller size. This latter point receives attention in a section devoted to the development of a secondary market for Islamic securities.

1.3.2 Participation Partnerships

The prohibition of *riba*, defined as a positive and predetermined return on capital, does not mean that investment of all descriptions is discouraged. Nor does it mean that the provider of capital should not benefit financially from a project in which he has invested. In chapter two, a detailed account is given of the ways in which the principle of participation is practised by Islamic banks both for funding operations and in the form of tradeable securities. The form and degree of partnership is discussed in addition to the ways in which profits and unexpected losses are shared.

This form of investment is particularly attractive to Muslims as it involves the theme of co-operation through shared effort and shared risk, combining two of the factors of production for mutual benefit. *Zakat* or alms giving is one of the five pillars of Islam, designed to sustain the less fortunate. Whilst banking of any sort cannot operate on the basis of charity, Islamic financial principles maintain that an entrepreneur should not face double jeopardy when undertaking a venture with bank funding. A partnership with the bank entails the sharing of resources, expertise and the sponsored project's fortunes. A failure is the responsibility of both partners and in such a case, it is considered unjust for the individual to have expended time and effort, to have lost whatever capital he was able to contribute and at the same time be obliged to repay the bank with interest from non-existent profits.

Although profit and loss sharing is undertaken by Islamic banks in the form of *musharaka* and *mudaraba*, this activity should not be regarded as the mainstay of their financial activity. The theory is attractive from many points of view but in practice, the situation is different: The Islamic Development Bank has expended 13.5% of its total financing budget to date on equity participation schemes. Much of this proportion was filled in the first few years of operation out of enthusiasm for the procedure's principle. Having approved a total of ID43 million for equity participation operations in 1980–1981, the figure for 1988–89 stood at only ID1.4 million for three projects.⁶ The IDB states that a major review of its equity portfolio is under way.

Material taken from interviews with the Islamic Development Bank as well as with branches of international Islamic banks in Europe and Bahrain has helped piece together reasons for dwindling enthusiasm about a mode of financing that was initially strongly favoured by these institutions. The fact that profit and loss sharing arrangements have also gained the attention of non-Islamic financial institutions as large as the World Bank begs the question of the competence of Islamic banks to make the system work. A trend away from PLS arrangements over the long term may be seen to cast doubt upon a real separate identity for Islamic banks— it is arguable that their adaptation of conventional instruments of finance makes them reactors to Western trends rather than financial innovators on a grand scale.

1.3.3 Mark Up and Profit Margin Operations

For a number of reasons, those expecting the newly created Islamic banks of the early 1980's to be providers of risk capital on an international basis were soon proved wrong. The drawbacks of participation finance activity led Islamic banks to seek alternative ways to employ their funds. The result is now plain to see: a very meagre proportion of banks' budgets are spent on long and medium term corporate sponsorship and

most of the activity is centred around domestic and international trade financing.

What then are the major benefits of trade finance to the bank, and to what extent can it be considered a genuine Islamic activity?

A brief answer to the second question can in part be provided by referring to the Quran which is quite thorough in its information on trade and commerce. Particular stress is placed on fair and honourable behaviour as well as on the perils of concentrating on commercial activity to the exclusion of religious obligation. For as long as a suitable balance is maintained between the two, allowances may be made, such as the permitting of trade during the pilgrimage, but the balance should always remain in favour of God rather than family and possessions:

“Say: ‘If your father, your brothers, your wives, your tribes, the property you have acquired, the merchandise you fear may not be sold, and the houses you love, are dearer to you than Allah, His apostle and His cause, then wait until Allah shall fulfill His decree. Allah does not guide the evil-doers.’”⁸

Such detailed information clearly leaves no doubt that the activity itself is an acceptable enterprise. Interpreting the modern-day adaptation produces a less sure answer. Legally, the mark-up technique of *murabaha* cannot be considered as interest by a different name. The economic result suggests that there is little, if any difference. By concentrating on the legal rather than the economic distinctions, perhaps Islamic banks obey the letter rather than the spirit of the Quranic law.

The question of why mark-up is favoured over the PLS arrangement requires more gradual examination and is addressed throughout this thesis. It will be observed that even in longer term operations, equity participation is avoided while banks opt instead for hire purchase or leasing contracts.

The final aspect of this general trend in financing policy covers the broader factors of supply and demand as well as the wider economic results of the banks' choice of investment mode. To a certain extent, this choice is governed by competition; the need to make profits and satisfy the consumer. However, Islamic finance is supposed to distinguish itself by its socio-economic impact as well as by its financial success. Neglect of such considerations compares Islamic banks to those early Muslims who are warned against favouring their possessions over Allah and His Prophet. Hence the conclusion to this work weighs up the success of Islamic financial institutions in terms of their international competitiveness as well as examining the extent to which Islamic finance is achieving its broader aims. Are the two mutually exclusive?

Looking ahead to the experience of those Islamic financial institutions with whom interviews were conducted, it would appear that western scepticism of their ability to compete successfully is unfounded, even though this has indeed been somewhat at the expense of its developmental aims. Western bankers have pointed out that its initial success in the Gulf came as a direct result of the region's property boom, providing a quick and easy return on investment. Critics also hinted at an expansive attitude locally towards a system based on Islamic ideology. Statements such as these are based upon confused logic; perhaps it is valid to state that outside economic factors, such as a regional recession, are partly to blame where Islamic finance has fallen short of its aims. It is, however, inconstructive to suggest that the reverse holds true. In the work that follows, it is hoped that some of the wilder claims and accusations will be answered in the light of actual experience.

1.4 Summary

In such a large subject, of which little has received any serious attention, it is difficult to be both informative and concise. It is hoped that a comparison with established

conventional bank practice in existing markets will help to define the problems Islamic finance faces in trying to gain a foothold. A study of banking theory and the practical experience of Islamic financial institutions in London, Europe and the Middle East is the basis for an evaluation of the performance of Islamic finance in general over the last two decades and a prognosis for its development into the next century.

Footnotes

- 1 Volker Nienhaus, *Islamic Economics, Finance and Banking, Theory and Practice*, in *Islamic Banking and Finance*, Butterworths, London, 1986.
- 2 Ibid, p.5.
- 3 *A Theoretical Justification of Islamic Banking*, Arab Banker, Vol.5, No.3, 1985.
- 4 David Baldwin, *The Role of Islamic Banks within The Turkish Financial System*, p.68, MA Thesis, University of Durham, 1988.
- 5 Sayyed Quttub, *In the Shades of the Quran*, Part 4, Beirut: Arab Tradition House, 1967, p.74. Quoted from Sami Hassan Homoud, *Islamic Banking*, London: Arab Information, 1985, p.69.
- 6 The Koran, translation by NJ Dawood, (1956). The Cow, 2:275.
- 7 None of which represented original investment in any case. Source: IDB Annual Report, 1409H.
- 8 The Koran, *op cit*, Repentance, 9:24.

CHAPTER TWO

BACKGROUND TO ISLAM IN THE ECONOMIC SPHERE

2.1 Scope

In addition to a brief theoretical account of some of the wider issues that are involved in Islamic economic conduct, this chapter addresses some of the practical aspects of Islamic finance as carried out by Islamic banks and finance houses. Specifically, the aim is to examine the instruments and methods of investment that are available to the financier working within the framework of Islamic economics as well as the method in which they are practically employed and to what extent the theory of Islamic finance coincides with banking practice. Particular attention will be paid to the suitability of interest-free banking practice with respect to international trade finance, multinational and portfolio investment. The final section of the chapter addresses the ways in which Islamic financial institutions could augment their client appeal and profitability by offering a wider range of services as well as the role that a supranational organisation such as the Islamic Development Bank can play in fostering the development of those new financial instruments. This would go some way towards meeting the banks' statutory liquidity requirements while at the same time presenting the institution with investment opportunities for the profitable employment of excess liquidity; a recurrent dilemma for non interest-based banks.

When considering a set of rules and injunctions such as those to be found in a system of economic behaviour, it is not unusual to see its practical application differ somewhat from the seemingly straightforward predictions and patterns found in its theory. The introduction has illustrated that Islamic economics is no exception to the rule, other than that its economic theory still bears the strong imprint of religious dogma whereas the West has separated the two disciplines. However, even before an

examination of the theory in question is carried out, it is logical to define the value of the driving force behind the creation of an economic system which differs so greatly in many ways from the capital-based system of the West.

2.2 Islamic Economics and Finance

Islam as an inspiration for a set of economic principles cannot be viewed as a religion alone. Mannan points out that beyond this, Islam is a social system, a composite code and a civilization in which religion is just a part.¹ Most importantly within the economic sphere, Islam has forbidden the taking or charging of interest which it places in the same category as usury, most often translated as *riba*. Even here, a discrepancy arises, for *riba* as found in the holy Qur'an is equally well translated as increase which, in the form of profit, is positively encouraged under Islamic tradition. Apologists for the continued use of interest in the Muslim world are apt to declare that the prohibition of *riba* in the Qur'an applied only to usury, and not to the taking of interest; numerous passages on the subject exist within the Qur'an, and it is from the interpretation of these passages that those holding differing viewpoints are able to defend their opinions.

Whatever may be the ultimate opinion of the '*ulema*', the prohibition of the taking of interest stands at present and it is in the absence of this tool that the economics of Islam must operate. It is not simply a blind religious fervour that prompts the abolition of interest, but rather a conscious determination on the part of the '*ulema*' to live within the spirit of Islam as a whole, as defined by Mannan above, where the ultimate objectives are socio-economic justice and an equitable distribution of income and wealth. It is believed that the presence of interest in a financial system only serves to exacerbate the problems of the gulf between rich and poor. Yet the theory of Islamic economics is not simply a pale and pruned adaptation

of the western model. The rules and exhortations of Islam as a seventh century religion are reflected in the instruments used for maintaining the movement of money within its socio-economic framework today. Within the banking system, interest is seen as a hindrance towards the realization of the goals outlined above and steps have been taken both to obviate the need for it, and to provide a suitable equivalent. To avoid confusion, what may be labelled interest accruing from, for example, a fixed asset capable of providing a service is allowable in Islam. It is permitted even at a set and predetermined rate which is called rent to avoid the connotations of the word *riba* amongst Muslims. Rent from the fixed asset remains acceptable in an atmosphere of certainty pertaining to the returns to the lessee from that asset for as long as the lessor is prepared to waive rent from his property, if the asset should break down or the market change. If these circumstances pertain, then any uncertainty of livelihood for the lessee remains irrelevant and the fixed rent is Islamically allowable.²

Two fundamental value judgements within Islam are particularly pertinent to its way of banking and they concern the attitude to savings and investment. Islam stands firmly against conspicuous consumption such as spending on luxury goods. These are not only surplus to the purchaser's requirement but also serve to illustrate his high position in society whereby he can treat such goods as status symbols to vainly assert his social superiority. On the other hand, it does not encourage meanness and the hoarding of money. Investment and consumption serve to stimulate the economy whereas hoarding is conducive to stagnation. This latter trait is discouraged in two ways. Firstly, the absence of interest on deposits removes a positive incentive to maintain 'idle' money in a bank account, and secondly, the imposition of *zakat* as a wealth tax leaves unused money open to speedy erosion. This, coupled with inflation leaves the uncreative use of money a singularly unattractive proposition to the investor under an Islamic economy. Mannan does not believe that this is a solely negative move which is liable to erode savings as he maintains that the rate of savings is determined

by the rate of investment rather than the interest rate.³

The ways in which funds may be used to stimulate economic activity domestically and internationally as well as providing the investor with the opportunity of making a profit, will be examined in the following section. Before moving ahead to the next topic, however, it seems reasonable to make one further comment on the force and effect of Islam on the economy and this concerns the rate of growth as a representation of the efficiency of an economy. In this circumstance, the proof of the system's efficacy is not necessarily to be observed through external indicators such as may be employed towards the same purpose in the West: in effect, the comparatively slow growth rate experienced generally in Muslim countries is not necessarily indicative of poor economic theory and policy. Firstly, the concept of growth in Islam and its importance is liable to be different to that found in a capitalist economy; a factor which will become more apparent as the instruments of Islamic finance are discussed as well as the stress placed on other issues such as social welfare. Moreover, the rate of growth should not be confused with a country's development which is not governed simply by economic policy; within the Middle East particularly, development is prone to the interference of outside factors, social, political and historical. It is within this sphere that the examination of financial instruments takes place.

2.3 Islamic Bank Operations: Investment and Commercial Financing

Islamic financing operations can be placed in three main categories. Firstly, by means of investment financing—funding an enterprise where the bank shares in any profits while bearing a proportionate risk of loss. The second area is trade finance, again divisible into three sub-sections, discussed below. Finance by lending forms the third main division and, although it constitutes a significant part of the Islamic Development Bank's activities in the form of the Special Assistance Account, its

application is based more upon charity than on competitiveness. Socio-economic impact is, of course, intrinsic to the ideology of Islamic finance but in the sphere of international banking where profits are necessary for survival, it does little to improve the competitiveness of Islamic banks themselves.

Some of the methods of financing that will be examined in this section cannot always be accurately defined. That is to say that the practices adopted by institutions offering Islamic finance are not standardised and therefore any definition of these practices is necessarily a guideline. A distinction is made here between traditional investment on an Islamic basis and the financing of commerce and trading operations. Amongst the procedures examined below, only *mudaraba* and *musharaka* fall into the former category. A brief survey of Islamic financing procedures follows, outlining the mechanics and rationale behind each one, and where appropriate, information on the apportioning of finance and any shortcomings encountered is given.

2.3.1 *Mudaraba*

The theme of partnership between bank and client is a strong one which runs through the fabric of Islamic financing operations and is clearly seen in the terms of *mudaraba* and *musharaka*. The two methods have much in common; both are fiduciary contracts requiring the provision of capital as well as time, effort and management skills from the partners in the operation, either singly or with both sides providing all these factors. Furthermore, both rely on good faith, honesty and fairness without which there would result dissatisfaction, conflict and destabilisation. More specifically, they are a contract in profit sharing with the bank acting as the *sahib al-Mal* or financier and the client as *mudarib* or entrepreneur. It is not always simple to decide which of these methods of financing is the appropriate one in a given situation and indications given by the Muslim jurists often attached to financial institutions are not always

positive, as seen in the exhortation to limit *mudaraba* to trading activities such as buying and selling.⁴ Furthermore, in the case of financing current Islamic banking operations the application of *mudaraba* is limited again by scholars who argue that it should be limited to self-liquidating transactions. These are encouraged because on liquidation, it becomes easy to ascertain and distribute the assets involved in a contract and thus the rights and liabilities of the partners can be settled without dispute before any new contract is undertaken.

The question of adaptability regarding this profit sharing arrangement is an important one. Some scholars maintain that the principle involved in the *mudaraba* arrangement could be used to provide credit advances via the central bank to commercial banks in the event of a credit squeeze.⁵ This is, however, an artificial solution to the problem with the commercial banks being required to set aside a certain amount of reserves to fund a 'common pool' to be used in such an eventuality. More feasible and practicable is the use of a profit sharing arrangement to fund business expansion in preference to private or corporate investors. It has been pointed out that family businesses in Muslim countries sometimes forego expansion by public quotation fearing this would result in the control of the business passing out of their hands.⁶ The resultant venture capital gap could be met in part through *mudaraba* financing by Islamic banks whereby a separate company is set up by the bank and its client, involving no risk of the client losing control of his original business.

It is inevitable that some scholars, proud of a socially responsible economic system, are apt to make much of certain aspects of the theory involved without giving enough consideration to the practical side. For instance, Abdeen and Shook observe:

" *Modarabah* is popular in Islamic banking because it is a mechanism for economic development in which monetary assets are introduced into the production

process in order to transform them into real factors of production... The adoption of *Modarabah* by the Islamic bank stems from the realization that it provides an Islamic solution to the economic dilemma of how the owner of monetary assets and the businessman can be brought together on common ground.”⁷

Just how useful does this distinction prove in practice? Although it may be considered commendable to bridge the gap between financier and entrepreneur, it should be remembered that this is also the function of western banks although of course the terms of the latter’s arrangement will be significantly different. *mudaraba* is, in some cases, a clumsy way of financing a business operation. In an open economy, as for example exists in Kuwait, trade financing requirements are mainly for imports from the industrialised West, and the traders generally require short term finance. Similarly in Saudi Arabia, in part arising from an open economy, the production base is limited and local independent credit demand is not great. Those who do seek credit are much more likely to turn to the Saudi Investment Development Fund whose generous terms leave the commercial banks ignored to a large extent by business. Inevitably, the role of Islamic banks seeking to operate in the area is likely to be similarly restricted and the lure of overseas investment would be a strong one.

2.3.2 *Musharaka*

Before examining instruments which may be available to Islamic financial institutions and adaptable to a new purpose, it seems reasonable to complete this brief survey of those procedures in financing that are presently in use and recognised. Similar in characteristics to *mudaraba* is *musharaka* where the difference between the two lies in the nature of the contribution of the partners involved: whether the partners assist with finance as well as management as in the case of *musharaka*, or with one factor

only as described above. Abdeen and Shook point out the benefits of *musharaka* financing quite succinctly:

“ One of the main advantages of *musharaka* is the understanding that the bank is a participating partner and behaves as such if expectations of sale of the commodities or the manufactured products are not fulfilled and more time is needed.”⁸

Defined as equity participation, *musharaka* would be more attractive to an expanding business as described under the *mudaraba* section, in preference to private and corporate investors. This procedure is necessarily not a predatory one as the Islamic bank is merely interested in obtaining a return, not in controlling the company. In addition to investment projects, *musharaka* can be applied to other activities such as a negotiated profit sharing arrangement arising from an overdue payment on a letter of credit. The bank may decide not to charge interest on the postponed payment, sharing instead in the profits of the importer at a ratio agreed in advance.

This method of financing is also adaptable to the purchase of property or real estate with the bank assessing the incoming rent from the property and sharing it with the client according to the share of each partner in the financing of the project. Gradually, the bank's share is reduced as the client pays up the instalments of the loan, resulting ultimately in the transfer of the whole property to the client.

There is no fixed formula for the distribution of profits in accordance with the amount of capital put forward by the partners but they agree to divide profits in a proportion determined in advance as well as deciding the duration of the operation. The project may last a matter of weeks, months or years and in the case of a long or medium term operation, it is likely that some form of decreasing participation may be agreed upon, as described above so, that the ownership of the whole operation finally passes to the client, the bank having been paid back the principal as well as a

satisfactory share of any profits.

It should soon become apparent that although this procedure of profit sharing, either by *mudaraba* or *musharaka* is both Islamically desirable and in theory likely to return a profit to both sides, its chief drawback must be the cost of implementation. Once in operation, the running costs are unlikely to be significantly greater than any other investment undertaking by the bank, but the cost and additional expertise required to vet a prospective client's credit-worthiness and to carry out a feasibility study of the proposed project is likely to be high; a daunting situation to all but an established and already profit-making institution. A further consideration for the successful operation of this financing method is the ability of the bank to follow up the project with proper audits and periodic business decisions that befit the bank's dual status in the enterprise as both partner and provider of capital. Needless to add, the bank is not covered against the possible failure of the project it is financing. Under the *shari'a*, the lending institution may ask for collateral to insure the bank against the partner's neglect or irresponsible procedures, but this does not cover normal business risks.

In the case of the Islamic Development Bank, an institution to which a later chapter is devoted, the costs of appraising the proposed scheme as well as the process of initially attracting the entrepreneur may well be sidestepped in future leaving others to do the spade-work and reducing the bank's role to one of indirect participation.⁹ The IDB certainly cannot be classed as a high street bank, Islamic or otherwise, but the sharing of the project's inception costs with other institutions better able to carry out the sort of detailed analysis required under such circumstances is a way of cutting expenses whilst remaining involved in the project; it is a procedure that may be of considerable benefit to mainstream banks. Participation solely in providing capital in twenty out of fifty eight equity schemes undertaken by the IDB up to 1987 changes the classification of this tool from direct to portfolio investment and illustrates the need

for adaptability of Islamic methods of finance where it may otherwise be impractical for the financial institution to become involved in an investment.

Further problems confront the concept of equity financing. One major source of frustration to investors, institutional or private, concerns the dearth of stock markets in the region. The difficulties arising from this situation are complex, but basically stated, it is difficult to make liquid or sell an equity stake in an economy which lacks a market in which to trade the stake. This problem confronts governments in the Middle East as well as investment institutions when faced with the problem of financing budgetary deficits. Unlike the United Kingdom for example, Middle Eastern governments have no developed capital market on which to sell bills and bonds. Banks would be obliged to provide a guaranteed rate of high return via high interest rates in order to persuade customers to hold such assets and this, of course would be Islamically unacceptable. To counter this deficiency, it is not surprising that banks find the prospect of entering Euromarkets the only possible alternative. In this section there yet remains a further internal Islamic procedure to examine.

2.3.3 Murabaha

The rapid and reasonably predictable turnover of *murabaha* operations makes it a profitable means of using surplus funds on a short term basis with the option of depositing such funds in interest bearing accounts unavailable to Islamic banks and the alternative of leaving such funds stagnant equally unattractive. In his paper, "How to Islamise the Kuwaiti banking system", Kabbara suggests that the introduction of this tool should constitute the first step in the process of such a transformation:

"The application of *murabaha* at the early stages of Islamic finance stems from its simplicity and clarity. Moreover, it requires minimal alterations of the existing system of trade finance and minimal training of bank employees. More significantly,

the introduction of *murabaha* facilitates the provision of Islamic short-term finance in an economy which is predominantly trade orientated.”¹⁰

Originally, the Islamic Development Bank used *murabaha* to mop up surplus funds, employing them for trade financing in a method directly related to the documentary letter of credit. On the theoretical side, it is a popular method of encouraging trade between Muslim countries and improving the balance of payments situation that exists between them. *Murabaha* is encouraged by the Saudi-based Islamic Development Bank as a method of trade financing amongst its member countries, particularly those in the oil sector, but besides oil, commodities such as refined petroleum products, palm oil, cement and cotton and jute products are traded and financed in the short term by *murabaha*; these being particularly desirable Islamically as they are commodities for production rather than consumption.

For the banks themselves, however Islamically motivated they may or may not be, *murabaha* is attractive to them as a means of providing short-term credit whose return on investment is all but guaranteed whilst still conforming with *shari'a* law. The mechanics of a *murabaha* are relatively simple: the bank agrees to buy goods from an overseas supplier on behalf of its client, the 'real' importer, and thus opens a letter of credit to the supplier. The imported goods received by the bank's client are in fact owned by the bank which sells back the goods to its client at a slight profit. This mark-up on sale cannot be deemed interest as the profit is raised on real goods, not simply borrowed money. In respect of the *shari'a*, this is not a profit received at no risk, as despite expressing an intention to repurchase the goods acquired on its behalf, the client is under no legal obligation to do so. If the repurchase is not undertaken, the problem of an anticipated loss on further sale, particularly on a capital good for which there may be no market, is a very real one. In Saudi Arabia for example, those lucky enough to receive an Industrial License are likely to be operating in a near monopolistic situation as the Saudi government does not set as much store by

competition as we do in the West, if only because of the limited size of the internal market which may justify only one producer. Under these conditions how is a bank to find a customer with similar requirements to coincide with their unsold capital good?

However, the risks, although real, are not perceived to be as high as those involved in equity financing and moreover, the returns are regular. From day to day, banks are more able to anticipate their needs for liquidity to such an extent that trade credit infringes only marginally on the inter-bank market: that is to say that banks are unlikely to run out of money through advancing trade credit on which they receive no return.

Furthermore, this is no cosy sideline to convince banks that they are operating in an Islamically desirable manner whilst attaching little importance to this investment method and it has become more than a means of investing funds not required for project finance. Between 1977 and November 1982 the IDB financed 145 *murabaha* operations totalling \$US1,949.56 million, representing approximately two-thirds of the total amount of funding operations approved by the bank. A paper presented in 1981 by Dr Fahim Khan showed that the banks included in his survey had a preference for financing trade and investment in real estate, both of which provide quick returns on funds invested.¹¹ In the early stages of the development of Islamic Finance, it was necessary to show good profitability so as to provide a credible alternative to the interest-based banks operating in the region. This progress was continued up to 1987 when the 4,355 million Islamic dinars worth of foreign trade operations represented more than twice the size of the bank's capital.¹² A similar trend can be seen in the increase of *murabaha* clients at the Dubai Islamic Bank between 1980 and 1982. The number grew from 335 in the first year to 953 in 1981 and up to 3300 in 1982.¹³

2.3.4 *Ijara/Ijara wa Iktina* (Hire Purchase and Lease Financing)

One of the main attractions of leasing operations to Islamic financial institutions is that it provides opportunities to work with leading international corporations which serves to boost the banks' reputation and inculcate a sense of confidence in the minds of undecided clients. It also has the advantage of producing regular returns and being less risky in the long term than an equity participation scheme.

Banks may purchase machinery or production equipment on behalf of a client, agreeing to let the client rent it back. The bank is paid either in instalments that represent payment for borrowing equipment that it owns, or alternatively, the leasing is conditioned to purchase by the customer with the rental payment fixed or in proportion to the rented asset's contribution to profits of the enterprise in which it is being used. By this method, the customer becomes owner of the asset when the rental charges are the same as the cost of that asset. This instrument of finance has gained popularity in some countries where the rental payments are tax deductible.¹⁴ This method of financing best lends itself to the longer term funding required for capital goods, with commodities and raw materials the domain of *murabaha*.

2.4 Practical Aspects of Islamic Financing Procedures

It has been stressed in the preceding sections that the financing methods examined are those which are available in theory and which have been given a clean bill of health Islamically by the 'ulema'. This should not suggest either that all these methods are presently employed by Islamic banks operating in the Middle East or that no other instruments are being considered as a means of making Islamic banking a more viable alternative to conventional banks which provide a wider range of services. As has been illustrated, many factors conspire against a greater use of *musharaka*, for example,

in some countries of the Arab Gulf particularly where the local credit demand is not great, where more appealing terms are offered to the few who do require credit and where the banks have neither the experience nor the personnel to carry out intricate feasibility studies of proposed schemes. Conversely, such a climate is conducive to the financing of trade by the instrument of *murabaha*.

In addition to considerations of the commercial climate required in which Islamic finance will flourish, there are cases where a mode of financing has been tailored to meet the banks' needs while at the same time disadvantaging the client by allowing him to bear a disproportionate share of commercial risk. The weight given to trading instruments in the contemporary practice of Islamic banks, although acceptable, becomes a little less desirable when it is established just how little risk the bank is actually shouldering. A financial institution can almost rely on obtaining profit from the mark-up on sale involved in *murabaha* because it is unlikely that a client, having approached the bank to purchase goods on his behalf, will renege on the agreement and miss out on a trading opportunity, as well as souring relations with the bank simply to exercise the Islamic right not to buy. Thus, cases of non-repurchase must be rare, and with this in mind, the profit earned by the bank is almost risk free and as such, strongly reminiscent of *riba*.

Where other forms of financing are undertaken, according to Fahim Khan,¹⁵ actual malpractices are identifiable. Most involve a sidestepping of the risk-bearing responsibility by the bank in some way. In the case of leasing, clients have been obliged to undertake the insurance of the asset against all risks at his own expense, legally the responsibility of the bank. The same author cites abuses in profit and loss sharing arrangements whereby a Reserve Account is established by the client and profits above a lower than expected percentage margin are paid in annually, providing the bank with a reserve from which to draw in case profits fall below the set percentage. If the account is insufficient to meet the bank's return requirement,

he adds, then the client is obliged to make up the short fall by selling its equity shares to the bank.

With this in mind, it is not surprising that even in the case of a complete transformation of banking practice from the *riba*-based banking system to the Islamic model, such as occurred in Pakistan, a traditional attitude to bank clients still pertains. Similarly, there remains a reluctance on the part of the banks to take part in equity sharing schemes. As Presley observes:

“ Equity participation and *musharaka* accounted for less than 15 per cent of the total, owing in part to a lack of appropriate institutional and legal infrastructure, experience, and trained staff to evaluate projects requiring participation by the banks. In view of the predominance of the short term mark-up based operations, bank managements did not encounter serious adjustment difficulties; the basis of banking operations has remained the banker’s knowledge of the client and familiarity with their creditworthiness rather than the expected profitability of the activity for which the financing was sought.”¹⁶

Once again, the problems of initiating equity participation schemes, not to mention the effort of maintaining them, leaves the Islamic bank providing a less than complete service to its clients, even in the absence of competition from interest-charging institutions. Moreover, the former is not achieving a level of profitability which would make it a viable player in the inter-bank market, even if the latter’s activities were conducted in an Islamically acceptable manner.

2.5 Further Development of Islamic Financial Instruments

It may be true that in practice some of these methods of *halal* financing are open

to abuse, and that Islamic banks neither offer the same wide range of services to their clients, nor provide themselves with the same investment opportunities in the wholesale market. There is nonetheless a perceived need on the part of conventional commercial banks to offer specifically Islamic financial services to satisfy a growing number of prospective Muslim clients. The National Commercial Bank of Saudi Arabia, for example, offers Islamic trade finance to its customers as one of its services.¹⁷ Similarly, links between Islamic and conventional financial institutions have been strong, due in part to the trading situation between the Islamic Middle East and the West, as described above, and also the links are as a result of the more developed nature of Western financial markets which allows greater diversification in portfolio investment than may otherwise be found in the Islamic World. Thus, instead of forcing the instrument to fit a situation which has no real appeal to an Islamic bank, it may be beneficial from the point of view of earning an efficient and *halal* profit to investigate and emulate in an Islamically acceptable manner the way in which Western financial institutions make their money, achieved as a result of flexibility through diversification.

That this may involve not just the evolution of the banks themselves, but also the economic environment in which they operate is a significant consideration. Banks cannot operate in a vacuum, and to increase their scope of operations as well as their profitability, they will need outside assistance both for the creation of new financial instruments, and for the creation of markets in which to trade them. The idea of a central bank, or more particularly, a development agency, in this role may not be as fanciful as it sounds. The creation, in 1986, of an Islamic Unit Trust by a leading English merchant bank is a good indicator of how strong the demand for Islamic finance can be, if only realistic investment opportunities are presented. Nor can the altruistic dimension of a profit redistributing organisation such as the Islamic Development Bank be ignored.

Further considerations involve the relationship of Islamic banks with their conventional counterparts, nationally and internationally. From the account given in this chapter, it is possible to see that much thought has gone into the concept of Islamic banking and that its framework is well-developed, especially with regard to the retail sector and the choices presented to the potential investor. In the wholesale market, the structure is less than adequate. The heavy reliance on external trade both within and outside the Islamic world makes cogent some degree of cooperation between the two banking systems, especially with the Western institutions, as most trade from Muslim states is with Islamic rather than non-Islamic states.¹⁸ Yet it is difficult for a relationship to evolve, legally and practically without there being a standard code of practice and a sense of unity among the Islamic banks within a given country and amongst such banks in general.

The two banking systems can be considered complimentary in many ways, rather than mutually exclusive. In most Islamic countries, Islamic and *riba* banks operate alongside each other although not necessarily in conjunction. The practicality of their co-existence in the market place is attested to by the fact that both return profits and remain in business.¹⁹ To break even, however, is a situation quite different from achieving a substantial share of the market. With very few exceptions, Islamic banks must compete with conventional banks for profits in the retail sector, whereas in wholesale markets, no exceptions are to be found. Even after the complete Islami-sation of the Iranian economy in 1983, the interbank market continued to operate under the same interest-based system that had prevailed under the Shah's regime. The contention ran that the charging of interest between financial institutions did not constitute *riba*. This being the most favourable climate regarding competition in which the development of Islamic banking must take place, it becomes clear that outside assistance is vital.

Part of the role that a supranational body may play in accelerating the maturing

process of Islamic finance is contained in the following remarks:

“ Islamic banks are at a considerable disadvantage in facing competition with conventional banks because they do not have access to the money markets and may even face hostility from the conventional banks in these markets. The conventional banks can always resort to other banks and to the central bank when they face a difficult situation; this is not often the case for Islamic banks. A solution to this problem is to make provision for central bank assistance to the Islamic banks on a basis compatible with the *shari'a*.”²⁰

Islamic Banks requiring cash at call presently have no option but to hold cash reserves which yield no profit, inter-bank deposits being unlawful because of their *riba* element; the same holds true for government securities. Clearly, something similar to conventional securities is required although operating within the regulations imposed by the *shari'a*, one to be traded amongst Islamic banks, the other would involve tradable debt instruments issued by governments of Muslim states. The mechanics of these instruments as well as the markets in which they may be traded are topics which will be examined as a conclusion to the chapter, with particular emphasis on the role that the Islamic Development Bank could play in this context.

2.6 New Islamic Financial Instruments and Their Market

There are many considerations that govern the question of new developments that may transform the ways in which Islamic financial institutions conduct business in the 1990's. Not only would there be the need for sufficient buyers and sellers in the market, it would also be necessary for a market structure to be created in the first place and for an institution, probably in the form of co-operating central banks, to

provide a regulatory framework. This would not only involve the need to observe correct commercial procedure by the participating banks, but would also require an understanding of what constitutes Islamically acceptable practice; one set of religious guidelines would help to make the practice of Islamic finance more homogeneous and convincing to partisans of conventional finance. The issue of a central Islamic bank or regulatory authority is a thorny one. The Islamic Development Bank is often projected into this role; doubtless, there are ways in which this supranational institution can aid the progress of Islamic banking, and a section devoted to the IDB discusses them. For now, it should suffice to state that present circumstances make the assumption of a central bank role by this institution extremely unlikely.

In this sphere, perhaps the most significant contribution that the Islamic Development Bank can provide is that of principal market maker and the guarantee to repurchase any certificates that it might issue. The necessity of this latter undertaking cannot be over-emphasised. In the absence of a secondary market, the purchasing of shares is likely to be slow owing to investors' awareness of the lack of a trading place in which to offload their certificates. The possibility of repurchase by the bank will provide the prospective investor with the liquidity element required by him as an owner of assets.

The new instruments mentioned at the end of the previous section would doubtless meet the pre-requisite of tradeability, but they would be presented to the market at different levels. Whilst the market in government debt instruments would have to be at the national level, it has been suggested that the market in Islamic certificates of deposit would operate internationally.²¹ Increased co-operation between Islamic banks is necessary to launch this instrument in an extremely competitive market; once again, the international dimension turns attention towards the Islamic Development Bank. Chapter six assesses the extent of this institution's contribution to the development and marketing of new financial instruments as well as the creation

of their market. In more general terms, the chapter makes a practical assessment of the Islamic Development Bank's role in promoting Islamic finance worldwide. With this in mind, more detailed examination of new financial instruments is deferred until then.

Footnotes

- 1 Muhammad Abdul Mannan, *Islamic Economics: Theory and Practice*, The Islamic Academy, Cambridge, 1986, p.159.
- 2 M. Fahim Khan, *Economic Rationality of Islamic Banking* paper presented to Seminar on Islamic Banking, Leicester, July 26, 1988, p.3.
- 3 Mannan, *op cit*, p.178.
- 4 John R. Presley (Ed), *Directory of Islamic Financial Institutions* Croom Helm, London, 1988, p.24.
- 5 M. Umer Chapra, *Towards a Just Monetary System*, The Islamic Foundation, Leicester, 1985, p.206.
- 6 Rodney Wilson *Development of Commercial Instruments in Islamic Finance*, paper presented at SOAS conference on Islamic Economics October 1989, p.7.
- 7 Adnan M. Abdeen and Dale N. Shook *The Saudi Financial System In The Context Of Western And Islamic Finance*, Wiley, Chichester, 1984, p.188
- 8 *ibid*, p.187.
- 9 as in the case of the IDB, see Rodney Wilson, *The Islamic Development Bank's Role As An Aid Agency For Muslim Countries*.
- 10 Haitham S. Kabbara, *How to Islamise the Banking System in Kuwait*, paper presented to Seminar on Islamic Banking, July 26, 1988, pp.29-30.
- 11 Contained in *Money and Banking in Islam*, Ahmad et al, International Centre For Research In Islamic Economics, Jeddah, 1983, p.14.
- 12 Rodney Wilson, *op cit* p.455.
- 13 Abdeen and Shook, *op cit*, p.190

- 14 John R. Presley, *Directory of Islamic Financial Institutions*, Croom Helm, London, 1988, p.28.
- 15 Fahim Khan, *op cit*, p.11.
- 16 John R. Presley (Ed.) *Directory of Islamic Financial Institutions*. p.265.
- 17 Rodney Wilson, *Development of Commercial Instruments in Islamic Finance*, paper presented to a conference on Islamic Economics, SOAS, 28 October 1989, p.3.
- 18 *ibid*, p.4.
- 19 The Islamic banks will occasionally harness the savings of a sector of the population who have previously not held a bank account, considering all banks to be either foreign-owned or *riba*-based. This has been the case with the Jordan Islamic Bank.
- 20 John Presley (Ed), *op cit*, p.62.
- 21 Rodney Wilson, *Development Of Commercial Instruments*, p.8.

Chapter Three

THE EUROMARKETS

3.1 Structure of the Euromarket

3.1.1 Definition

Stated in the most basic terms, a market exists when buyers wishing to exchange money for a good or service are in contact with sellers wishing to exchange a good or service for money. In this instance, a market is defined by the forces of supply and demand without necessarily being confined to a specific geographical location. The concept of the market is a fundamental one in contemporary economics because, in a free market economy, this is the mechanism by which resources are allocated.

The Euromarket differs very little in concept. It is, by definition, unrestricted by geographical boundaries and relies on the basic forces of supply and demand for its continuing existence. A very important consideration for the operation of an offshore establishment is the necessity of good communications. It will be seen that the political and economic stimuli applied to Eurobanking activities in the post-war years were accompanied by great improvements in communications technology. Bearing in mind that a Euromarket is not a tangible institution, being in fact separate entities linked by telex and computer, it is reasonable to state that communications are a prerequisite for operation. However, the most significant factor contributing to the existence of Euromarkets is the way in which they differ from traditional banking facilities within a given country. In this context, for 'Euro' one should simply read 'external', showing that the financial institutions dealing in a Eurocurrency are not part of the domestic banking system and as such are not subject to domestic banking regulations. The important advantages that this status incurs will be examined

shortly. Nevertheless, although Euromarket centres enjoy this difference in status and can be distinguished by the services they offer, it is equally important to acknowledge their link with domestic markets. The Eurocurrency market, which will be examined first, is not a banking system in itself but rather an extension of the major countries' domestic banking system. To clarify this series of statements it is necessary to investigate how the Euromarkets work, looking specifically at the markets for Eurocurrency and Eurobonds.

The origin of the Eurocurrency market had little to do with the Arab world, although the OPEC states played an important role in its later development. United States dollars, the first major currency to be found in this market, were first held in this external capacity shortly after the Second World War by Communist countries. Fearing the appropriation of their dollar assets by the United States, these countries preferred to hold them in Paris and London, outside the control of their country of origin. The US dollar is not the sole currency unit used in this market's transactions. However, the currency involved must be freely convertible: one that will appeal to the greatest number of financial institutions in the market. Therefore it is usual to see deposits and loans denominated in Deutsche Marks and Sterling in addition to US dollars. The Eurocurrency market is thus composed of financial institutions bidding for Deutsche Mark deposits and making Deutsche Mark loans outside West Germany, financial institutions outside the UK which perform similar services with sterling—and so on. When considering the size and unrestricted nature of this market, it is also worth noting that the currencies loaned need not necessarily be those of either borrower or lender.

3.1.2 Some Features of Euromarket Operations

The greatest advantage to be found in Euromarket operations is the lack of domestic

banking regulations, indeed, this is the key to their success. The constraint most significant by its absence is that of a minimum reserve requirement. Without this, Eurobanks are able to make profitable use of all deposited funds rather than keeping aside a fixed percentage with the central bank or federal reserve at minimal or zero interest. As a result of this maximal use of funds, the Eurobanks are able to offer slightly higher deposit rates and lower lending rates to their clients. Consequently, one observes that the Euromarkets are fully a wholesale operation with profits being made on the sheer volume of business passing through the participating financial institutions on the interbank market. Below is an example given by Adrian Buckley of a typical Eurodollar transaction.¹ A US corporation with a \$2 million surplus notices the more attractive rate offered on dollar deposits outside the US where the surplus was originally held in a time deposit at a local US bank. Having switched the time deposit's now matured funds to a demand deposit, the funds are then transferred to the bank's London branch where a time deposit is made. The route taken by these funds is not particularly intricate, but in order to observe who gains from the transaction and how this is so, it is important to chart carefully the course of the US company's dollar deposit.

“..This process creates a Eurodollar deposit, substituting for an equivalent time deposit in a US bank. The London branch of the US bank deposits the cheque in its account with a US bank. The US company holds a dollar deposit in a bank in London rather than in the USA. The total of deposits of the banks in the US remains unchanged. However, investors hold smaller deposits in the US and larger deposits in London. The London bank now has a larger deposit in the USA. The increase in the London bank's deposits in the US is matched by the increase in dollar deposits for the world as a whole. The volume of dollar deposits in the USA remains unchanged while the volume in London increases.”²

It is now that the real value of a deep market for a given currency becomes apparent. The dollars can be passed on between many banks although it may not be necessary for each bank to have a regular contact with more than a couple of other institutions. Should the London bank not have a commercial borrower which requires the funds, it will place them on the Eurodollar interbank market. This process can continue through a number of Eurobanks until a final non-bank borrower is found. Each bank in the lending process pays a slightly higher rate than the previous one but, at around one eighth of one percent, margins on the interbank market are very small. It is also important to note that the passing on of funds on the interbank market has no effect on the extension of credit until the funds are passed on to a non-bank borrower such as another corporation or a government.

Within the currency loan market, the lending policy of the Eurobanks differs significantly from that of domestic banks. This raises a number of issues. Firstly, the practice of lending large sums to few customers is vital to the profit-making capacity of financial institutions in the Eurocurrency market. These profits rely on the continuing attraction that the offshore sector holds for its clients; substantial loans at competitive rates. These rates could not be maintained if Eurobanks were to serve the smaller customer whose marginal cost would be greater than a larger one. As a result, in comparison with domestic banks who offer a much wider range of services to a wide cross-section of clients, Eurobanks maintain significantly lower overhead costs, aiding profitability. In addition, being beyond the control of their host country's government, Eurobanks are not obliged to undertake the financing of projects considered important for that country's economic well-being, but not necessarily a profitable venture by the bank. The social benefits and costs of Eurofinance are not issues of primary importance to participating financial institutions. The second observation concerns how Islamically justifiable a policy with such a narrow outlook may be. There is no welfare dimension to Eurocurrency transactions

which favour those with an impeccable reputation for creditworthiness rather than those who may be equally deserving if only the bank would undertake an examination of the financial record of such a case. This of course would raise overhead costs and change the complexion of the bank's overall policy.

Customer contact is on a very much smaller scale than in the retail sector with most of the transactions taking place on the interbank market. A separate study will be made of the role of Islamic banks within a market involving interest charges and what may arguably be classified an inequitable code of conduct. This in itself requires further exploration. Whilst a long term securities market such as the US debt market revolves around the credit rating assigned by agencies such as Moody's and Standard and Poors, customer status is slightly less well defined in the Eurocurrency market and is based on reputation. As we enter the 1990's, financial institutions of all kinds should be aware of the brittle nature of reputations; what may appear to be a sound lending opportunity can often turn out to be just the reverse.

Moreover, all basic Eurocurrency loans are unsecured credits and while in practice borrowers of unimpeachable reputation may well deserve such a credit rating, the much wider availability of funds for loan, owing in part to the expansion of the market over the last decade, has allowed less highly rated borrowers to enter the market. For example, what may be classed as economically suspect governments have entered the medium term Eurocredit market seeking funds for infrastructure projects and for financing balance of payments deficits. Lessons are soon learned on a smaller scale, too. Although a quite distinct entity offering its clients different services to domestic banks, the Euromarkets nevertheless cannot afford to ignore the trends that the latter observe in their domestic and international 'regular' transactions. Indeed, the fact that banks can arbitrage between domestic and Euro-business leaves the Euro interest rates subject to banks' behaviour rather than directly by the supply and demand for money by non-banks in the Euromarket.³

In the case of Eurocredits with a maturity date of up to ten years, the problem becomes more acute. Due to the fact that loans on the Euromarket rarely fall below one million dollars in value, with profit being made through large movements of money rather than via a high rate of interest, it is important to have reliable up to date information on the final borrower. It may be stated that the risk involved in lending above a certain figure to a single borrower, putting all the eggs in one basket, can be lessened by syndicating the loan with other banks. Nevertheless it should always be borne in mind that an bank has the capacity to over-lend, in which case it leaves itself open to crashing. The spectre of a widescale run on banks for this reason is unpleasant to contemplate. Further prudential and economic objections to the existence of an unregulated banking system will be studied in a separate section.

Before an examination of the practice of Euromarket operations, it is logical to note the political and economic factors contributing to its growth, why it continues to thrive and the role the OPEC states played in its evolution.

3.2 Development of the Euromarket

The Eurocurrency market was conceived for a variety of somewhat negative reasons and its expansion is partly due to similar considerations. Just as the Communists in the 1950's sought to keep their dollar assets free from the risk of US confiscation, political factors conspired in the 1970's to keep Arab funds from being directly invested in the US, a country which had recently been the object of an Arab embargo.⁴

Economic restrictions provided another part of the impetus allowing the observation that much of the energy for development came from the supply side of the market. In the late 1950's, sterling's weak position, along with the restrictions on its use for financing third country trade, led to the British bankers' use of dollars in this capacity and consequently their interest in the Euromarket to provide those

dollars. The US added to this growth during the 1960's as regulation Q restricted the rate of interest US banks could pay on deposits.⁵ The American answer to the ensuing credit shortage resulting from the flow of funds to London and Europe was to establish branches in European financial centres and channel funds back to the USA. The mechanics of this arrangement has been explained above.

The 1970's saw the arrival of the Arab world on the Eurobanking scene. This was in great part due to the huge OPEC surplus following the 1973 oil price increase. OPEC's devotion to Eurobanking facilities stemmed from the massive size of the surplus which had to be recycled somehow and the system's safety, efficiency and competitiveness in this process. The large OPEC surplus meant corresponding deficits in the oil importing countries. This switch in fortunes left deficit countries with a number of choices as Adrian Buckley observes:

"They might recognise that their deficits would not be temporary and attempt to restructure their economies to lessen dependence on oil and to stimulate new exports, using reserves and borrowing to finance the restructuring. They might deflate their economies by holding down domestic consumption and investment, limiting demand, and thereby minimising borrowing. The option most widely chosen by developed countries involved a combination of financing and deflation."⁶

Irrespective of the course chosen, the impact of the oil price rise and its possible future use as an economic weapon was undeniable. It is also reasonable to state that the role of the Euromarket in bringing oil-importing countries to this realisation is a significant one. Furthermore, its continuing use for the financing of deficits seemed assured. In January 1974, France arranged a \$1.5 billion credit that would fund approximately one third of its estimated current account deficit for 1974.⁷ Although the loan was not drawn on in 1974, Daniel Kane observes that the market's capacity

to provide credit of this size after billion dollar credits of 1973 gave an indication of its depth and flexibility as an international capital market.

Having traced the development of the Euromarket to a position of maturity, it remains to study some practical considerations of its operation.

3.3 Euro-Finance in Practice

3.3.1 The Attraction of Eurocurrency Transactions to Borrowers and Investors

It should not be assumed from the outset that the Euromarkets are an ideal place for borrowing and investment for all those who qualify to make use of the markets' services. Several factors pertain that contradict such an assumption. The risk factor is relevant to both the borrower and the investor as well as the market as a whole. In theory, it is possible to argue that Euromarkets both increase and reduce risk exposure on the part of the investor. One line of reasoning suggests that a host government may seize the assets of a Eurobank operating within its country or somehow restrict its activities for reasons of political expediency or to drastically alter its foreign exchange position. This is known as sovereign risk. In simple terms, because Eurodeposits are located in a different country, they are in some respects subject to the jurisdiction of that country. Consequently depositors may be deprived of their funds at maturity by an unexpected action from either of the two countries; or indeed from any country involved in the chain of interbank transactions. Adrian Buckley offers the example of a US depositor in the Eurodollar market holding a claim in London but ultimately receiving payment in the USA.

On the other hand, holding a deposit in an offshore market may be considered prudent where there is the fear that new capital controls may be imposed on the

disposition of residents' funds. This latter consideration is however only one amongst many; it is unreasonable to suggest that the main attraction of the Euromarket lies in its capacity to reduce risk. In effect, the different domestic and offshore interest rate levels may arise through the latter market being perceived as more inherently risky. To add weight to this claim, one should consider the differing position of central banks to domestic banks and their external counterparts. Whereas the central bank of a certain country may undertake to rescue troubled domestic banks, why should it do so for an offshore branch? After all, having gained an enviable commercial position by operating outside the financial law, it is unreasonable to summon the law-maker when such behaviour has led to difficulties. Furthermore, it is not easy to ascertain who should be the lender of last resort when difficulties originate from loans on the books of foreign affiliates. This contentious issue is more thoroughly assessed in the later section on the case for control of the Euromarkets.

In addition to the risk factor we observe the problem of exchange controls. These take many forms ranging from the requirement for residents to surrender all holdings of foreign currency to restrictions on the acquisition of assets and liabilities denominated in a foreign currency. In a wider sense, the controls may involve the stipulation that foreign companies meet certain requirements for setting up business in the host country to restrictions on remittances out of that country. The effect of such controls made in order to maintain an artificially high currency value is particularly evident in some parts of the Middle East. Here, governments restrict foreign borrowing by domestic companies as well as making it difficult for depositors to invest abroad and the resultant increase in black market activity, both in currency exchange and unavailable foreign goods, is only one symptom of restrictive economic policy. This apparent digression does however illustrate a point. In countries fortunate enough not to require them, absence of exchange controls allows non-bank institutions to tap the Euromarket, creating an economic condition wherein the creation of a Eurobank-

ing centre in the Middle East made good sense to the region's inhabitants. Neither Bahrain nor any of the adjacent oil-exporting states of the Arab Gulf are hindered by any kind of exchange control. Further details of Bahrain's diversification from its limited oil reserves to its position as a thriving offshore banking centre are provided in chapter five.

3.4 Euromarket Interest Rates: Further Considerations

It has been established that interest rates within the Eurocurrency market are fundamentally determined by the nature of the market's composition. To this remark has been added the existence of a strong link between domestic and offshore interest rates. This section aims to look more carefully at this link in terms of why and how it is maintained; a logical examination for it is within this interest-dominated sphere that Islamic finance houses must operate if they are to play a role in the lucrative interbank market.

Eurocurrency markets *per se* face further competition from what may be termed the intermediate position held by International Banking Facilities (IBF's). These arose in 1981 out of a desire on the part of the US authorities to attract offshore funds to internal institutions which shared many of the characteristics of fully-fledged Eurobanks whilst still being subject to a certain amount of control from the host country.⁸ With these offering a lower sovereign risk than Eurobanks and domestic banks looking even safer, it is plain that there is more than one segment in the total market for credit denominated in a given currency. These various financial institutions merely act as intermediaries within the market for taking deposits and making loans.

At least the method of switching funds between domestic and offshore markets, namely arbitrage, is Islamically acceptable as it is not in itself speculative. Unfortunately, this is of course an arbitraging of interest rates, occurring to make use of

profit opportunities available in the international markets. An arbitrage flow of funds will take place between the two markets if the difference in their rate of interest is greater than the foreign exchange differentials involved in the new market.⁹ Under conditions that are free from such obstacles as exchange controls described above, arbitrage between the two segments of the money market ensures that interest rates remain parallel both in their level and in the size and timing of their changes. Adrian Buckley observes the evidence of this correspondence:

“The close cleavage of rates has regularly been demonstrated in empirical work; but where exchange controls or the like are in place, the tendency for the close movement of rates in domestic and external markets is to be found much weaker. Indeed, an indication of the efficiency of capital controls can be seen in the degree of divergence of interest in the two markets. Wide divergences are associated with tight capital controls, and vice versa.”¹⁰

For reasons of differing levels of risk observed in the markets by depositors and the lower costs to borrowers through lower costing external transactions, the rate of interest posted by the two (or three) sectors is very unlikely to be precisely equal at any given time. However the value of this link with domestic markets is, to the unregulated Euromarket, an important one. What then governs the rate of interest on the various classes of securities that Eurobanks offer?

The relevance to this discussion of term structure centres on the market's varying preference for securities of differing maturity: whether there is a preference for long term securities reflected by higher expected interest rates than may be found on a series of shorts over the same period, or vice versa. In equilibrium, the interest rate for all securities, short and long, can be the same showing that short term borrowing and lending is just as expensive and profitable respectively as it is over the long term.

The reasoning behind the term structure theory is fundamentally the same for both markets. Prices on the London Stock market, for example, are primarily based on what investors, institutional and otherwise believe is likely to happen. Differently put, it is based on their expectations. Thus, in equilibrium, the investor finds that he achieves the same result from consistently re-investing in shorts over a set period as he would by investing in a long-term security that covered the whole period.

However, in practice investors need some kind of encouragement for exposing themselves to the risk of lending long. In these circumstances, the liquidity preference theory suggests that longs will give higher yields than shorts. Related to this supposition is the inflation premium theory, similarly indicating that interest rates on long-term securities must be higher than on shorts to compensate for a longer exposure to savings erosion. This time then, it is a matter of possible loss rather than a deprivation of choice through fund illiquidity that contradicts the theory of interest rate parity over the full range of maturities.

After establishing the reasons for varying returns on investment determined by an assessment of risk and provided for by a different rate of interest per unit of investment, it is considered worthwhile to inspect the market for longer-term credit.

3.5 The Eurobond Market

This section gives an indication of the Eurobond market's characteristics— what is available, how the market works and its advantages to the players involved. Thus only those features that are distinct from Eurocurrency markets, providing investors, banks and borrowers with a significantly different service, are discussed.

A small amount of space must be devoted to an analysis of how the Eurobond differs from any other bond, in particular the international bond with to which it bears

a close relation. The similarity between the latter two ends when it is observed that the Eurobond, in addition to being offered for sale in a variety of different countries, is also underwritten by more than one organisation. Thus, they may be raised in one country by a non-resident company and placed in a currency common to neither the company nor the country in which the bond is issued. Importantly, they are offered for sale in more than one country with international syndicates of underwriting and selling banks appearing on the tombstones. Whilst some international bonds are bought by residents of more than one country, Eurobonds are intended for sale to a broad spectrum of international investors.

To be attractive to a wide range of potential investors, Eurobonds must be denominated in a strong or well-known currency, investors having trust in its future value. The same of course holds true for bonds denominated in more than one currency; it is also common to have ECU's or SDR's as the unit of denomination.

Eurobonds are generally issued by corporations or governments needing secure, long-term funds. Herein lies one of the chief advantages for investors. Although not subject to the stringent entry requirements of the US debt market, the Eurobond market is nevertheless very much a 'name' market: it is perceived as safe, and needs to remain that way for a market cannot continue to function without trust. Those permitted to issue Eurobonds must already have a high reputation for credit-worthiness before they may do so, be they governments or multinational companies. In addition to this, owing to the offshore nature of Eurobond issuing, interest can be paid free from income tax.

On the borrowers' side, considerations such as possible government restriction on foreign investment and lower lending rates than in the domestic bond market combined with less red tape which results in capital being raised more quickly are among the more obvious factors contributing to a preference for the Eurobond market.

There are however, questions of 'policy' rather than tangible and direct economic advantages that encourage the raising of long term capital in the Euromarkets. In the case of smaller companies, these include a desire to spread its name in the international financial community, to keep foreign operations separate from and independent of domestic operations, or to distribute its stock as widely as possible. This last aim can be achieved if the company has issued convertible bonds, allowing the part-substitution of stock for dividends.¹¹

A final look at the Eurobond market reveals that it comprises both a primary and secondary market, the latter having been rapidly expanded and integrated in the late sixties and early seventies by correspondingly rapid advances in communications technology. This is an essential feature for assuring the liquidity of Eurobonds. Furthermore, a secondary market is not only essential for day to day operation but it also has obvious advantages over restrictive domestic stock exchanges.

"By direct international dealings among professionals, bypassing the exchanges, the mechanisms and the rules of which are too local in character ... the Euro-Bond market has created in the age of telex a new form of secondary international market far better suited to the geographical diversity of the international investors than what can be accomplished in traditional national markets."¹²

3.6 The Interbank Market

Closer scrutiny of the interbank market as opposed to a broad overview of the Euromarkets involving the provenance and destination of funds reveals a number of interesting features. Although to note every movement of money within the whole Euromarket system would involve worthless double-counting and give a false indication of the size of the market, the customary netting out of interbank transactions

ignores a fundamental factor in the successful operation of the Euromarket. This is the worldwide redistribution of liquidity; the efficient linking-up of lenders with a surplus to borrowers. An examination of interbank market operation shows that this market serves a number of economic functions which turn on its efficiency as mediator between lender and borrower.

The efficiency of this linkage is the primary contribution of the interbank market to the world economy; its broad base and speed of transaction also provides an efficient means for managing foreign exchange and interest risks. In addition, this market helps players in the money market avoid a certain amount of red tape as well as taxes and other constraints found in domestic money markets. Islamic banks and financial institutions must consider very carefully their attitude to how the interbank market works as well as its advantages and drawbacks. It is inadequate to look in isolation at the ethics of each transaction between Eurobanks without prior consideration of why the transaction is being made. That each time the money is passed on it incurs an extra increment of interest is one factor; that it may benefit the economic well-being of a whole money market centre is another which highlights a need for pragmatism amongst the Islamic banks' religious supervisory boards if successful inclusion in this lucrative market is to be achieved by these institutions.

In the case of the Eurocurrency market, banks are able to exercise a certain degree of choice in their field of operation. Despite the huge size of this market, which by 1981 had reached an estimated \$1.6 trillion in deposits,¹³ the mechanics of an essentially interbank market allows different banks to specialize in different functions and credit transformations, all of which contributes to the efficient movement of funds from net lender to net borrower. The interbank market operates on the process of information and delegation; an institution which has access to a non-bank depositor's funds will take them on the strength that someone at the end of a link of banks, of whom the original deposit taker need only know one, will require these funds. It

is arguable that Islamic banks may be best suited to a role in which they either solicit the original deposit or pass it on to the final borrower. These banks are thus involved in the interbank market but rather than awkwardly fulfilling their role as a link in the chain, they may be able to make profitable use of their Islamic identity, at least regionally and become the all-important link between banking institution and non-bank borrower or lender.

It is worthwhile considering how a bank can achieve an advantage, first of all in soliciting deposits. The advantage may arise from a number of different considerations, among which may be the bank's reputation for prudent investment. More specifically to Islamic banks, the advantage may be due to a shared ethnic or religious identification with potential investors. Banks taking deposits in Bahrain may benefit from a combination of the previous two factors with the comparatively unregulated environment of the area or for example with an the attitude of the Saudi Arabian Monetary Authority which appears to have the blessing of a reliable lender of last resort.

Similarly, a bank may have an advantage in lending money at the end of the chain which arises because of either historical ties to corporate or government borrowers or simply because a bank may be located in a region which is suffering from a current account deficit.¹⁴ While no bank, Islamic or otherwise, can have much effect on the latter situation, they can nevertheless benefit from having available wide information about borrowers or having a good propensity for quickly assembling and correlating information about the credit-worthiness of potential borrowers. Islamic banks, still relative newcomers to the international banking scene, cannot claim all of these advantages: they may benefit from religious identification with an important proportion of investors and borrowers as well as the chance of location in a favourable international banking environment such as is found in Bahrain. However, they cannot hope to have established a solid reputation for financial acumen as well as prudence

that will lead to their being chosen in preference to banks with a proven record and reputation for both by any other group than Muslims. Whilst this need not preclude the involvement of Islamic banks in the interbank market, it does at the same time present a strong case for the combination of experience from *riba* banks with the local advantages (for the Arab Gulf at least) offered by Islamic operators. An historical parallel has been provided by the Saudisation of foreign banks operating in Saudi Arabia in the 1970's. In this circumstance, one would observe a situation of mutual co-operation as opposed to unilateral nationalisation that led the two types of banks to combine forces.

Before making judgements on the feasibility of a combination such as is described above or on the deeper involvement of Islamic banks in the Euromarkets as a whole, by way of conclusion it seems logical to observe the risks involved in the whole structure of Euro-finance and to examine the possibility of wide-ranging supervision of the Euromarket system.

3.7 The Case for Supervision

There are three sides to this discussion on controlling the Euromarkets. The first is an examination of the perceived need for the supervision of Euro-Finance in general and is followed by a brief study of what controls might be implemented and how. In this context, it is considered appropriate to study the probable result of these attempts to change legislation governing the international movement of money as well as the controversy that surrounds the issue of control or supervision of the financial institutions themselves. Thus, the discussion will include not just restrictions placed on capital mobility within the Euromarket in general, but also the possibility of an international central bank being set up to monitor the performance of banks' offshore branches and the feasibility of such an institution acting as lender of last resort.

There are three basic objections to an unregulated Euromarket. The first is put forward by those countries who believe that inflation results from the Euromarkets' capacity to increase the velocity of credit circulation as well as the debatable ability of the market to create credit.¹⁴ Whilst domestic inflation may or may not be attributable to offshore banking activity, the results arising from a banking crash which may be prevented by regulation are very much easier to identify. "Existing regulatory policies," observes Guido Carli, "are basically oriented towards 'benign neglect.'" ¹⁵ In a situation of such loose supervision, it is argued that unregulated banks will tend to over-lend and, that the interbank market which so efficiently redistributes liquidity on a global scale will also quickly transmit credit shocks if there is a default at any stage of the interbank chain. Of course, banks are not the only ones to suffer: depositors feel the cost as does the economy in general under a situation of unstable credit.

The third major argument concerns international capital mobility which clearly frustrates monetary policy and exacerbates exchange rate variability leading to the endless wrong-footing of international trade.¹⁶ However, whereas monetarists may cite these important principles, the political inertia and logistic difficulties of implementing any kind of supervision back up the understandable determination of most international bankers to maintain the status quo.

Thus, the vested interests of bankers on one side and monetarist opinion on the other provide two opposing views to the question. However, it would be inaccurate to define the controversy in such polarised terms. There is a 'grey' area occupied by those shifting opinion according to the prevailing economic climate. For instance, when a crisis of confidence in credit has occurred or is predicted, calls for a more responsible lending policy and a sensible reserve ratio are at their most audible. Such calls in the late 1980's however would most likely have been deemed over-bearing while economies benefitted from the results of a liberal lending policy.

Clearly, external supervision which encourages rather than stifles the transmission of credit is appropriate but it should have the capacity to restrain irresponsible lending that would damage the reputation and compromise the stability of the Euro-markets. Herein lies the crux of the question: the supply of credit is determined by investors' confidence in the system that distributes and returns it.

"Money is like a lady who, in order to remain such, does not tolerate being talked about... in order to *établir le silence de la monnaie*, a lender of last resort has to stand behind it in order to 'cut the gossip short.'"¹⁷

Whilst the statement that money (in this case Eurocurrencies) must remain untarnished by gossip in order to remain viable is accurate, is it not possible to look to the opinion of the domestic central banks of the Euromarkets and gauge the likely stability of the offshore money markets from that opinion? These institutions after all, conduct transactions on the Eurocurrency market and a brief look at their motives for operating there may help to gauge their real reaction to a market which, on the surface, detracts significantly from their authority.

The central banks of underdeveloped countries are most likely to make deposits in the Eurocurrency market, the returns being more attractive than for example gold (zero) or US treasury bills.¹⁸ Euromarkets can be employed as a tool of domestic monetary policy, in trying to prevent an increase in the exchange rate value of the dollar for instance. This can be attempted by the central bank increasing the supply of its dollar holdings to the Eurocurrency market. Similarly, if a central bank dislikes the prospect of an increase in interest rates in the Eurodollar market, it may try to influence that interest rate by supplying dollars.¹⁹ These three examples illustrate three different reactions to the Euromarkets by central banks. Only one of them shows a reaction to a situation that would not have existed had there been no Euromarkets.

It does not require the immature state of an LCD to lead a central bank to gamble in the Eurocurrency market. Below is cited a speculative failure by the German Bundesbank in 1961:

“Eurodollar facilities have been used extensively not only for speculation against a currency, but also for speculation in favour of a currency. This was done, for instance, in 1961 when Eurodollars were borrowed and sold against D. Marks and Swiss Francs in anticipation of a revaluation of these currencies, rather than a devaluation of the dollar.”

The German monetary authorities, by supplying the Eurodollar market with dollar deposits through the intermediary of German banks, increased the difficulty of their own task in resisting the pressure for a second revaluation. In fact they initiated and maintained a vicious circle when lending their unwanted dollars to the German banks, and, through them, to the Eurodollar market, for much of the self same dollars were sold by the borrowers against D. Marks, so that they found their way back into the Bundesbank's reserves, only to be re-lent again to the Eurodollar market through the German banks.²⁰

Mistakes of this sort illustrate that there is occasionally the mentality among central banks of ‘if you can't beat them, join them.’ Yet factors other than the possibility of manipulation for benefit conspire to make this a matter of accepted fact. When one considers the problems facing the creation of a central bank for the European Community,²¹ certainly much nearer to being a single identity than the Euromarket, the obstacles involved in setting up a ‘bankers’ central bank’ look insurmountable; to wit the painfully slow machinations of that other international financial body, the IMF. Moreover, it is surely better for central banks to play along with a system that they can at least observe openly. After all:

“...regulation in some form is necessary for stability, yet in a flourishing market system, regulation tends to spawn deregulated centres because people want to get out from under, and escape to areas of greater freedom.”²²

The picture of future Euromarket stability should not, however, be seen as a gloomy one. The Euromarkets grew and prospered as a result of their separation from the political and economic constraints of domestic financial practice; any attempt to control and regulate such a financial market would result in an even looser and potentially more volatile system. There is, however, a significant difference between regulation and supervision and, in a market so reliant on information and co-operation, it is not unreasonable to believe that reforms seen as aiding efficient practice as well as restraining imprudent policy would be universally welcomed. A financial market needs the confidence of its bankers no less than the confidence of its non-bank players.

Footnotes

- 1 The US dollar was the original currency of exchange in this market, hence the terms 'Eurodollar' and 'Eurocurrency' have become interchangeable.
- 2 Adrian Buckley, *Multinational Finance*, Philip Allen, Oxford, 1986, p.296.
- 3 L. Alan Winters, *International Economics*, Allen and Unwin, London, 1983, p.332.
- 4 Daniel Kane, *The Eurodollar Market and the Years of Crisis*, Croom Helm, London, 1983, p.103.
- 5 L. Alan Winters, *International Economics*, p.332.
- 6 Adrian Buckley, *op cit*, p.299.
- 7 Daniel Kane, *op cit*, p.106.
- 8 Henry S. Terrell and Rodney H. Mills, Jr, *International Banking Facilities and the Eurodollar Market*, in *Eurodollars and International Banking*, Paolo Savona and George Sutija (ed), St Martin's Press, New York, 1985, p.183.
- 9 Paul Einzig and Brian Scott Quinn, *The Euro-Dollar System*, Southampton, 1977, p.64.
- 10 Adrian Buckley, *op cit*, p.310.
- 11 Yoon S. Park, *The Euro-Bond Market: Function and Structure*, Praeger, New York, 1974, p.58.
- 12 Robert Genillard, Partner, White, Weld & Co., in a speech before the Economic Club of Chicago, March 13, 1969. Quoted in Yoon S. Park, *op cit*, p.91.
- 13 Paola Savona and George Sutija (ed), *op cit*, p.1.
- 14 Richard J. Herring, *The Interbank Market*, in Savona and Sutija, *op cit*, p.112.

- 15 A number of authors hold differing opinions on this. The view that sees the money multiplier in the Eurocurrency market as very small, and that the most significant causes of and treatment for inflation are to be found in the domestic arena, seems to make the most sense.
- 16 Guido Carli, *Eurodollars: Policy Analysis*, in Paola Savona and George Sutija (ed), *op cit*, p.139.
- 17 L. Alan Winters, *International Economics*, p.342.
- 18 Guido Carli, *op cit*, pp.148-9.
- 19 Rene P. Higonnet, *Eurobanks, Eurodollars and International Debt*, in Paola Savona and George Sutija (ed), *op cit*, p.34.
- 20 *ibid*, p.35.
- 21 Paul Einzig, quoted by Rene P. Higonnet, *op cit*, p.38.
- 22 See *The Economist*, 10 February 1990.
- 23 Peter M. Oppenheimer in Paola Savona and George Sutija (ed), *op cit*, p.106.

CHAPTER FOUR

THE ROLE OF ISLAMIC BANKS IN INTERNATIONAL FINANCIAL MARKETS

4.1 Interview Methodology

This work has so far examined the modus operandi of the Islamic banker and investor within an arena which is at least positively disposed towards Islamic finance. Subsequently, it has observed the workings of a Western financial market that will tolerate the presence of Islamic banks only so long as they are able to compete successfully within that market. This section combines the information from the previous two chapters with a case study of Islamic financial institutions, two operating in London and one in Geneva, to observe how amenable is the West to the principles of Islamic finance. This is based upon the success of these three companies in competition against Western banks. The problems encountered in this sphere and the prospects facing Islamic banks in the West will be discussed in reference to interviews given by the three banks. This is a study of competition, cooperation and innovation.

The role of the three Islamic financial institutions, namely the Al-Rajhi Company for Islamic Investments Limited, the Al-Baraka group and Dar al-Maal al-Islami (DMI), comes under scrutiny in this chapter. Although a similar line of questioning indicated an interest in how these three institutions operated in Western financial markets, it soon proved impractical to approach all three with the same prepared questionnaire. Several factors conspired to prevent such a uniform approach; one which may at first have appeared to be the most logical one for the sake of a comparative analysis. Firstly, what may well be a homogeneous set of questions was certainly not answered by a homogeneous group of bank officials. However, this does not suggest that the information obtained from one source can be considered superior or the last word on a given subject simply because one individual holds a high

position within the company, or that another, involved in the theoretical side of bank operations is less able to provide practical information on the day to day running of the bank.

Secondly, in view of the fact that there does exist a divergence in the activity of these three banks, it would have been impossible to follow up in detail the same questions at each interview. What may be the crux of one bank's strategy may be a matter of comparatively small importance to another.

Thirdly, experience quickly demonstrated that an interviewee may care to develop ideas on a subject of particular current importance to his bank, one which may either have been totally missing from a set questionnaire, or a subject on which the discussion could provide more eloquent and informative answers than may have been obtained through brief, and often tedious, separate questions. As in any line of questioning, leaving the subject to speak freely and without unnecessary interruption can lead to a more productive discussion and a more accurate assessment of what the subject deems important. Furthermore, in this case it allows the subject to convey information without the feeling that an interrogation is taking place.

In short then, it is the search for qualitative rather than quantitative information that leads to an approach involving questions tailored, often during the interview, to each separate case. Discussions were based around three main questions involving the nature of the company's business. How, in the case of Al-Baraka does its London office differ in function from the Bahrain operation? Who are the main depositors and borrowers? How much weight is given to a separate function; are more funds used in *murabaha*-based trade finance, for example, than in equity investment? A more general conversation touched on topics which called for opinion rather than hard facts. It is perhaps unsurprising that this part of the interview yielded the most useful information on the nature of the companies' activities. Questions concerning

the development of new Islamic financial instruments and the future of Islamic finance in general tended to produce the most varied response.

4.2 Al-Rajhi

Fourteen centuries ago, the spread of Islam led to a vast increase in trade between nations and it was moneychangers, similar in most respects to Al-Rajhi, were instrumental in facilitating this trade. The Al-Rajhi Company for Islamic Investments Limited has progressed a long way from its origin as a *suq* money changer although as a sizeable Islamic financial institution, it continues to play a role in the finance and development of trade, albeit a more vital one than that to which the average money-changer would aspire. The relatively humble origin is of some significance in itself, for the company has mirrored the progression of Islamic banking from its infancy to a system of maturity with a far broader outlook than simple moneychanging and lending activities. Its growth is attributable to a number of factors that differentiate this company, and indeed moneychangers in general, from conventional financial institutions, even within the Kingdom of Saudi Arabia itself. Moneychanging activity has taken place in an atmosphere where customer loyalty, family involvement within each company and a lack of aggressive, Western-style competition amongst firms and this has ensured that a present day moneychanger operates in a way that is virtually unchanged from the time of the prophet Muhammad. Moneychangers may diversify to a small extent in order to offset the effects of seasonal downturns in currency exchanging activity, but it has not been seen as necessary or certainly within the spirit of Islamic teaching to buy out or merge with the competition and so attempt to corner the market. Nor does the comparative success of one company such as Al-Rajhi sour the atmosphere of peaceful co-existence that obtains amongst the traditional cluster of *suq* moneychangers. In the *suq* in Jeddah, the up to date exchange rate information

of the Al-Rajhis brought about by the breadth of their international contacts puts them in a position of what may be termed price leadership within the *suq* economy;¹ a position from which the other moneychangers stand to gain.

Acting in their traditional role as moneylenders, institutions such as Al-Rajhi continue to enjoy a popularity amongst merchants that appears to be in inverse proportion to the actual cost of borrowing from this source. A number of reasons help explain this situation, amongst which are the flexibility of loan repayment, a closer relationship between borrower and lender, personal and commercial privacy and speed of transaction. Furthermore, although one may accept the assertion that borrowing charges are indeed higher than those of commercial banks,² the difference is not necessarily a great one because of the low overhead costs of the moneylending establishments in comparison with the banks. Lastly, moneylenders are unregulated, which most significantly absolves them of the need to keep an unprofitable reserve requirement with the central bank.

It would however, be a mistake to identify the Al-Rajhi corporation as the most successful establishment in a quaint system that is a microcosm of national economic operation. There is much more to this corporation than a parochial popularity which is based upon social and religious identification with its clients. With more than two hundred and seventy five outlets in the kingdom, Al-Rajhi boasts a more extensive network than the National Commercial Bank, Saudi Arabia's largest banking enterprise. It has grown to such a size that it is now a registered Islamic financial institution,³ a step not only important for the status it conferred but also in regard to the new restrictions that would accompany such a change in status. The second factor which points to its maturity and international reach is the extent of this company's contacts outside Saudi Arabia. Such links bring advantages that do not accrue to traditional banks. For instance, whereas the banks generally obtain their foreign exchange via SAMA, Al-Rajhi works through European centres such as

Zurich and obtains foreign exchange at favourable rates. The company, acting as wholesale supplier to other moneychangers, is also eligible for the standard discount that accompanies bulk purchase.⁴

Having examined the place of the traditional moneychanger and lender within the *sug* economy of Saudi Arabia as well as some of the reasons that explain the pre-eminent position of the Al-Rajhi corporation within that framework and their subsequent transformation to a registered financial institution, it is a logical progression to observe its purpose and performance abroad.

Although prevented by British banking law from soliciting deposits in the United Kingdom, there is much else that an institution such as Al-Rajhi can perform even within the confines of such a restriction. The premises at 2, Copthall Avenue are a representative office only. It serves as the eyes and ears of the Headquarters in Saudi Arabia, not just to identify prospective corporate borrowers in this country but also as a 'think tank' internationally. It is significant that Al-Rajhi still has confidence in London's status as an important international financial centre. The office is staffed by bankers whose primary purpose is to make Islamic financial practice more acceptable to prospective clients who may not necessarily be fired with enthusiasm for a means of financing simply because it takes place within the framework of Islamic principles. Consequently, it is considered reasonable to assert that, in order to attract large non-Muslim clients as borrowers, the stress placed on the social benefits of Islamic financial practice may take second place while the financial benefits of banking with regard to Islamic social conduct are brought to the fore. Outside Saudi Arabia, Al-Rajhi is a tiny player in the international financial field and requires good results just to stay on the pitch and in order to do so, this company's activities must appeal to prospective clients as well as to the *shari'a* committee. It would however be a mistake to conclude that the two considerations are mutually exclusive: individuals with experience from mainstream banks combine their knowledge of the Western markets

with that of those responsible for maintaining an Islamically acceptable method of operation.

In identifying the main thrust of this bank's lending operations, it was first necessary to ascertain the source of loanable funds, the financial activity of Islamic banks in Western markets being determined by the nature of their deposits at home. In this respect, Al-Rajhi fits into a pattern found by many of its competitors in the Middle East. A very large proportion of its liabilities are short term, coming in this case from deposits of expatriate workers in Saudi Arabia. In fact, at one time, expatriate workers counted for fifty percent of the population and it was important to attract their custom. The proportion may have decreased relative to the indigenous population but the same principles apply. These workers, of mixed nationality, are generally single status work permit holders performing menial tasks but for whom the remuneration is relatively high. There being little in the way of outgoings for these workers, most of their earnings can be regarded as surplus and they seek a way in which to remit the funds home. A Bangladeshi worker for example, may pay in his riyal-denominated earnings to Al-Rajhi which in turn transfers the worker's funds to a branch of his own bank, the Bank of Bangladesh, for instance. In this way, depending on the speed of this three way exchange, Al-Rajhi may have the funds for any amount of time between two days up to two months at the outside. These must be invested over a similarly short space of time.

Hence the workings of *murabaha*, a popular short-term method of investing funds, has been further streamlined by the 'think tank' at Copthall Avenue so as to make its operation even more straightforward and thus attractive to prospective borrowers. For three of the factors that influence the decision of companies to borrow funds from a particular source are of particular importance to an Islamic bank. The most directly relevant is that of experience. How much is known about *murabaha* financing? A source of funds that appears cheap must be proven to remain that way.

As this is basically the same as Bankers' acceptance, no major problem is encountered. The cost of borrowing itself must be competitive; in this respect, *murabaha* must be able to compete with US commercial paper, the cheapest alternative. It is recognised by the staff at 2, Copthall Avenue that a competitor, new to the international financing scene must be prepared to forego some amount of profit if it is to retain the custom of a Blue Chip company. Thirdly, while *murabaha* is cost attractive, administratively it is ugly as it involves a great deal of paperwork; this may prove a baulking point to many otherwise satisfied clients. It is not unusual for large corporations to have their own treasury departments whose dealers are there to put through transactions and who are actively uninterested in paperwork. Al-Rajhi makes life easier for the dealers, either handling the paperwork itself or having it done by someone other than the borrowing company.

In addition to making the whole financing package more simple and attractive to the borrowing client, by retaining control of the paperwork, the bank can ensure that funds are being used towards the purpose for which they were supplied and not arbitrated towards a different investment. This safeguard serves also to reassure the *shari'a* committee that both the letter and spirit of Islamic law is being observed. Staff at the London office were eager to stress that this committee should not be looked upon as a body of unrepentant academics who place religious objections in the way of financial progress. I was informed that it is all too often assumed by those who are unaware of the true nature of Islamic finance that professional bankers operate despite the restrictions placed upon their activity by the scholars who make up the religious supervisory committee, rather than in conjunction with them. It is evident that this is not just company loyalty to an Islamic employer. Although Islamic banking practice may occupy a niche here in the West, for depositors in the Middle East there are a number of other institutions offering an Islamic method of financing with whom a deposit may be placed. The presence of the *shari'a* committee assures Islamic

legitimacy to depositors and would prevent a sudden run on the bank's reserves in a situation of public doubt as to whether funds were being utilized in an Islamically acceptable manner. This consideration more than makes up for the contention that the existence of such a committee denotes a lack of trust in the bank's ability and desire to identify what is and what is not Islamic.

4.2.1 Longer Term Operations

In consideration of the short term nature of the bank's deposits, it was unsurprising to find that medium and long term lending took a much smaller portion of the bank's funds. Funds invested over a longer period of time were placed in asset-backed facilities such as shipping and real estate and other leasing operations where the dividend was shared between bank and client. Significant, if perhaps unsurprising by its absence, was equity participation, nonetheless recognised as the operation most in keeping with the social values of Islam. It was indicated that experience had not been generous to the cause of *musharaka* financing packages and consequently the company was unwilling to undertake this kind of investment. This statement was tempered with the comment that it is not the method at fault but the purposes for which it has been applied. Most experience has come from the Islamic Development Bank which Al-Rajhi considers is sometimes obliged to undertake funding of projects as a development assistance agency rather than as a bank and consequently may not always expect a return on its investment.

Musharaka funding of a top-grade Western project would indeed be desirable but the competition to fund such a project would be very stiff and it is unlikely to be on the basis of profit sharing in any case. A company with an excellent record would be almost certain to earn a profit at a later stage and may be willing to pay a large interest bill rather than share future profits. The obverse of this equation looks

slightly ominous: what is set out above suggests that only a bad risk seeks equity participation from a bank as, in the comparatively unlikely event of a profit accruing, the entrepreneur will not mind sharing it with a partner who may have shouldered the lion's share of the financial risk.

Similarly, joint venture operations may be considered desirable, but when one considers the delaying of decisions taken by the Imperial Bank of Japan and the Three I's (Investment In Industry),⁵ it is not reasonable to expect Islamic banks to identify opportunities for a good investment any more speedily than this corporate bundle can manage.

The legitimacy of share dealings remains a problem area. It is not only Al-Rajhi that believes the present situation of a ban on investing in a company that includes interest at some point on its balance sheet should be adjusted, or at least tempered. Can mutual funds be set up for the purpose of buying equities for example? This is for investment rather than trading purposes, of course. In this respect, Al-Rajhi considers that the setting up of an Islamic fund by Kleinwort Benson in 1986, despite its present dismal returns, may further the development of Islamic finance in a different way to that which may be supposed. In addition to the very important role of bringing Islamic financial practice to the attention of the Western world, Kleinwort Benson and Union Bank of Switzerland are opening a window to buying stocks which has found favour with those Muslims who have actively sought out what they accept to be Islamically acceptable investment. This view is strongly held by DMI and will be examined in the relevant section.

The involvement of a large Western institution in such projects suggest a desire on the part of Western finance houses in general to become involved with Islamic banks in order to identify lending opportunities for a growing number of clients; ethical investment of all kinds enjoying popularity at present. Leaving aside the

question of equity, such opportunities may arise through other forms. For example, a fund could be put together for the leasing of aircraft or housing, rental income being perfectly acceptable in Islam. An idea was put forward by a consultant with Al-Rajhi which suggested the setting up of an offshore Islamic mutual fund for banks to invest surplus liquidity on a unit basis. Evidently, this would require organisation and co-operation to ensure that the fund is not drained overnight but would help with the perennial problem of how to put spare funds to use as well as illustrating the desirability of bank co-ordination towards more effective financial practice.

4.3 Al-Baraka

The Al-Baraka group has an altogether different background to that of Al-Rajhi. Most obvious is the difference in age of the two institutions. However, although set up as recently as 1982, the Al-Baraka group includes banks, investment companies, financial advisory and management companies and affiliated institutions in Bahrain, Saudi Arabia, Turkey, Jordan, Tunisia, Luxembourg, Denmark, Thailand, Malaysia, Mauritania as well as Great Britain. By 1987, the group boasted a total balance sheet of over \$1.5 billion.

The activities of Al-Baraka's London office in Cavendish Square reflect this difference in status and maturity. Al-Baraka might be described as a tailor-made international banking conglomerate, whereas the Al-Rajhi corporation has built itself up from more humble origins. The most important difference between the two groups in London is the nature of their activities in the city. Al-Baraka more closely fits the conventional definition of an investment bank due to the broad reach of its activities. Al-Rajhi and DMI, on the other hand, place greater emphasis on money market activities such as currency swaps; this makes them appear more as specialised FX institutions than an all-round investment bank. In Cavendish Square, Mr Hamdi

outlined the purpose of having a base for the company in London.

Primarily, he explained, the bank served as a correspondent for other Islamic non-bank financial institutions in Great Britain, arising from its size and the extent of its international connections. Another side to its role was observing local financial practice and where possible, adapting it to fall within the guidelines of Islamic principles. This role also involves the promotion of Islamic financial practice amongst Western banks. Indeed, it may be conceded that the route to a more general awareness of the benefits of Islamic finance lies in the adoption of Islamic methods of handling money by the mainstream banks, so bringing it to an existing wide client base. The reverse relies on the ability of Islamic banks not only to prove their own worth by performing well, but also to entice investors away from the more traditional interest-based methods of making money. A wider appraisal of this task is examined as part of the conclusion to this chapter. With this in mind, observation and cooperation between Al-Baraka and the local and established financial institutions is of great importance.

The third and perhaps most simple function of the Al-Baraka office in London is to encourage trade with the Middle East. In this respect, its aim if not its method differs little from any other office of Al-Baraka.

Bearing in mind the aim of this chapter to examine the role of Islamic banks situated in Europe with particular regard to wholesale financing operations, the discussion held with Mr Hamdi centred on the second purpose of the office as described above. It will be observed that material relating to actual decisions and action taken tends to refer to trade financing of some description. Al-Baraka after all is little different to any other Islamic bank in that its liabilities tend to be very short term and that *murabaha* financing packages appear to be the most efficient way of putting such liquidity to a profitable use. Moreover, it is attractive to borrowers who are

happy to commit their custom to an Islamic institution as long as they do not find themselves paying over the odds for the privilege. It will also become apparent that, in the case of longer-term financial activity, the discussion becomes more academic than practical, particularly in the case of equity financing packages. This suggests that while much thought is devoted to this activity, it needs some important changes, mostly via the education of borrowers and lenders to make it a feasible method of financing and a significant part of any bank's activities.

One hundred percent of this bank's depositors are Muslims from overseas. The make-up of borrowers is however, very different. These latter are mainly British-based private investors or international companies. Al-Baraka will lend to any client who is prepared to accept the Islamic formula for handling money, in this instance involving large corporations such as ICI as well as mid-sized and small companies. Overseas businessmen are regular borrowers, particularly those from Turkey, Sudan and Bangladesh for whom Al-Baraka is the primary bank.

The creation of new financial instruments has been based around the adaptation of established ones. In the case of *murabaha* financing, the adjustment has entailed a streamlining as in the case of Al-Rajhi, as well as a tightening up of the process because the bank has had the nagging suspicion that funds provided for trade finance are not being used for that purpose. It was pointed out that Islamic banking is asset-related and as such, it is logical that the institution that provides the funds for a specific purpose should desire to see this carried out. To clarify the situation, the process involved in a *murabaha* financing deal was reiterated.

In the case of a bank or commodity broker being asked to conduct trade in a soft commodity such as copper, the individual concerned will look for a contract waiting to be financed and then inform the Islamic bank of the increment involved; one over LIBOR, for instance. The Islamic bank then authorises a trading bank to

sponsor the transaction.

The suspicions hinge on the matter of how the Islamic bank deals with the acceptances which may be traded up or discounted— being used as a financial instrument in fact. It is, of course, Islamically unacceptable to buy a debt at a discount price and later redeem it at a higher price. Consequently, Al-Baraka finances the trade bill (it buys the virgin acceptance and can be sure of exactly what it is financing) and then keeps it. In this way, there is no unlawful benefit brought about by the bank's initial action, profit only accruing to the bank itself as a result of the original mark-up on sale. Speculation unrelated to the asset financed is avoided.

Much of the interview at Cavendish Square covered problems of liquidity management in the Middle East as the view was held that this was directly relevant to the bank's operations in this country. However, as this topic involved a discussion about the lack of a secondary market in the Middle East and the possibility of rectifying the situation with the help of the IDB, this will be included as part of the chapter on that institution.

4.4 Policy and Education

It was unsurprising to hear that none of the three banks concerned were willing identify anything other than the most general trends in their activities. One individual admitted even before the interview had started that he would be playing his cards close to his chest; a curious choice of phrase for an Islamic banker, but one that is nevertheless quite understandable. As a result, it was the general discussion that tended to distinguish one interview from another, opinions and trends being much more assimilable and memorable, at least to this writer. Mr Hamdi was more than willing to discuss the finer points of Al-Baraka's financing operations, but indications for the future of Islamic finance in Europe appeared more clearly stated in the general

discussion that concluded the interview.

Two themes ran through the discussion. The first was co-operation with the Western financial institutions and the second was the natural progression to the future of Al-Baraka's operations from its European base. The themes are of course directly related as both are the concern of Al-Baraka's London office and because progression is seen as impossible without cooperation. It is obvious however that in an atmosphere of such strong competition, Western banks are unlikely to aid Islamic financial institutions merely for the sake of good relations. A continuing 'internal' dialogue, most recently occurring at the February 1990 conference in Algiers on Islamic banking ensures that Islamic financial practice does not stagnate, instead investigating new areas in which to operate and defining the degree of participation in Western financial practices that may be allowed.⁶ Islamic banks already trade stocks on the Euromarket, on the surface a notably un-Islamic system, but in Mr Hamdi's opinion, it is not the advances made into what may be termed Western financial strongholds that chart the spread and influence of Islamic banking. Rather, it is the extent to which Western banks feel the need to cooperate with their Islamic counterparts.

Mr Hamdi struck a chord with other bankers who were interviewed. He believed that the guidelines set for Islamic financial practice should not be viewed as a hindrance to profitable operation. In fact, these 'restrictions' conspire to place Islamic finance in a profitable niche; one which Western banks are eager to emulate. Initially it was surprising to hear such enthusiasm, again from all three institutions, for the Islamic investment funds set up by Western banks, especially in view of the unremarkable performance of Kleinwort Benson's Islamic Unit Trust.⁷ The significance of Western interest in this sort of investment as well as the issuing of leasing certificates by Barclays bank is greater than it may appear; the important matter being that a two way traffic can be established. Western expertise can be aided by the knowledge of Islamic acceptability of such investment which would come within the domain of

banks such as Al-Baraka. Muslims are more likely to commit funds to a Western-run fund if it has the approval of an Islamic bank's religious supervisory board. If progress is made on the acceptability of investment in public quoted companies, banks in the United Kingdom can in turn identify lending opportunities for Islamic banks; namely companies for whom interest receipts are not the crux of their profit-making ability. It should once again be noted that there exists a close parallel interest in ethical investment on the part of both Islamic and *riba*-based banks; the gap between what has come to be called 'green' investment and Islamic investment is not, in concept, a wide one.

The last subject to be discussed was the preponderance of short-term trade financing when an analysis is made of the investment structure of Islamic banks. This point was conceded, perhaps lamented, but it is in this area that the importance of Islamic banking flourishing in the West was given the most emphasis by Mr Hamdi. There is a world of difference between the one-off financing of the dry dock in Bahrain for instance, and the countless longer-term lending opportunities that exist in England. Yet, in this country, the problems involved in promoting the idea of participation finance go beyond convincing investors to make available funds that may be totally lost if an enterprise should fail. Islamic banks that operate *musharaka* finance as a means of investing depositors' funds can receive no backing or license from the Bank of England. Indeed, as such institutions are not beholden to their depositors, they are considered more as a mutual company and as such come under the jurisdiction of the Department of Trade. Moreover, viewed as a threat to the stability of the British banking system, they are barred from soliciting deposits as banks. It is unsurprising therefore, that Islamic banks must hold such high cash reserves.

Once again, the onus is on the West. This is not an obligation to inculcate British investors with Islamic values but is the most effective way of bringing what is, on paper, undoubtedly a more equitable way of sponsoring business initiative.

Mr Hamdi cites a parallel between the uncomplaining way in which we watch the deduction of tax from our income with only the most indirect say on where those taxes should be spent and the way in which savings are deposited in an Islamic bank. The depositor has, in the latter case, voluntarily shown similar trust and is rewarded for it, either through dividends paid, or through the treatment he can expect to receive as a borrower of funds from the same bank. British banks rightly subject any prospective enterprise to a most comprehensive feasibility study in which is included a market sensitivity analysis, legal controls and a cost benefit analysis; after such a rigorous examination, it appears unreasonable to Mr Hamdi that the bank should not shoulder some of the financial responsibility for what it has deemed a worthwhile lending opportunity. Equally, it should be simple to add a PLS account to the existing choices provided by banks to depositors: why should a central bank doubt the public's ability to distinguish between a 'safe' deposit account and one tied to the fortunes of a bank?

Concluding the interview, it was made clear that it is not only the entrepreneur who benefits from such a policy but the financial health of the lending bank which learns to lend according to merit instead of solely on the strength of reputation and the interest receipts that will surely accrue from lending on a large scale to companies, no matter how improbable the purpose of the loan or near to bankruptcy the company may be. Developing a theme, these considerations bear upon the economic well-being of the whole country. It will take a great deal of time, positive results and education before such an attitude becomes common currency outside Islamic banks.

4.5. Dar al-Maal al-Islami

4.5.1 Background

The third big Islamic banking house to be examined in this section is Dar al-Maal al-

Islami (DMI) whose headquarters is in Geneva. This company is a true conglomerate with a variety of institutions and branches around the world. Founded in 1981 by Prince Muhammad al-Faisal Al Sa'ud, Chairman of the International Association of Islamic Banks (IAIB) in Jeddah, five years later, DMI wholly or partly owned twenty one *shari'a*-based institutions in thirteen countries. This tally includes eight Islamic banks, seven investment companies, three insurance and three business firms with a capital investment of over US\$100 million.⁸ Private and institutional savings of more than US\$1.7 billion, coming mostly from the Gulf and Saudi Arabia have been mobilised globally. After a run of losses peaking in 1983 and 1984 resulting from losses in commodity dealing, the fortunes of this giant company appear to be improving again.

It was surprising to hear the huge losses of 1983 (US\$45 million in unsuccessful gold trading) mentioned so readily by Moustapha Sakkaf, Executive Vice-President of DMI's Treasury Department. He did not regard such a colossal mistake as a real embarrassment however, knowing firstly that it did not reflect poorly on Islamic finance as a system, there being nothing specifically Islamic about commodity dealing. Secondly, he added wryly that such a mistake was unlikely to happen again. Nor had the episode wrought any permanent damage on the fortunes of DMI whose financial health now looks fine. The most important figures are quoted below.

DMI has approximately one hundred thousand clients and forty thousand shareholders. Dividends have tripled from their 1986 price of 50 cents per share— funds under management have also tripled, now standing at US\$2.6 billion.

Experience has also shown this institution that equity participation on a grandiose scale, for example funding agricultural projects in Sudan or purchasing shipping fleets for Saudi Arabia, has proved unprofitable. This is undoubtedly better suited to a development institution whose capital is cheap, that is to say provided by government

subscription. Whilst being equally eager to receive a return on its investment, such an organisation is not answerable to shareholders who require a dividend. Moreover, it was added that some development agencies are prepared to undertake funding of projects considered necessary but unlikely to be profitable. Mr Sakkaf was at pains to explain that despite being a Muslim institution in every sense of the phrase, DMI was unable to operate as a charitable institution. Smaller projects, identified as reasonable are willingly entered into and syndication with other banks to spread the risk is also common practice.

4.5.2 Liquidity Management

Treating the symptoms of excessive liquidity is not an occupation peculiar to DMI. However, much of the interview was spent discussing exactly how surplus liquid funds are employed. Consequently, it seems logical to devote a separate section to the discussion.

Once again, a comparison between the current situation of Islamic and mainstream banks gives the clearest indication of the problem. It was pointed out that about ten percent of the funds held in a Western bank are liquid. This compares with a seventy percent figure in the case of DMI. Just as in the two previous cases, the short term nature of depositors' funds was alluded to, clients committing funds for an average of three days. Almost fifty percent of this liquidity is used in money market swaps of foreign exchange.

Options and futures trading was discussed and raised a noteworthy point. Opinion differs on the acceptability of such practice and the extent to which it may be employed. To clarify this statement, there are some who believe that the whole system is governed less by the process of prudent risk taking than by the presence of players whose sole involvement is for pure speculation. This is ceded up to a point; ar-

guably, the speculators provide vital liquidity, but the question that arises is whether an Islamic bank can involve itself in a system that caters for speculators, even if they themselves do not fall into such a category. Moreover, there is some doubt as to what degree of involvement is permissible in a market which may not serve any real economic purpose in terms of growth and services. Certainly, the situation is far from clear but DMI allows itself some freedom of choice in the field, in spite of giving a degree of recognition to the objections raised. Basically stated, there are a number of religious texts which prohibit deferred payment on the exchange of money as well as some food commodities. This led to some jurists placing a ban on any forward or future dealings in currencies.

Less strident jurists distinguish between currency exchange where a spot price is paid for one currency and the other currency is paid later, whereby the rate of exchange may include an element of interest to compensate for the deferred payment. This compares unfavourably with currency exchange where an agreed rate is paid simultaneously for the two currencies at a later date, thus avoiding doubt about the loan element involved.

DMI recognises that clients of an Islamic bank undergo the same business risks as any other client and consequently desire to lessen their risk where possible and seek a favourable way of doing so. Few businessmen after all, are able to purchase in advance the currency they need for the future, nor do they wish to expose themselves to the risk of price fluctuation of commodities in which they are dealing. With this in mind, DMI maintains that profits arising from keeping businesses covered to some extent against risk are perfectly legitimate. Options trading is considered '*al-Bai'bi'l-Arbun*' or selling with the opportunity to make profit. If the option is not taken up, it is simply an opportunity which has been foregone.

Commodity trading was mentioned again, but this time in a more optimistic

light. It hardly needs mentioning that no Islamic bank will deal in *haram* goods, and DMI is no exception. Although last year, trading in allowable commodities was unsuccessful, Mr Sakkaf believes that his bank was not the exception; very few banks made money due to a 'choppiness' in the market. This year the situation is different with the identifiable trends, upward or downward visible. For reasons of stability as well as dubious legitimacy, the stock market is out of bounds for this finance house. While there are those who wish to see the stigma lifted from share trading, there remains a marked coolness towards stock markets in general since the slump of 1987.

4.5.3 Venture Capital

DMI sees itself as a leader amongst Islamic banks in the field of venture capital. In such a high risk area, it is impressive to note that this company has committed even as much as one percent of its funds under management to such operations. Certainly, the rewards can be high, but a long term commitment is required with up to three years of negative return on investment, even in the case of an ultimately successful operation. DMI is involved at all levels of venture capital, from seat finance, through mezzanine to more mature finance— obviously receiving less proportional return according to the greater maturity of its entry stage. A successful project sponsored from its inception will present larger and larger returns and the bank will remain with the company until it has reached the stage of going public, at which time DMI may 'cash in' so as to avoid share dealing.

Venture capital operations are considered by this company to be of the utmost importance and the attention it receives makes it eligible for further development. This is particularly so with regard to following up on the initial investment. In the West, a firm may be brought into being through the sponsorship of a bank which then may provide funds for expanding operations and, at a later stage, the bank may

help defend against hostile takeovers as well as advising the firm on its own plans for expansion. It is a pity that knowledge gained through guiding the firm from an early stage should become instantly obsolescent at the moment shares are offered for sale. The thrust of Mr Sakkaf's argument was that, in order to operate efficiently, Islamic banks must eventually come to terms with the financial market. This may involve some sort of discrimination between firms for whom interest payments are an important part of the balance sheet and those who may be involved in interest payments merely through the traditional borrowing process that is currently offered by non-Islamic banks. This is basically a question of intention on the part of each business; a combination of caution following the 1987 crash and informed deliberation on the part of the religious supervisory board must necessarily precede any move made towards investment in publicly quoted companies.

4.6 Prospects and Problems for Islamic Banking in Europe

A substantial portion of interview time was spent discussing the future and problems faced by each institution. Most features of these discussions, such as Mr Hamdi's call for the increasing education of Westerners to the claimed personal financial gain as well as wider economic benefit of Islamic finance, have been noted previously. However, it was evident that many opinions on this subject were shared, the salient features appearing below.

Most unequivocal was the belief that Islamic banking had found a niche which was worth exploiting; one that is strengthened by the interest expressed by the Western financial institutions. Having established this niche within the global banking system, it is important to be aware that the US\$90 million invested worldwide by Islamic banks constitutes a drop in the ocean. This can hardly be construed as a threat to the status quo of international banking operations; while Islamic finance is

unlikely to supercede interest-based operations, it is also unlikely to infringe upon the transactions of the *riba* banks. The 'Islamic windows' of the latter demonstrate that it is considered worthwhile to tap a new source of investor. In order to achieve the best results in this area, all three of the finance houses involved in this chapter have no doubt that a phase of cooperation for mutual benefit is under way. Islamic banks can help identify lending opportunities and add legitimacy to a *riba* bank's Islamic activities, while contact with Western financial practice may help 'educate' Islamic banks by observing the operation of ethical financing as conducted in an unregulated situation.

Mr Sakkaf of DMI was aware of the results of Western ignorance of Islamic banking. In Europe, individuals tend to import the politically-charged situation into the rule books of Islamic banks. Catchwords such as 'fundamentalism' are bandied about in a context that includes finance when it should remain firmly at home 'with the new Ayatollah in Iran'. Such a mentality has led people to associate the run on Faisal Finance in Cairo with a lack of confidence in the principles of Islamic finance rather than with the simple, if unfortunate fact of the company being managed by men of dubious reputation. Yet the IOS scandal of the early 1970's did not cast doubt on the credibility of Swiss banking.

The familiar problem of the lack of a central bank was mentioned and given as one of the major reasons for requiring such a high degree of liquidity amongst Islamic banks. Although the size and international nature of the Islamic Development Bank should help to make it an ideal candidate for assuming this position, so far, experience has shown that this role has not been aspired to. DMI was obliged to pay cash in 1983 for its losses on the commodity market and the IDB showed no interest in bailing out the Kuwait Finance House in 1987. These facts were presented as such, not as a disparagement of the IDB and helped illustrate a further point. The direction taken by an institution such as Al-Rajhi is firm and clear as employees answer directly to an

homogeneous group of owners. It is unreasonable to expect firm and swift decisions from a body composed of such a variety of nations, each bidding for their national interest and all of very different economic strength and maturity as in the case of the IDB, and here a conflict of interest in direction is inevitable. Moreover, the addition of the role of central bank to the existing one of development assistance agency cannot be achieved in a short space of time.

Meanwhile, Islamic finance must continue to perform successfully in order to grow. In the opinion of the staff at Al-Rajhi, one of the best areas of operation ideally suited to them is the investment of mutual funds. It is recognised that the attraction of non-Muslim investors will not be easy, at best a lengthy process. The most cheering prospect should be the conducting of business with large international corporations. In this respect, contacts as well as indications of past performance are important. Personnel joining Al-Rajhi have been known to take clients with them, and this can do nothing but good.

Almost everything that concerns the future of this enterprise hinges upon recognition and reputation; if a good deposit base can be built up, international Islamic banking should in future continue to reflect its solid record of growth in the Middle East over the last decade. With administration streamlined, the availability of large deposits from Muslim investors at home, and a price competitiveness that originates from funds placed on a profit and loss basis, Islamic finance houses situated in the West should be able to establish the sort of reputation that leads to their continuing success abroad.

Footnotes

- 1 Rodney Wilson, *Banking and Finance in the Arab Middle East*, Macmillan, 1983, pp.11-12.
- 2 *ibid*, p.14.
- 3 This took place in 1983, in a royal decree.
- 4 Rodney Wilson, *op cit*, p.18.
- 5 See Financial Times, 11 April 1990.
- 6 Such as options trading, although the degree of restrictions applied to this activity remains uncertain.
- 7 Which, after three years has experienced a fifty percent drop in value.
- 8 "Islamic Banking", *Aramco World Magazine*, May-June 1987.

CHAPTER FIVE

BAHRAIN

5.1 Background. The Creation of Bahrain as a Money Market Centre

Broadly speaking, there are two factors that account for the emergence of Bahrain as a financial centre for the Middle East. The first concerns its desire to diversify into such an area and the second concerns its suitability to do so and the existence of a climate conducive to the emergence of a banking centre anywhere in the Middle East. Bahrain was ideally placed, historically and geographically, to take up this role and the authorities recognised the need for diversification into an activity that did not involve heavy capital investment. A solution in the field of financial services both took account of, and answered the problem of a very limited reserve of oil and the dangers of reliance upon this industry.

The major historical influences concern Bahrain's experience as a centre for trade and commerce which is linked to the history of British involvement in the island. Other than via the marketing of pearls through the British empire, the island's links with Britain were as a result of the strong military presence maintained there, a presence which continued up until the 1960's and led to the widespread use of English as a second language on the island.

Prior to the discovery of oil, pearling was the islands primary industry; one on which it relied too heavily. After the collapse of this industry following the entry of Japanese cultured pearls into the market, it became clear that strong dependence on one industry was short-sighted. Consequently, on the discovery of oil in the 1930's, the island did not experience an unfocussed spending bonanza, the need for diversification, especially in view of the limited nature of the oil reserves, being clearly recognised.

Oil was discovered in Bahrain shortly before the rest of the Arab Gulf, giving the economy a head start on the neighbouring countries and this, coupled with the high level of human resource development, was another factor that led to Bahrain's foundation as money market centre, a role that called for such a combination of features which would give the island the necessary maturity in financial practice.

Domestic banks had been present in Bahrain since the establishment of the Eastern Bank in 1920, shaking the financing monopoly of the traditional moneylenders and was soon followed by the advent of another British bank and the later creation of the National Bank of Bahrain. This latter development occurred less out of any deep-seated nationalist feeling than to prevent Bahrain being the odd one out during the politically sensitive 1950's.

Ironically, it was not a local institution that set the scene for financial diversification in the area. Whereas the National Bank of Bahrain concentrated on developing a wide retail network, the British banks placed more emphasis on offering a wider range of services to larger business clients as well as serving local trading interests and the requirements of personnel from the oil companies and the military.

Put briefly, with the development of oil, the role of the state in the economy increased dramatically. Hitherto, a hands-off approach to regulation had prevailed but with the increase in royalties accruing to the government, balancing the budget became far more complex. Also, the maintaining of liquidity given the lure of higher returns on assets abroad was a job suited to a monetary agency which was set up in 1973, coinciding with the first oil boom of the early 1970's.

Bahrain's geographical position left it well placed to take advantage of the effects of the boom, particularly in the neighbouring states of Kuwait and Saudi Arabia which allowed no foreign banks to be located on their soil. Thus, in response to the factors mentioned above and a desire to diversify into a service field, Bahrain

obtained a more stable financial independence from its dwindling oil reserves when legislation was passed in 1975 permitting Offshore Banking Units (OBU's) to establish themselves on the island. It is also important to observe that, although serving as more than a simple replacement for Beirut, with the onset of the Lebanese civil war, Bahrain conveniently replaced that city as the Arab world's most important banking centre at the optimum time for such a transition. The scene was set for nearly a decade of thriving financial activity in the Arab Gulf, an area that the international financial community could not afford to ignore.

5.2 The Development of Financial Activity in Bahrain

An indication of Bahrain's regional importance is given by the number of Arab banks operating there. Excluding the branches of foreign, Western-owned institutions, fifteen OBU's are situated in Bahrain at present along with six locally incorporated full commercial banks (FCB's). The domestic market is a fraction of the size of its offshore counterpart. Working from statistics given by the Bahrain Monetary Agency, Capital Intelligence quotes end assets of only \$4.5 billion compared with \$65 billion for all OBU's (including foreign branches).¹ It is worthwhile remarking that, in terms of customer deposits, the OBU market is only six times larger than the domestic market.

Bahrain as a local money market centre is essentially a wholesale market to serve banks and other financial institutions rather than private individuals or even governments. Its main aim is to attract clients' deposits and to lend to others, particularly in Saudi Arabia and Kuwait. It is reasonable to state that it is the existence of an appropriate legislative background that makes Bahrain viable as a money market centre. The deposit and lending rate is determined by market forces rather than imposed by the Bahrain Monetary Agency and thus, rates on deposits

are higher than in Saudi Arabia or Kuwait and similar to Euromarkets elsewhere. Another characteristic shared with Euromarkets in general is the absence of a banks' reserve requirement, allowing all funds to be profitably used and leading to a lending rate that can be competitive with those in neighbouring countries. This atmosphere proved ideal for OBU operation and the market expanded rapidly after 1976. Assets and liabilities peaked in 1983 with one hundred banks having established offshore units on the island.

Bahrain is important for its role in recycling although it would be a mistake to place too much emphasis on this role; most of the recycling of surplus petro-funds is carried out directly in the London and New York Euromarkets. The real flows of funds were at one time concentrated between Bahrain and other Euromarket centres, principally London, the former accounting for approximately two percent of transactions on the world interbank market. During this high point in wholesale banking activity with such a strong presence of competitors, many foreign banks felt the need of some representation on the island in order to avoid giving away business to their rivals simply through being absent. A general downturn in banking activities on the island has left this philosophy somewhat dated. The reasons for the changing situation will be examined later. Lately, it is increasingly the local institutions that have the most significant role in the region with American and European-owned OBU's losing business to joint venture banks as well as to their Japanese and Far Eastern rivals.

A number of factors combined to affect the normal activity of the OBU's and slow the rate of growth after the 1983 peak. The effects of a worldwide recession were added to by mainly regional developments amongst which were a drop in the region's oil revenues, the crash of the *suq al manakh* unofficial securities market in Kuwait and the continuing Iran Iraq war. This latter problem had a great many more ramifications than a simple loss of confidence in the region's stability. It was

Iran's political overtures to Bahrain which it considered to be part of its territory without conquest that helped to shape Saudi Arabia's remarkably lax attitude to riyal trading occurring on its own doorstep but beyond its control. That said however, the downturn in OBU activity was accompanied by tighter restrictions on lending to Saudi Arabia and a curbing of the internationalisation of the riyal by SAMA. Although it is fair to state that the commercial banks of the region had by this time become increasingly sophisticated, particularly in Saudi Arabia, they were not in a position to replace the OBU's in handling the sheer volume of currency trading, for example.

When considering the continuing health of the OBU's, the most significant factor is undoubtedly the state of Bahrain's business within the Arab region. This is widespread; about seventy percent of funds come from Arab countries of which about fifty percent is reinvested in the area. This shows the local importance of Bahrain which, as stated previously, cannot merely be a centre for recycling oil revenues to the outside world for this would have left the locally-based OBU's under-employed with such transactions being carried out in the London and New York euromarkets.

Although Bahrain may not hold quite the attraction to Western-owned financial institutions that was evident in the early 1980's, it would be too sweeping a statement to write off the island's role as an intermediary between the countries that are net borrowers and those that are net depositors both within the Middle East and outside it. Bahrain serves many functions and it would be a mistake to do more than identify the weight that appears to be given to each separate service in terms of clients' demand. As an offshore money market, Bahrain could for example, be identified as a tax haven as it operates outside the regulatory control of the national institutions whose currency is traded on the island. Although not all offshore markets can be classed as Eurocurrency centres, Bahrain certainly functions in this sense because deposits are made in currencies other than Bahraini dinars.

In trying to identify new trends in financial activity, it seems logical to examine the opportunities for expansion within the Arab world. At the moment, Bahrain is an important centre for short-term finance within the Arab world and the Gulf in particular. In fact, is it considered wise that Bahrain should rely so heavily on income from money market transactions? New activities could include fee-earning services that come from merchant and investment banking where the OBU's serve as intermediaries on acquisitions in the Western world. Trading in certificates of deposit and futures dealings look set to replace earlier OBU activities; indeed, some bankers no longer regard Bahrain itself as a wholesale banking centre. Whether or not it is inaccurate, such a statement does not suggest that Bahrain has given up its aspirations to a regional role in finance.

It has been suggested that with the emphasis on bank diversification, it looks likely that the market will become an intra rather than an inter-bank one. Arab banks working within the framework of the GCC are still well placed to continue in the area even if foreign banks decide to move out. It is extremely difficult to make statements of fact or even accurate predictions from behind secondary source material. It was considered far more difficult to identify the role of Islamic financial institutions within such a fluid situation, especially when one realises that they are newcomers to a relatively young banking community. That said, over the past fifteen years, financial activity has become rather predictable and, on the individual level, banking is now a somewhat staid activity. A discussion with a young English banker working in Bahrain revealed that career progression has become steady and unremarkable as the dynamism that accompanied the boom cycles of the 1970's and 80's oil industry has left the area having been replaced by an attention to bank hierarchy. In certain cases, it would appear that flair is less important than office politics — at least from the point of view of career progression. Obviously, such a view is a subjective one and tells less than half the story. This is not necessarily the case in all non-Arab

institutions; those that set up operations purely to make a fast profit have already left. Many others have found it worthwhile to persevere even though this decision has entailed an adjustment in financial practice and working harder, often at greater risk, for similar rewards.

To acquire a balanced view at first hand, interviews were conducted in Bahrain with individuals from both Islamic and conventional banks in an attempt to place the role of Islamic finance within this arena of change.

5.3 The Financial Situation of The Arab Gulf in The Context of International Market Changes

Already, the 1990's promise to be a very different decade for the international investor from the previous one with a new emphasis upon greater sophistication and an accompanying need for more careful investment. 1989 saw some momentous changes around the world, and these have an important bearing on the Gulf investor. Europe cannot fail to make headline news; the single market of 1992 is given added impetus by the imminent German reunification and the peaceful break-up of the Warsaw Pact is likely to shift the area defined as Europe increasingly eastward with the new Germany at its centre. A further ramification of Soviet liberalization towards its satellite states is a decreased expenditure on defence. The end of the cold war and its promised Peace Dividend should also see a reduction in the US budget deficit with the concomitant benefits of greater investments and stronger growth in the following decade.

Moreover, with the growing importance of Europe comes a changed emphasis on the distribution of world currencies; more players are taking an important part in the world economy. Up until recently, the US dollar remained unchallenged as the key reserve currency. Although the dollar still accounts for 60 percent of world

reserves, an increasing regionalization in the world economy has seen the role of the dollar diluted in favour of the DMark. Some 25 percent of world monetary reserves are in DM compared to only 9 percent in 1975.²

What is the effect of these changes on the Gulf investor? As suggested, none of the above factors serve to make the management of investment portfolios any easier; having achieved what may appear to be a reasonable balance amongst the various instruments available in the international markets, constant adjustment is necessary to maintain an equilibrium. Thus far, Bahraini banks cannot claim a particularly high degree of involvement: Gulf investors since the early years of the oil boom have had sizeable investments overseas, this applies to governments, wealthy private investors and financial and trading institutions. Investments have ranged from bank deposits and fixed income securities to shares, real estate and direct investment in businesses abroad. Most importantly, a significant proportion of these investments has been made through intermediaries in London, Zurich, New York or Tokyo, leaving the Gulf important for its pool of investors but perhaps less so for local financial institutions.

It may be that this situation is undergoing a change, one that could be particularly beneficial to Islamic financial institutions. Whilst some OBU's have left the island, others continue to apply. These latter have observed an upturn in Gulf economic activity and a consequent slowing down in the outflow of capital towards international markets. Funds invested in the region will serve to expand businesses already located there as well as establishing new ones or will take advantage of the recent surge in the region's stock and real estate markets. Mr Henry Azzam of the Gulf International Bank was eager to point out that this was a matter of proportion: whilst there should be a noticeable if slow repatriation of some of the funds invested abroad, it should also be observed that despite the improvement in investment opportunities at home, they remain limited. Considering the high propensity to save in the region, it is as yet unlikely that enough domestic outlets can be found to soak up

the surplus funds that result.

As a postscript to this section, it may be useful to observe the group on which the financial activity in the Gulf turns; the private investor. GIB places them in three broad groups: institutions, wealthy individuals and less wealthy private investors. Institutions, both financial and commercial as well as the wealthy individual investors have maintained a high profile in the international markets and have been actively sought out by international financial institutions who have been able to offer them a wide range of services.

Despite the important differences between these groups, all of whom are likely to have different expectations for their investments and are likely to take differing positions on risk exposure, there are similarities running through them. Speculation tends to be less important to the investor than the conservation of his investment and that investment tends to be short-term, suggesting a preference for liquidity and quick return. What may be termed a lack of adventurousness is further reflected in the Gulf investors preference for his money to be invested in a familiar environment such as his domestic market, USA and Europe rather than in the Far East. Products such as direct investment in real estate rather than leveraged buyouts and precious metals rather than commodities appeal once again because of their familiarity. A precis of GIB's research into investment priorities leaves a "league table" that runs as follows.

Equity ranks highest amongst GCC investors with a bias towards local stock markets. Internationally, the US stock market leads the field for investments, followed by Germany, Japan and the UK. Liquidity preference has been expressed via a means unavailable to Islamic banks; bank deposits ranking second on the list with the major currency of deposit being the US dollar but with increasing importance being attached to Gulf currencies as well as to the DMark and the Japanese Yen.

Real estate comes third internationally and clear first if only domestic investment is considered. This is followed by bonds, attractive by their liquidity and low risk. Increasing sophistication among Gulf investors has seen the once-attractive gold and other precious metals decline in popularity, moreover this type of investment is, unsurprisingly, rather too speculative for the average Gulf investor. The same attitude applies to commodities, as in addition to their speculative nature, it is difficult for the investor to obtain the information support that is available with more conventional instruments.

This then, is how investment priorities measure up against each other in the Gulf. It is encouraging for Islamic financial institutions to observe that their particularly local appeal is now increasingly accompanied by a trend towards regionalisation; further improvements in telecommunications have eroded Bahrain's position as a money market centre as a result of its time zone situation. Longer dealing hours from London to the Far East have made such an intermediary position increasingly irrelevant and obsolete. However, the section above has demonstrated that the same problems face Islamic OBU's as pertain to their commercial banking counterparts. Liquidity tends to be high in the Gulf and the preferred ways of investment are not all available to Islamic financial institutions. The following sections describe how the separate arms of two Islamic OBU's, Al-Baraka and Massraf Faisal Al-Islami (also known as FIB or Faisal Islamic Bank), operate within this framework of time and preference.

5.4 Al-Baraka Islamic Investment Bank, Bahrain

Al-Baraka has an important presence in Bahrain. In addition to the main office, there are also two subsidiary companies; Al-Tawfeek Company for Investment Funds and Al-Amin Securities. Discussions took place at the main office and also at Al-

Tawfeek which is 99.5 percent owned by its parent company and is responsible for short-term investments. Dr Faisal Lakhwa kindly agreed to give a broad outline of the activities of Al-Tawfeek, as did Mr Abdullah Abol-Fatih of Al-Baraka. The material that follows is as a result of two separate interviews but as the fortunes of the companies are so closely connected, they are treated under one heading. Further information was gathered from annual reports and working papers.

The bank offers two investment accounts; the Joint Investment Account for which the minimum deposit is US\$5000, and the Specific Investment Account for sums over half a million dollars. The return on investment ranges from ten to twelve percent on the bank's own funds, with the most recent figure for the Joint Investment Account being an 8.56 percent return, the bank having taken a maximum of two percent as *mudarib*.

Since coming to the island in 1985, Al-Baraka has had the intention of expanding its scope of operation outside the Arab world, with special attention having been paid to the Far East. For the time being however, seventy percent of the bank's investment remains in the Middle East, Turkey, Pakistan and North Africa.

The term structure of Al-Baraka's funds was one of the first features that indicates the importance of retaining a separate arm for short-term investments; 75 percent of funds being committed for one year or less. No Islamic bank officer interviewed in Bahrain denied that a longer term commitment of funds required greater education in Islamic investment methods and this could only come about as a result of a higher degree of exposure to the consumer / depositor of safe and profitable operation by institutions such as Al-Baraka. Presently, Gulf investors, contributing the lion's share of deposits, are not offered a particularly wide range of investment packages.

Islamic banks, although aware of the narrowness of their reach in comparison

to their competitors, are certainly not covetous of every type of investment that is available to traditional banks, not even those that are Islamically acceptable. The greatest perceived problem is that of reconciling risk management with a competitive return on investment. Al-Baraka does not imagine itself unique in facing this conundrum; the trade-off between caution and reward is faced by persons from all walks of life, not just within the banking community. Yet, as a relatively new concept in international finance, Islamic banks have to perform safely and profitably on a broad scale if they are to achieve their wider objectives.

“... we in Al-Baraka Islamic Investment Bank, Bahrain, surely wish to see such Islamic financial institutions play a pioneering role in achieving economic and social development and establishing economic integration among Islamic countries. And this — we believe — will not be achieved unless Islamic banks first outdistance traditional banks working in our countries in every aspect such as providing all banking services and gaining the clientele of the mass.”³

The international commodity market is seen by Al-Tawfeek as a safe arena of operation but one that offers little in return. Similarly, the process of placing funds at one over LIBOR is not the way to keep a bank's shareholders content and so its unavailability to Islamic institutions is a source of inconvenience rather than missed opportunity. Although acceptable to Muslims and often quite profitable, returns on real estate are nevertheless considered very cyclical. Housing booms and business district development cannot sustain themselves indefinitely and one ponders on the balance of the Kuwait Finance House's investment portfolio, one third of which is directed towards real estate. A similar trend is noticeable at the Dubai Islamic Bank.

In considering the problem of the lack of an Islamic capital market, a discussion on Islamic securities took place. The idea of a securities company is under study

although this can barely be labelled a definite objective of this Islamic bank, much less actual practice. An Islamic security would be distinguished through being fully backed on the operations side by an identifiable Islamic transaction. The chief objection of the *shari'a* committee to the conventional alternative is that, while many banks issue paper, certificates for example, investors cannot be sure whether they are indirectly supporting a chain of chemists, a casino or an arms manufacturer.

In this case, the action would revolve around *murabaha* or lease contracts. Here, a minimum level of for example US\$10–15 million is raised by public subscription; an investment towards a specific fund.⁴ The public would also be the source of re-financing. There are three main features of the share certificate which should make them attractive to the public. Firstly, since the maturity date of the transaction is known, the date that the dividend is to be paid is also known. Secondly, having negotiated, the investor will be aware of the return on a given transaction as well as on the overall fund: although it is not of course fully guaranteed, simply defined and expected. Thirdly, the investor has the right to buy, sell or redeem his certificate to the issuing company, the price being posted weekly.

There are two lines of thought within the Al-Baraka group in Bahrain and they centre on the future function of the island. That its importance as an international money market centre has dwindled somewhat is unquestioned. However, considering the increasing weight given to trade finance, is Bahrain the ideal location from which to oversee the transactions incurred? One estimate places the ceiling on trade within the Arab world at US\$300 million annually. The evidence suggests that this does not represent the vanguard figure of a regional trade boom, and makes dismal reading.

One opinion views Dubai as a candidate for handling the financing of trade, both outside and inside the Arab world. The Emirates in general and Dubai in particular are much more competitive in terms of comparative advantage; Dubai is

more open than Bahrain and keen to attract further custom. Whilst long haul routes between Europe and the Far East are increasingly doing away with a Middle Eastern stop, Dubai is attracting any existing traffic by offering half-priced landing charges. Dubai has a more cosmopolitan and dynamic spirit, it is anticipated that similar terms combined with a naturally growing financial importance will see international banks located there in the not too distant future. Bahrain's advantages that accrue from its offshore status will simply be undercut by Dubai.

The reasons why Bahrain should retain its primacy as a Gulf financial centre seem however, far more cogent, not least because the Gulf investor, as well as being cautious and conservative also seems to appreciate a degree of permanency which has only recently been achieved. During the 1970's, any observer of the almost frantic competition within the Gulf to build the most modern hotel, the tallest office block or the most imposing monetary agency headquarters would attest to the fact that an entrenchment has taken place. If this should run contrary to nomadic origins, so be it: a change of lifestyle has been marked in lasting terms.

To recreate a banking community on the scale of Bahrain would require the wholesale relocation of the players themselves, an unlikely prospect and one which may well lose money for any company prepared to try. The OBU's that have already left Bahrain have left the Gulf altogether; no amount of regional relocation would have persuaded them to stay. Consider the chief factors behind their departure. Bahrain is geographically perilously close to Iran and the Gulf war drove some financial players away under the shadow of possible annexation of the island. Secondly, the economic situation has changed since the days of the development boom when banks were clearing three or four percent over LIBOR due to the demand for funds. To realise that kind of profit these days would require the shouldering of unacceptable risks.

There can nevertheless be no doubt of the need for a Middle East financial

centre; theoretically, improved telecommunications would allow London to carry out Bahrain's money market dealings, but there is an increasing emphasis being placed on the provision of services. Here, greater confidence might be placed in a centre that is visible to local investors, 'local' in this case denoting Muslims / Arabs from the Gulf. Evidently, conjecture on the future of Bahrain does not involve the uprooting of Al-Baraka, nor, for that matter, of the Faisal Islamic Bank. The rents may be high in Bahrain, but it will take more than a few cut-price incentives from Dubai for the Islamic banks of Bahrain to give serious attention to the question of relocation.

5.5 Past and Future is Tied to Saudi Arabia

It is inevitable that Bahrain should have strong ties with Saudi Arabia. Not only is the island linked to its mainland neighbour by a 25 kilometre causeway paid for entirely with Saudi money, but it is inevitably the focus of attention for Saudi investors, corporate and private, for whom the attractions of Bahrain's offshore status are most apparent. Within the GCC, there are no controls on the transfer of funds and it is consequently unsurprising to see that eighty to ninety percent of Al-Tawfeek's funds come from the Gulf area. The greater proportion of these come directly from Saudi Arabia, there being no requirement for a collection agency or any other such financial intermediary.

Al-Baraka, which is seventy percent Saudi-owned reflects the wider situation in Bahrain at present; the fortunes of the two being inextricably linked. In the past, banking expertise in Bahrain allowed it to act without competition as an investor of Saudi funds. At the time, Bahrain appeared to be an offshoot of mainland Saudi Arabia, an impression which was further strengthened by the building of the causeway. Recent independence on the part of Saudi banks due to increasing expertise has left bank staff in Bahrain at best under-employed, but the fact remains that Bahrain is

not of a sufficient size to exist independently of its next door neighbour. It does not have the trading links that stretch all around the Indian ocean that so favour Dubai's progress, nor does the racial mix of Bahrain result in the same entrepreneurial spirit that pervades Dubai. There can be little doubt that Bahrain is casting about for another role, nor that it is most logical, considering the human resource development, that Bahrain's future remains in banking. Obviously, there is no single panacea for the symptoms of economic woe; the future will depend on the island's ability to adapt. The introduction of Islamic banking to the island is a good example of the efforts being made by the Bahrain Monetary Agency to ensure that every chance is given to the banking community — as a Middle Eastern base for international Islamic finance, Bahrain is the scene of regular seminars and conferences on the subject. It may well be in the interest of the BMA to aid the development of an Islamic interbank market, a concept that will be examined as a conclusion to this chapter. Inevitably, this will directly aid Islamic banks, but in the light of other institutions such as the Gulf International Bank and the Arab Banking Corporation offering Islamic finance, it is perhaps not far off the mark to suggest that encouraging Islamic finance and bringing to it the experience of nearly two decades of Offshore operations would aid the banking community as a whole.

5.6 Further Obstacles to Islamic Finance

Al-Baraka is as keen as any other Islamic bank to build up the Islamic financial markets but cites the well-known shortcoming of a lack of suitable opportunities, putting an approximate figure of US\$500–600 million at most.

A further difficulty faced by Islamic banks centres on a lack of information; not just ignorance on the part of the consumer of Islamic banking services, but also on the part of the authorities towards the more basic principles involved in Islamic

financial practice. In the case of *murabaha* financing, for example, the question of whether or not banks should establish commercial companies or not was raised. It was necessary to explain to the authorities that *murabaha* was a commercial transaction, for with the bank actually owning sponsored goods for a certain length of time, it had appeared to be an investment. It was pointed out that existing laws were still not suitable for Islamic operations to be recognised on account of their merits instead of being questioned with every innovation. This is not a problem faced by conventional banks. Ironically, I was given to understand that the West is more amenable to some principles of Islamic finance, although they may not be labelled as such; less difficulties would be faced in accepting the idea of ownership of goods as a service for a client rather than as a speculation on the bank's own account. As mentioned by the London branch of Al-Baraka, *murabaha* should imply that the bank actually holds goods before selling them. However, if this is taken in its literal meaning and a commercial company considered, the final decision rests on the opinion of the religious supervisory board as well as the extent to which mark-up finance is used by the bank concerned.

The status of equity trading remains unclear and Al-Baraka considers that this is a further reason why the Islamic Unit Trust conceived by the IDB has yet to make headway. There is to date, no *fatwa* that examines the buying and selling of equities for companies that deal with traditional banks. Only the *shari'a* board of the Islamic Bank of Jordan has declared that private Muslims may invest in companies' equity but it has delivered no statement on banks. Therefore, the Islamic Unit Trust has encountered the drawback of less than one hundred percent approval from the banks that would be major initial contributors. In Jeddah, the *Majm'a al-Fiqh* or Society for Jurisprudence has decreed that when financing is needed by a company, *muqarada* certificates may be issued in the process of floating a limited company for the required funds. This decision was only directed to Jordan. To each separate Islamic bank,

the situation vis-a-vis shares trading is largely a matter of personal choice and interpretation which has led to a variety of different positions being adopted on the issue. Until there is a consolidation of the process of judging upon the legality of new financial instruments, especially those adapted from Western financial practice, there will continue to be a lack of synergy in the performance of Islamic banks worldwide.

5.7 Massraf Faisal Al-Islami, Bahrain

FIB has been in Bahrain since July 1982 and presently, its authorised and paid-up capital is US\$30 million. It is principally owned (89%) by the Dar Al-Maal Al-Islami Trust which in turn is administered by its wholly owned subsidiary, DMI in Geneva. Of the remaining eleven percent, the Islamic Takafol Company of Bahrain holds ten percent and HRH Prince Mohamed Al-Faisal Al-Saud owns a one percent stake.

Between 1984 and 1988, customer deposits have grown from US\$2.3 million to nearly one billion dollars with investment accounts forming the vast majority of the total. One quarter of these deposits were utilised in financing operations of which the major portion was used in trade finance. The percentage breakdown of the bank's total financing portfolio runs as follows:

Trade Finance	74.0
Manufacturing	5.4
Agriculture	1.8
Construction	5.1
Others	4.0

The liquidity situation at FIB does not differ from the norm of Islamic banks:

"In pursuant to the policies established at the Bank, a high level of liquidity was maintained. A total sum of US\$1,007 million was invested in short term, quickly



realizable instruments of the maturity terms extending up to one year. This comprises 98.7% of the Bank's total assets. Of these, US\$258 million, i.e. 25 percent of the assets and 26 percent of the short term investments were realisable within a period of 30 days."⁵

The Faisal Islamic Bank of Bahrain makes good use of its extensive network of offices around the world. This is most obvious when examining the source of funds for the 1989 financial year.⁶ Out of the one billion dollars that were managed by FIB, \$450 million came from the DMI headquarters in Geneva and \$550 million was collected in the Gulf area, of which Saudi Arabian investors contributed 80%. These funds are gathered and transferred to Bahrain via collection agencies throughout the kingdom.

The range of international banking services that FIB offers its clients is wide, encompassing foreign exchange operations, letters of credit and letters of guarantee as well as leasing, Islamic securities and Islamic syndication. Peculiar to FIB is a system of parallel purchase and sale of currencies and commodities. However, none of the above truly break new ground, and at interview as well as in literature provided by the bank, it is the difficulties the bank has faced and the means by which they are to be overcome that gained the most attention.

Foremost amongst these is the pace of recent developments in conventional financial markets which conspire to leave those such as Islamic banks in a position that suggests a lack of flexibility and competitiveness on their part, in terms of services provided and return on investment. One of the more pressing problems, mentioned in almost every interview has been liquidity management and the related issue of finding liquidity instruments to overcome the unnecessarily high level of idle funds that Islamic banks find themselves obliged to maintain.

Liquidity constraints further conspire to hold back longer-term investments as much of the crucial short-term returns normally accruing to conventional banks are unavailable to their Islamic counterparts due to the investment instruments or products that are employed. In consequence the latter must devote time, energy and funds to those activities that are both stable and profitable in order to satisfy customers and demonstrate the efficacy of the system. Restricting the withdrawal of deposits is not an answer as Nabil Nassief argues:

“To overcome even a part of this constraint, it may be argued that withdrawals could be minimised by restricting investors to specified projects or longer term pools of funds relating withdrawals to the maturity of a relevant project, funds or time the actual cash flow is generated. In a highly competitive and flexible market, this situation will severely restrict choice and in turn the system’s success.”⁷

As most interbank market activities fall within the category of the Euromarkets, it will be observed that much of the subject has been covered in chapter three. Entry into this type of activity or an Islamic equivalent thereof will involve careful preparation. Within the foreign exchange market alone, transaction volume is estimated at at US\$150 billion a day; players include banks, institutional investors (insurance companies, for example), individuals and brokerage houses. There is no reason why Islamic banks should not fit into this scheme, but at FIB, those responsible for researching the issue are aware that the market is extremely competitive and only the most cost effective and efficient players will be able to survive and prosper. The future need not be bleak however. It was pointed out that necessity on the part of Islamic banks has bred invention and innovation. Consequently, it is not unreasonable to suggest that they could adapt some of the market products to suit their own objectives and norms of practice.

The aim to establish such a market is well known, as are the twin problems of speculation and unearned gain within the existing one. There follows a study of the subject considered as a feasible bank project with its attendant aims and conditions.

5.8 An Islamic Interbank Market

The absence of an inter-Islamic bank market does not affect the development of Islamic banks alone. When the lending policies of such institutions are taken into account, it is likely that the corporate sectors in Islamic countries are suffering as a result of the inefficient transfer of surplus funds from one geographical section of Islamic society to another. The problems faced by the banks themselves due to an inability to borrow and invest funds on the interbank market are more direct, and they fall into three main scenarios.

Firstly, Islamic banks are unable to realise a return on their funds if a suitable investment opportunity does not present itself. Secondly, unless the bank has sufficient funds of appropriate maturity available, a suitable investment may be missed due to an inability to quickly find additional funds from elsewhere. Thirdly, having found a good investment and with suitable funds available to go ahead with the transaction, the bank may yet be hamstrung if it is subsequently faced with withdrawals on such a scale as to be unable to meet the depositors' calls. The adverse effect on the bank as well as on Islamic finance in general are obvious and far-reaching.

The products and instruments created for the inter-Islamic bank market must both conform to the *shari'a* at the same time as being suitably liquid. Unfortunately, Islamic countries are seldom able to provide a combination of the qualities required by Islamic banks to draw up products, which include an acceptable yield, easy cash convertibility and general recognition by other Islamic banks. The absence of a central bank hints at further problems with a proper regulatory environment and legal

framework. Moreover, in many Islamic countries, strict exchange controls are maintained, impeding the free movement of funds. In spite of a desire on the part of those involved, such a situation can lead to an inadequate supply of investors without whom the system is bound to founder.

Further limitations on the development of Islamic marketable instruments are outlined by Nabil Nassief. He points out that thus far, the number of such instruments developed by Islamic banks which may be used on an interbank basis or which may be traded on a secondary market is relatively small. Most obviously, Islamic financial institutions, being relatively new to the banking scene and few in number, are not in the same strong position as mainstream banks to develop new financial products. The possibilities for adapting conventional money market practices are of course very limited due to their inherent interest element.

Any interbank product created and traded by an Islamic bank must fill a number of basic pre-requisites. It has been suggested that mutual funds or participation certificates may comply with the injunctions of Islamic law, where relevant to market operations. The funds must necessarily comprise transactions that generate extra capital to be subsequently distributed among the participants in the scheme. It is anticipated that investors should be kept constantly abreast of the value of the assets in each investment pool, preferably on a daily basis. In this way, it will become clear which bank is managing its fund most efficiently, consequently attracting liquidity whilst poor performers will be unable to do so. An alternative to the investment pool idea is provided by relating the certificates to an underlying financing programme with a single corporate client. The return will relate to the actual activity in which the funds are invested. Once again, the assets must be frequently valued in order to calculate returns to the participants.

Problems with such a scheme tend to revolve around the anticipated small size

of the market. Specifically, when a client wishes to leave or enter the pool, each movement must be matched by finding funds from other sources; not an easy task and one which will involve an uneconomical amount of time, so defeating interbank market objectives.

An alternative to longer term Eurobonds has been promoted by FIB. The bank has pioneered the technique of syndicating individual financing transactions under short term *murabaha* contracts. The receipts from this process are structured into a pool, a *mudaraba* in fact which is then utilised for a syndicated transaction. FIB has handled seven such transactions to a total value of US\$600 million over the past two and a half years. The most obvious drawback here is that the transactions cannot be instantly implemented on demand. They have however proved popular within and outside the sphere of Islamic banking.

Guaranteed reciprocal loans, whereby a borrowing bank agrees to provide the same service to the lender at a later date, runs into problems even at conception. Whilst a number of Islamic banks may agree in principle to deferred repayment independent of the prevailing conventional interbank rate, religious scholars argue that reciprocity on the part of the borrower is not obligatory in the case of an interest-free loan. The stumbling block this provides to what may have been a workable system is a gigantic one.

In conclusion, it is clear that any foray by Islamic banks into the conventional interbank market must be planned with great care; the latter has after all, taken a number of years to develop flexibility and the speed of innovation and development that it boasts at present. It is equally clear that Islamic banks must draw up products and operations that would gain favourable attention from conventional banks in order to make full use of the size and efficiency of the market. Islamic banks have four basic processes, *musharaka*, *mudaraba*, *ijara* and *murabaha* from which to develop further

products. This and the creation of new 'core' products will take further research as well as study of and cooperation with *riba* banks if anything worthwhile is to be achieved.

There is no doubt that Islamic banks entering into the system would give Bahrain's interbank market a boost and a further reason for pre-eminence in the Gulf. It could well serve as a focus of interest for Islamic banks worldwide as a centre for adjusting their liquidity. Thus, the fates of Bahrain as a banking centre as well as Islamic finance as a viable means of handling money.

Nabil Nassief's concluding remarks connect cooperation in this venture with the well-being of Islamic banking in general:

"Islamic banking has made tremendous strides during the past two decades. With progress, their needs have also grown considerably. It is high time that they got together, pool their resources — manpower, infrastructural and monetary — to take care of their fast-growing needs. It is quite possible that in the beginning, substantial assistance will be derived from central banks of Islamic countries and the Islamic Development Bank but as products are developed which are acceptable universally and confidence grows in the efficiency of the system and players, a greater number of participants will be drawn to the operation of the market."⁸

Footnotes

- 1 A Cyprus-based bank analysis and rating agency, see "Bahraini Banks: A Closer Look", *Arab Banker*. Vol.9, No.5, 1989, pp.16-18.
- 2 *Gulf Economic And Financial Report*, Published by Gulf International Bank, February 1990.
- 3 *Islamic Banks: Reality and Aspirations*, paper presented to the 13th meeting of the Directors of Operations and Investment of Islamic banks, Turkey, October 1989.
- 4 The US dollar is the currency of deposit for all deposits with Al-Tawfeek.
- 5 Faysal Islamic Bank, Bahrain, Annual Report 1988.
- 6 Figures, quoted in US dollars, are approximate.
- 7 *The Development of an Interbank Market for the Islamic Financial System*, presented by Nabil Nassief, Managing Director, Faysal Islamic Bank of Bahrain EC., March 1990.
- 8 *ibid.*

CHAPTER SIX

THE ISLAMIC DEVELOPMENT BANK

6.1 Creation and Role of the IDB

In addition to its declared role as a development assistance agency, much is expected of the Islamic Development Bank outside this field. As a supra-national body, it would appear to be the ideal candidate for the promotion of Islamic banking, particularly in the sphere of international finance. The decade preceding the creation of the IDB saw a greater than ever polarisation between rich and poor Muslim countries as the oil import bills of resource-poor countries rose substantially, in line with the oil price increase which left the net oil exporters of the region very much better off. Considering the historical links provided by extensive trade within the Middle East and, most significantly, the religious conviction that draws Muslims to Mecca at least once in their lives, it is not surprising that the members of the OIC (Organisation of the Islamic Conference) should be jointly informed, as well as concerned about this increasing wealth gap. Nor is it unusual that, amongst believers of different countries, altruism should be a major factor behind the establishment of an institution whose aim is to cure at least some of the symptoms of economic inferiority and thus help to redress inequality wrought by a lack of resources.

In order to highlight the significance of the IDB and its activities within the Middle East, it may be worthwhile to consider the following points. The uniqueness of this institution derives from a combination of factors. The IDB is one of only two multinational Third World financing agencies in the Middle East.¹ It is the sole institution that conducts its funding activities according to the *shari'a* law and, most importantly for this study, the Islamic Development Bank is uniquely placed to oversee and promote the spread of Islamic banking throughout the Muslim world. Acting

as central bank and lender of last resort, this agency could help reassure other central banks of the solidity of Islamic financial practice outside the Middle East. In supporting such projects as Islamic Certificates of Deposit by underwriting the market, the IDB has gone some way towards achieving a wider recognition of and participation in *shari'a*-based financial instruments.

Evidently, much is expected of the IDB and it is inevitable that a disparity should arise between this and what is actually achieved. Considering the size and composition of the institution, it is perhaps remarkable to note what has actually been achieved to date, for the decision-making machinery could not possibly be as well-oiled as it would be in a single, homogenous entity. Nor do the vested interests of one party necessarily coincide with those of another. This chapter aims to examine the aims and expectations of the IDB with reference to material taken from written work about the bank as well as from interviews with its officers. Thus it is hoped that a balanced view is given of the IDB's aspirations and activities.

Established to undertake long-term financing of development projects and the short-term financing of trade, the IDB comprises forty five members, an increase of more than one hundred percent on the original twenty three at the bank's inauguration in 1975. These are qualified for inclusion through membership of the OIC and a willingness to conform to the bank's decisions. Thus, from the outset, it is clear that membership of this financial body is far from restricted by considerations of wealth, political persuasion or even by a history of antagonism through boycott, as in the case of Iran.²

Taking into account the fact that the IDB is placed to make the greatest impact on Islamic finance in general, many of the issues that concern this institution are directly relevant to commercial Islamic banks. Possibly the most closely connected issue is that of financing procedure. In spite of a different mode of funding its capital

base, the problems that the IDB faces with equity participation projects are basically the same as those encountered by its commercial counterparts. Evidently, the recent depreciation of member countries' currencies against the Islamic Dinar has done little to help the situation. Identification of and competition for feasible projects that anticipate a sure and speedy return is equally tough, but as a development assistance agency, the IDB is more likely to take a long term view about infrastructural projects that are less attractive in respect of repayments. Such projects tend to have a strong socio-economic impact and, since its inception, the Bank has financed 126 of these operations to a total value of nearly ID649 million. Repayments have been scheduled for between twenty five and thirty years.

Nevertheless, it would be a mistake to identify the IDB as a charity; a further examination of the source of the bank's capital is included later in this section but for now, it is sufficient to state that it is not easy to augment these funds. Unlike other development agencies that are able to raise funds in the market place, the IDB has been almost solely funded by members' capital subscription. In view of the worsened economic circumstances of its member countries, calls for an increased subscription would be most unlikely to be met. Hence it is highly desirable that loaned funds should revolve and inevitably, the safest return tends to come from trade finance.

More than any other Islamic financial institution, the IDB is placed to challenge and overcome the problems faced by the genre and it does so with skill and imagination. Projects such as the Islamic Banks' Portfolio develop links with commercial entities that benefit both parties. Indeed, any project backed by the IDB has a far greater chance of success than one it avoids. Moreover, the size of the Islamic Research and Training Institute (IRTI) which occupies one of the bank's three buildings at its headquarters in Jeddah suggests that any operation conceived by this body is likely to be far from a flash in the pan. All the evidence points to the suggestion that the IDB actively co-operates with other Islamic financial institutions rather than

stealing their market and crowding them out.

It is evident that in order to increase the funds at its disposal, even to maintain them at the same level, the IDB must be innovative. The question of developing Islamic securities and a dedicated market is therefore a relevant one when it is remembered that the IDB, like any other financial institution, must ultimately show a profit in order to remain in business. Viewed as a development assistance agency, it is arguable whether or not Islamic financing in this sphere is the most effective way of disbursing funds. With few good investment opportunities available, it has been stated that government funding is not ideal being to some extent at the expense of private capital finance.³ In what follows, it is suggested that there are even more fundamental questions such as the future of the IDB's development role which must be resolved before it is possible to assess the true impact of its funding.

6.2 Background to Capital Subscription

The idea of founding an Islamic development institution was conceived and first discussed by the OIC in the late 1960's with a strong impetus for action resulting from the oil price boom in the early 1970's. In simple terms, those enriched by the oil price rises were in a position, even under an obligation, to aid those Muslim countries who had become increasingly worse off as a result of an event that had enriched them. In effect, such a windfall was viewed as unearned profit.

A second meeting of finance ministers in August 1974 set narrower aims and definitions to the proposed bank. Primarily, financial activity was to be in accordance with the *shari'a* law. A great amount of leeway was given with respect to raising funds when it was stipulated in the Bank's charter that that it could accept deposits and raise funds in any other manner: the significance of this clause will become apparent later on.

Contributions to the authorised capital of 2 billion Islamic dinars, to be split into 200,000 shares of ID10,000 each, varied from Saudi Arabia's 200 million to the nominal contributions from the poorer Islamic states such as Chad, Guinea, Yemen and Afghanistan who raised 2.5 million each. Arguably, some countries were remarkably modest about their comparative economic status with Syria pitching its contribution at Mauritania's level and with Turkey offering no more than Sudan, but at the end of the first round of contributions, ID793 million had been raised. Benefitting from the 1979-80 oil price rise, oil rich member states were able to comply with the 1981 resolution to pay up the balance of the authorised capital; the paid up capital now stood at ID1820 million.

Although most of the rest of the shortfall between paid up and subscribed capital was later made good, this looks at present to be the limit of funds expansion. Having gladly accepted debt rescheduling arising from the 1988 Toronto summit of the industrialised countries, it is evident that the poorer IDB member countries are still not in a position to increase their modest subscription to the Bank's capital.

The economic situation with regard to the IDB's more developed member countries provides a contrast, but not an encouraging one. The oil exporting countries actually recorded a negative growth figure in 1987 following the downward pressure on oil prices in the middle of that year. It has been predicted that figures for 1989 will reveal a further reduction in GDP growth rates in all groups of IDB member countries following a slight rally in the figures for the previous year.⁴ Faced with such budgetary problems, the oil rich states are equally unlikely to contribute further to the Bank's capital. The expansive mood of 1975 where share capital funding on a no-return basis was acceptable, is definitely over.

6.2.1 Shortcomings of Funding by Capital Subscription

In the case of the IDB, the greatest disadvantages resulting from this mode of funding is a reliance upon it. The financial resources of the Bank are derived mainly from its paid up capital, the receipts of its Investment Deposit Scheme and its retained earnings. During the financial year 1988-89, these resources were distributed in the following way: paid up capital stood at ID1645 million compared with the ID67 million raised through the Investment Deposit Scheme. Total retained earnings, including the previous year's profits, amounted to ID22 million.

On first reading, this may look satisfactory but problems become apparent when one considers the Bank's aspirations to a multinational role. At ID2 billion, its capital is not significantly higher than that of the Saudi Fund for Development which stands at US\$3 billion, a ceiling which may in any case be raised at the discretion of the Kingdom's Council of Ministers. Viewed alongside the resources of the World Bank, those of the IDB are bound to look very modest, but the important consideration is that the latter cannot raise money in the market place by conventional arrangements such as bonds. Therefore, all subscribed capital must be actually paid in. Perhaps only approximately eight percent of the World Bank's capital base stands 'idle', leaving callable capital of more than ninety percent. As a direct result of the denomination of its activities, the IDB encounters yet another drawback. Heavy currency depreciation in recent years has made subscription in a strong Islamic dinar more expensive in real terms as well as increasing the servicing and repayment burden for any borrower whose premiums are in these hard currency denominated terms. Unfortunately, the problem is further compounded by the appreciation of the Islamic dinar against the US dollar. This has made borrowing in that currency from the World Bank a slightly less unattractive proposition than borrowing in Islamic dinars from the IDB.

Inevitably, difficulties in quickly raising funds in the market has a bearing on

resource mobilisation and the Bank must rely on activities which tend to be short term in nature and likely to produce a safe return. In order to be able to provide longer term project financing, whether it is done on the basis of equity participation, leasing or instalment sale, the Bank is consequently obliged to maintain a high concentration on trade finance. Whereas ID169.59 million worth of project financing was provided by the Bank last year, import trade financing which does not include the relatively new Longer Term Trade Financing Scheme accounted for ID459.74 million of total financing figure of ID668.89 million approved by the bank last year.

There is a further knock-on effect which comes as a direct result of the weight given to trade finance. Although there is a tendency to believe that developing countries require long-term financing for infrastructural projects whereas commodity finance is actually a more pressing need, problems can nevertheless stand in the way of successful *musharaka* transactions. Obviously, the greatest stumbling block in the case of countries such as Sudan or Mali which require soft loans, grants, or financing with a long repayment schedule is that trade finance loans tend to mature too quickly. However, even in the situation of a commodity loan where the *mudarib* has earned a sufficient profit to repay within the maturity date, it is quite possible that the *mudarib's* country does not have the hard currency with which to meet his obligation. The IDB is aware of this problem and tries to counter it. At present however, the Bank has found it necessary to compromise between long term and short term financing in order to survive in the market. The implications of this state of affairs will be examined in a later section.

6.3 Augmenting the Bank's Resources

There are a number of issues that are raised by this question, not least the means by which the IDB aims to accomplish this task. The question of whether anything

other than a substantial increase in these resources would have a noticeable effect on investment policy is a particularly relevant one. This in turn begs the further question of how to define the Bank's financing procedure and disbursement; whether the IDB is making headway in achieving the aims set out in its charter.

It should not be forgotten however, that the size of the capital base is not the only restraining influence on the Bank's financing operations. Just as with its commercial counterparts, the IDB has a policy on the mode of financing that it wishes to undertake in order to achieve its goals on a wider front. Hence, wherever possible, feasible long-term projects may take precedence over short-term success through more traditional and secure operations financed by the *murabaha* method.⁵

Constraints on the supply side are matched by those imposed by the limits of demand. Once again, this is a characteristic shared with the commercial Islamic banks where attractive opportunities for investments of a specific maturity date are not always available. Moreover, the competition to fund such projects is not necessarily limited to development institutions; conventional banks and local government subsidies number amongst the strong alternatives.

Nevertheless, to satisfy the perceived need to augment the funds of the Islamic Development Bank, two schemes were drawn up in 1987, one of which has the added bonus of promoting interaction amongst Islamic financial institutions.

6.3.1 The Islamic Banks' Portfolio

The Islamic Banks' Portfolio is an investment facility to contribute to the promotion of trade links between Islamic countries. Its basic structure is made clear by the first condition that attaches to it, informing prospective participants that financing is to be based on the Islamic *murabaha* principle.⁶ The document further stipulates that

trade is to be external and that the currency of transaction is the US dollar.

Twenty one Islamic banks joined in the foundation of the scheme by subscribing US\$65.5 million to be administered by a 'participants' committee' comprising thirteen of the founding banks. This capital, which is now fully paid in, is divided into share certificates worth \$100 apiece and which can be traded amongst the Islamic banks themselves.

Quoting the price of the certificates is tricky; supply and demand within the market helps to establish the financial position of the portfolio itself but in the absence of a regular market in the certificates, the IDB announces the price every three months, and trades at that price itself. Annual profit distribution allows five percent for the IDB as portfolio manager; the certificate holder taking ninety percent while five percent is set aside to support the financial position of the fund.

Officers within the Bank responsible for the portfolio see two separate stages to the successful operation of the fund, the first phase being to attract contributions from potential participating banks. This was achieved readily enough after an initial contribution of \$25 million by the IDB. The Al-Baraka group as a whole has contributed \$17.75 million with \$9.25 million coming from the Bahrain branch. Various branches of the DMI group have added a little over \$10 million to the fund.

The second phase involves creating or issuing the instruments through which the fund is to be invested. The Bank is trying to acquire the sort of assets, such as equity-based or leasing products that will enable it to further raise the amount under management. Thus far however, only trade financing on a *murabaha* basis has been involved, mostly because of the relative security and ease of operation that it provides, coupled with the need to establish a satisfactory record in order to attract contributors outside the Islamic financial field. Leasing, for example, requires a great deal more appraisal and running management; at present in the IDB, there is only

one member of staff to deal with this.⁷

Obviously, increasing the size of the fund depends upon the demand for certificates and the results they show. In addition to these more obvious indications of what constitutes a successful operation, there are also the benefits that accrue to the commercial banks through co-operation with an institution the size of the IDB which, as the largest Islamic financial body, is likely to have a more substantial clientele in favour of *shari'a*-based financial practice. Further proof of the drawing power of the Islamic banks' portfolio is attested by the presence of five Sudanese institutions amongst the founding member banks, and this in the face of economic hardship and a dearth of hard currency.

Such sacrifice and forward thinking was sure to pay long-term dividends and indeed it has. In addition, the certificates can ease the ever-present problem of short-term liquidity management. By the beginning of August 1989, twenty five trade financing operations worth approximately US\$72 million had been approved by the Bank. Profits increased 68 percent over 1987-88 to stand at nearly US\$5.3 million last year.

The future of this investment facility looks promising. With periods of credit ranging from six to eighteen months, the funds can be quickly recycled and profit speedily realised. Furthermore, despite its success and popularity, the scheme should remain manageable because, in considering further issues, the IDB has undertaken not to exceed ten times the initial capital at any stage.

Taken overall, the Islamic Banks' Portfolio is an extremely sound scheme. As mentioned above, commercial Islamic banks benefit from co-operation with the IDB in terms of being able to offer a wider choice of investment facilities to their clients. In turn, the IDB gains contact with a wider cross-section of clients who may have been overlooked were it not for the intermediation of the smaller, commercial banks.

6.3.2 The IDB Unit Investment Fund

Outline

Ever since 1980, the Islamic Development Bank has sought to increase the scope of the financial instruments at its disposal and in particular those aimed at raising revenue from the market place. The Islamic Banks' Portfolio and the Longer Term Trade Financing Scheme have helped mobilise resources by encouraging trade. This, while effective, could not be considered innovative. Meanwhile, the Unit Investment Fund, formerly the IDB Unit Trust, has been under consideration for some time; what appeared to be a comprehensive set of regulations for its launch was agreed upon in December 1986. Yet the scheme is still under review, giving an indication of the difficulties involved in entering a new and constantly evolving area of finance.

As a result of much internal dialogue as well as extended consultation with Robert Fleming of London who will continue to advise on the scheme, the amended regulations approved in September 1989 provide an outline to the workings of the fund. An initial US\$100 million worth of funds is to be offered and, as with the Portfolio scheme, it will be administered by the Bank and is to be denominated in US dollars. Financing in this instance takes place within the concept of *mudaraba*.

Once again, the IDB will act as *mudarib*, responsible for buying into a number of projects within the IDB member countries as well as company equity in non-member countries, 'primarily', states the Bank's literature, 'in the world's major capital markets.'

Herein lies a problem, one which may help explain the gap between the scheme's conception and its implementation. On one hand, many financial institutions, particularly those of the Gulf, consider that investment in the equity of *riba* companies is un-Islamic. The government of Kuwait, for example, is a major shareholder in the

Kuwait Finance House, the decisions of government ministries often being reflected in the general policy of KFH. This is a very serious drawback: as the initial issue of \$100 million is being targeted towards Islamic institutions, it is vital to have a speedy consensus on what constitutes an Islamically ethical investment because a banking community as new as this one cannot afford to be seen to disagree about such fundamental matters. To this end, investment in *riba* equity is to be replaced by leasing contracts. Of course, this alternative soon provides its own problems: primarily, in a package of leases such as might be presented as part of the fund, there will be a number of lease contracts that will have been guaranteed by an unrecognised guarantor. A further plan, whereby the IDB guarantees the guarantors in terms of the performance of contracts approved by them, looks likely to be ratified in the near future.

On the other hand, many of the projects being carried out within the IDB member countries are unsuitable for unit investment. Whereas the latter should be repurchaseable on demand, the former tends to involve a commitment over a long period of time, either to leased machinery or to a project that matures gradually—neither of which promise easy tradeability. Should the IDB oblige itself to buy into a half-used item of equipment, it is extremely difficult to form a basis for a price quotation and equally tough for the new investor to assess the value of a part share in a depreciating asset.

Obviously, asset depreciation is just one issue amongst many. One of the more knotty problems involves the procedure to be followed if unit prices are revised. Is a complete revaluation necessary, and if so, based upon what criterion?⁸

A source within the IDB is keen to see a more homogeneous product than is presently envisaged. Needless to say, the decision to remove *riba* equity from the fund has helped achieve solidarity amongst the participating banks. The contract

performance guarantee is also a welcome development. Yet homogeneity does not only contribute to a more manageable investment instrument: the fund product could be used as a guarantee itself and could provide a bond-like security if homogeneous enough. Moreover, to give an example, a product containing nothing but high quality equity would be very much more simple to bring to the secondary market than one containing a mixture of this and convertible warrants.

A unit trust must therefore be based on liquid assets, namely quoted (or quotable) shares. This is especially important if the scheme is to be used for successful resource mobilisation. The underlying stock prices determine the value of each unit trust and the IDB envisages the stock being quoted on the Amman and Karachi exchanges. However, it is anticipated that out of one million shares, the Karachi exchange could efficiently handle only four thousand at a time.⁹ Worse still, it is anticipated that it would require an unacceptable length of time to repatriate money in each instance.

It is evident that the teething troubles of this scheme cannot be eradicated overnight, yet this does not appear to unduly trouble its creator. Whilst it would be absurd to suggest that the IDB is equivocable to the scheme's outcome, it must be allowed that neither of these two schemes, however imaginative, look likely to increase the Bank's resources by a significant amount.¹⁰

A Variation on the Unit Trust Scheme

There is an alternative mode of resource mobilisation that has been considered at the same time as the unit trust, although it takes a very different path to reach its goal. This is the Investment Trust and the differences go deeper than a matter of semantics. Unlike the unit trust, this would be a closed end fund and although greater problems would have been encountered initially, this scheme has the advantage

of being ultimately easier to run. To set the operation going, a secondary market for Islamic securities would need to be set up; no easy task but one that has been at the heart of liquidity problems for some time. It would surely be in the IDB's own interest to create such an entity and arguably, this action lies within the spirit of the bank's charter which undertakes to promote Islamic financial practice within its member countries.

Although intrinsic to the success of an investment trust, the question of a secondary market for any tradeable Islamic investments is important enough to stand alone. The two basic factors that surround the creation of such a market are a combination of the resources, both human and financial that are required, and the perceived need for the market in the first instance. To date, talk between the IDB and commercial banks on this question has been no more than that: dialogue with no tangible result. Meanwhile, there are only two countries whose economy is run on Islamic lines. Other countries see no pressing need to develop a market peculiar to Islamic securities and once more, development is confined to discussion until funds and expertise are committed. The actual location of the market is a less important factor at this stage; until a more definite plan is drawn up, it is unlikely that any country will bid for an idea that has barely reached the drawing board. At present, the best that can be expected from countries both outside and within the IDB is a passive stance towards the market. Bahrain for example, might once have welcomed the business, but due to the present recession this is now unlikely to happen. In any event, beyond providing an appropriate legislative background, little else would be contributed without a sign of strong backing from the IDB.

Outside the Middle East, it is possible to see a market established in Europe, perhaps Denmark. This is not as unfeasible as it may seem. After all, SAMA's principal bank, Saudi International, is located in London but few difficulties are encountered in terms of service. As mentioned above, location is no longer such an

important factor due to improved communications.

In short then, the final shape of the unit investment fund will give some indication of the IDB's priorities and policy. Either way, the Bank has departed from its normal financing procedures for both permutations are innovative. Yet the benefits arising from a functioning Investment Trust would amount to considerably more than the modest increase in resources offered by the Portfolio and Unit Trust schemes. However, the colossal effort which would have depended on the enthusiasm of the participating institutions is now arguably out of reach. Islamic banking has certainly passed its honeymoon period where any initiative was applauded as momentous. Perhaps the same could be said of the budgetary situation of the oil price increase beneficiaries. It may be some time before goodwill and good fortune combine again in such proportions.

The IDB may have taken the course of least resistance and although the reshuffling of funds towards the unit trust has raised only US\$30 million in the market, it is possible to view this operation as an exercise in ingenuity and worthwhile research. The IDB can maintain its present operations through what it earns in trade finance, which is not to say that it views itself as a trade bank. Nevertheless, having remarked upon the difficulties of setting up any kind of unit-based investment it is fortunate for the scheme's instigator that an operating surplus and no pressing need for an increase in capital has allowed it to take time to examine and alter an idea before thrusting it unready into public scrutiny.

6.4 Project Finance

The extent of the socio-economic benefits arising from certain projects makes this the activity that most closely equates with the developmental aims of the IDB. The Bank offers project finance in the form of interest free loans, equity participation, leasing

and instalment sale; the chart overleaf shows the distribution of funds according to mode of financing. latter of these two.

Chart 6.1

**Amount Approved For Ordinary Operations
by Type of Financing (ID million)**

Type of Financing	1408H			1409H			Total (1396-1409)		
	No.	Amnt	%	No.	Amnt	%	No.	Amnt	%
Loan	13	48.3	29.2	13	52.6	30.3	126	648.8	34.3
Equity	2	2.3	1.4	2	1.4	0.8	60	253.1	13.4
Leasing	2	—	—	3	27.3	15.7	53	438.8	25.6
Instalment Sale	12	92.0	55.7	11	88.3	50.8	53	424.8	22.4
Profit Sharing	2	13.8	8.3	—	—	—	4	21.1	1.1
Sub Total	29	156.4	94.6	29	169.6	97.6	296	1831.7	96.8
Tech. Assist.	19	8.9	5.4	15	4.2	2.4	141	61.4	3.2
Total Ord. Operations	48	165.2	100	44	173.8	100	433	1893.1	100

Source: IDB 14th Annual Report.

Within the sphere of promoting enterprise, these methods of financing give some indication of the financial well-being of each borrower, whether that is a government department or an approved private entrepreneur. To a certain extent one can assume that an interest-free loan will not be offered for any other purpose than as aid to a deserving case that is unlikely to meet the repayment schedule demanded by the terms of an equity participation project.

At the more conventional 'business end' of the spectrum, instalment sales have the advantage of the beneficiary owning the asset in question immediately after delivery, unlike in leasing, where the bank holds title to the asset until the full value is repaid. Outright ownership then allows it to be used as a counter-guarantee to a financing institution providing guarantees to the Islamic Development Bank for the timely payment of instalments.¹¹ Whilst the generous terms of interest-free loans were advanced in one third of all projects financed last year, the proportion of financing by instalment sale has become more and more significant since 1984-5. Last year, it represented more than one half of the ID169.59 million project finance total.¹²

Within project financing itself, the IDB favours equity participation as it encompasses the values of shared effort and shared risk. However, this is a difficult area in which to identify suitable opportunities. Inevitably, competition is stiff for attractive projects. This is not to suggest that Islamic finance must necessarily cede to conventional funding but, as IDB officials were swift to point out, an entrepreneur who is reasonably sure of a forthcoming profit may prefer to stretch his finances at the outset rather than be obliged to share his profits later. Moreover, the IDB may lose out to a local, commercial Islamic bank.

An example has already been given of a successful enterprise encountering difficulties because of a country's external payments problems. Over recent years, this has become an increasingly familiar scenario: budgetary upsets have led to foreign exchange controls hampering the remittance of profits. The consequences of this situation to an institution such as the IDB are obvious.

These disadvantages have had a telling effect upon the Bank's equity portfolio. Last year, only three projects were financed by this method, none of which were entirely new. Thus, the question that springs to mind is; under what circumstances is equity participation a success? Given that this represents the core of Islamic financial

principles and has already gained the attention of the world's international banks as a possible alternative to debt finance, this question is a particularly topical one.

6.5 Major Issues in Equity Participation

In the experience of the IDB, the opportunities for equity participation have tended to present themselves in the more economically developed of its member countries. These include Turkey, Tunisia, Malaysia and Pakistan where private sector activity is accompanied by a demand for enterprise funding of all methods.

Nevertheless, even in these circumstances, the story does not end with approval given for funding to go ahead:

“Actual disbursements of equity finance have often lagged considerably after approval is given, partly due to slow project implementation, but also because of lax accounting standards on the part of the businesses being supported, and delays over auditing. Less than sixty percent of the equity funding approved by the Islamic Development Bank during its first decade of operations was actually disbursed.”¹³

To date, ID253 million has been spent on the Bank's equity portfolio, representing nearly 13.5 percent of total financing operations. In many cases the Bank has received no dividend and is often unaware of a given project's progress. Both sides can be responsible for this lack of information; a state of disorganisation may exist on the part of the beneficiary whilst a shortage of manpower at the IDB contributes to the problem.

Evidently, it is the lack of precedents in this field as much as the terms of the *musharaka* arrangement that prevent this method of finance from gaining acceptance amongst the more established companies. Certainly, a combination of the two factors

that has led to disappointing performance of equity participation amongst Islamic financial institutions in general and the IDB is no exception. As the 1988-89 Annual Report states, " A major review of the Bank's equity portfolio is under way."

Increasingly, the IDB is subscribing to lines of equity arranged by other, local banks rather than in the equity of each separate project. This switch from direct to portfolio investment does not place such heavy demands on the Bank's workforce and it spreads risk more evenly. Moreover, it marks an increasing level of co-operation amongst Middle Eastern financial institutions.

In drawing conclusions from the above information, it should be noted that this has been the experience of the IDB and cannot therefore hope to represent the main issues of equity participation in general. Commercial banks in particular may be considerably more sensitive to the speed and security of return and less interested in the welfare aspect that a development institution is liable to consider.

Above all, the IDB has been unable to identify suitable opportunities for this type of investment; opportunities that do not bear the hallmark of previous failures. Equity stakes appear to be unattractive to other investors; to date, the IDB has not managed to pass on a single one of its stakes to another party. Nor for that matter has any interest been shown in taking over the management of the whole a venture itself. This reflects on the illiquid nature of this method perhaps more than the choice of investment by the IDB.

Infrastructural projects, whilst vital to the country concerned, are not suitable for equity participation. Investment in a road for example, would bring in only the most indirect of revenues and even that would accrue over a lengthy period of time. It would be impossible to quantify and distribute those revenues in any case. Possible investment in countries such as Sudan, Guinea Bissau and Somalia tends to produce hidden problems. Funding a textile mill for example may appear a sound prospect

until it is understood that the proposed site is entirely devoid of land communications. Obviously, an institution that is part bank, part development assistance agency must evaluate the socio-economic impact at the same time as the financial rewards that accrue from its investments.

6.6 Conclusion. The Relationship between Capital Base Size and Financing Activities

The casual observer might be forgiven for believing that the IDB is suffering an identity crisis. It styles itself as a supranational institution yet naturally it is often subject to conflicting national interests. It aspires to a role as a multinational development agency yet its financial clout is little more than that of the national development funds of the Gulf. Moreover, despite the wide remit in its charter for raising deposits, it lacks the means for increasing the size of its capital base that are available to institutions more than twice its size.

Over the last forty five years the World Bank, for example, has raised funds in the market place between fifteen and twenty times whereas the IDB has had to rely almost solely on capital subscription. Although the observation is academic, for the sake of comparison it is worth noting that were the IDB to have a conventional capital structure, it could issue bonds on the security of its callable capital. With an authorised capital of 2 million Islamic dinars, a minimum of only 200 million need be paid in.

In an average taken of the transfer of reserves to developing countries, the IDB's contribution of just over ID300 million per annum does not figure when placed alongside the amounts put forward by the Asian Bank or the World Bank. The IDB must make a special effort to increase the funding available or face criticism, for if the Bank makes no real headway in resource mobilisation, then it has proved itself

unable to meet its obligations. Worse still, more has been paid in subscription to the IDB by its members than has been contributed by them to the World Bank which appears to be operating more effectively.

For the same reason, namely an insufficient capital base, it is difficult to view the IDB as a central bank for Islamic commercial institutions. Many further problems surround the assumption of this role, not least the possible conflict of interest with its other activities. Yet it is not worth contemplating a solution to these more peripheral difficulties before the central problem is resolved with a substantial increase in the Bank's funds.

All the indications point to a need for change. It would not be enough to rationalise activities to fall in line with the funds available. Although the IDB's articles of agreement place an emphasis on promoting trade, it is not envisaged as a trade bank above all else. Recycling of trade finance is a much easier proposition than equity participation schemes and other modes of finance appropriate to developmental objectives.¹⁴ However, if the IDB were to operate within its financial means and restrict itself to trade finance alone, it is unlikely that its members would remain satisfied with the utilisation of their capital. Were they seeking to invest profitably, it is improbable that the IDB would have been their first choice. Undoubtedly, altruism was a major factor behind the more developed countries' initial contributions and a desire to see some of the economic imbalance between them and the less developed countries redressed. This reflects a similar mentality amongst private investors in commercial Islamic banks where, in some cases, the individual is prepared to forego a certain amount of profit in order to be satisfied that his funds are utilised according to the principles in which he believes.

It is not enough to suggest that subsidised commodity financing or even the initiative taken in the Longer Term Trade Financing Scheme is sufficient to fulfill

the Bank's obligations to aid the economic development of its less fortunate member countries. While the IDB remains unable to commit sizeable funds over extended periods, its financing will continue to be aimed at those countries most able to use the finance productively: those that are able to meet the repayment schedules. Inevitably, this confounds the developmental aims of narrowing the gulf between rich and poor as it exacerbates the condition. Until the issue of insufficient resources for development is resolved, it is expected that any attempt to strengthen the Bank's role as a serious institution for development assistance will be both temporary and unsatisfactory.

Footnotes

- 1 "Arab Aid: Who Gives It?" in *Arab Banker*, Vol.5, No.1, 1985.
- 2 Iran was admitted as a member in 1989. Iraq received ID 10 million (US\$13.61 million) in trade finance last year despite its existing debt to the outside world. Source: IDB 14th Annual Report.
- 3 Rodney Wilson, *Saudi Arabia: The Islamic Development Bank's Role as a Pan-Muslim Agency*, in *Islamic Financial Markets*, Routledge, London, 1990, p.196.
- 4 Source: IDB Annual Report, 1409H (1988-89).
- 5 This may simply be a matter of degree. Trade finance for example, can also take place over an extended duration as encouraged by the Longer Term Trade Financing Scheme to which a total of ID301.5 million was committed last year.
- 6 Source: *Islamic Banks' Portfolio*, Information Bulletin, Islamic Development Bank, 1410H (1990).
- 7 Interview at the IDB, Jeddah, 13 May 1990.
- 8 Rodney Wilson, *op cit*, p.197.
- 9 Interview, 13th May 1990.
- 10 The Islamic Banks' Portfolio has increased the IDB's capital by less than 2.25 percent. Rodney Wilson, *op cit*, p.207.
- 11 *ibid*, p.208.
- 12 The total does not include technical assistance worth ID4.22 million.
- 13 Rodney Wilson, *op cit*, p.212.
- 14 More than eighty percent of short term trade credit is repaid on time.

CHAPTER SEVEN

CONCLUSION

7.1 Preliminary Remarks on The Assessment of Islamic Bank Performance

Much has been achieved by Islamic banks in recent years despite a number of obstacles to their progress. However, greater progress could have been made by Islamic banks had the nature of the Middle East's relationship with the West placed them in a position to develop in a less prejudiced environment. Islam does not separate religion and daily life and yet the Muslim world has, until very recently, been dominated intellectually by western countries. This has tended to thwart the development of an Islamic ideology for everyday life and indeed, for everyday financial activity. The extravagant claims made by Islamic economists are consequently an easy target for derision, considering the gulf that exists between the aims and the actual achievements of Islamic finance.

This concluding chapter aims to look at the strengths and weaknesses in the performance of a representative group of banks and to question whether their results were inevitable, that is beyond the control of each particular bank, or whether management policy made a significant contribution to the result.

7.2 Degree of Integration into Western Financial Markets

Before embarking on a more empirical assessment of banking according to the tenets of Islam, it may be worthwhile to consider the implications of competition in a system about which Islamic banks have fundamental ideological reservations. It is inevitable that the whole ethos of a financial market should be determined by the outlook of its major players. In effect, the system is almost inextricably *riba*-based and only the unlikely scenario of a complete Islamic bank monopoly would change this fact.

Most obviously, the time factor is an important one. No new ideology can be expected to have a great impact on an entrenched system built up over a long period and whose participants have become skilled in adapting their practice to meet changing conditions.

While financial market activity remains *riba*-based, the only way in which Islamic banks can compete on equal terms is to concentrate on financing which resembles that of its opposition without actually dealing in interest. To a certain extent, this is already the case: an emphasis on trade finance by mark-up, for instance, does not really fulfill the Islamic principles of partnership and risk sharing and this has shown itself a favoured method of financing. To steer too close to the financial practice of the West is to defeat the object of Islamic finance, and yet the experiment would quickly fail if some sort of compromise was not reached. *Riba* is acceptable to non-Muslims, most of whom do not give the idea a passing thought, because it is seen to work and financial institutions are trusted to turn the system to the client's advantage. Islamic banks, on the other hand, must presently undergo the scrutiny to which anything new is subjected, although ultimately, their operations may be very much more equitable, both in theory and practice. At present, the disinterested individual remains uninspired and uninformed about Islamic finance, while the potential customer is less concerned about the wider economic benefits than about the competitiveness and range of service offered by Islamic banks. Only when their system is recognised as safe and profitable can these institutions afford to assert themselves as more particularly Islamic.

Meanwhile, there is some evidence of a rapprochement between Islamic and non-Islamic practice. Ethical investment, whereby certain commercial activities are avoided and others encouraged, is very similar in outlook to investment according to Islamic principles. The pitfalls of debt financing are similarly recognised in the West and, while it may be some time before *riba* banks place an emphasis on equity

financing, their expertise in investment banking generally, would help promote the idea and the development of derivatives such as tradeable participation certificates. Competition from Islamic banks in this scenario would be wholehearted, that is to say, untainted by the suspicion that they were not fulfilling their wider economic objectives of more efficient and fairer distribution of wealth.

The concluding factor which concerns the state of the Islamic banks' challenge to *riba* institutions is each institution's hunger and need for success. The lack of a central bank on one hand highlights the terminal nature of any bank failure and so can be said to inspire profitable activity, but at the same time, it stifles innovation and places a premium on caution. Such a policy does not contribute to real success.

Conversely, an institution such as the Dar Al-Maal Al-Islami group which has strong political affiliations is far more able to withstand the occasional disastrous management decision than even a bank supported by a lender of last resort. This is due to having a backer determined to see the venture succeed. In contrast, a central bank stands ready to avert a confidence crisis in the whole banking system, not to guarantee the fortune of each separate institution. It would be a mistake to exaggerate the extent of the support offered, but taken to extremes, it would seem that the ultimate result of profligacy and of reactionary attitude to innovation is much the same. It is fortunate that Islamic banks seem to have learned the need for accountability for their actions as well as the need to offer a wider range of services at more attractive rates of return if they are to lure customers away from their rivals.

7.3 Supervision of Islamic Financial Institutions

This work has addressed the problems Islamic banks face through the absence of a lender of last resort. Central banks in the West have varying degrees of power and autonomy, but generally speaking, they all serve three main purposes: to guarantee

the safety of their countries' monetary system, to control the supply and demand for credit, and lastly, they oversee the activities of banks and protect depositors.¹ It is considered unlikely that any Islamic bank could fit comfortably into a system that is based and supervised according to western criteria.

From the outset, it should not be assumed that the host central bank is expected to supervise a radical change in its financial market simply to accommodate the arrival of Islamic banks to approved status. The latter could not contemplate an instant conversion to their system. Even if this were their ultimate objective, a more reasonable initial goal is that of providing devout Muslims with a full range of banking services. Nevertheless, the presence of Islamic banks as licensed deposit takers would necessitate changes in procedure that supervisory authorities would not be prepared to contemplate.

Obviously, it would be equally undesirable from the point of view of Western bank authorities for Islamic banks to operate outside their supervisory cordon. A far-reaching crisis of confidence may be precipitated by the 'uninsured' collapse of an unlicensed deposit taker which would have been closely identified with the established banking community.

The practical problems of calculating an Islamic bank's capital are vast. In the case of conventional institutions, the supervisory authority imposes a prudential ratio calculated on the value of its assets. This criterion is inoperable for Islamic banks whose asset value fluctuates. A significant part of the latter's revenue has been demonstrated to derive from administrative charges or where payment on a loan is tied to actual revenues from projects that were the object of the loan. This is similar to the way venture capital is used in the West, except that venture capital activities form only a fraction of a conventional bank's portfolio because of the risky nature of this activity. Although returns may be attractively high on occasion, they are

slow and unreliable compared with regular interest payments, further confusing the assessment of risk in the calculation of a bank's capital.

Another factor that concerns central banks in the West is the status of the depositor. Participation in PLS arrangements blurs the distinction between depositor and shareholder. Problems arise in a situation of reduced profitability and outright loss. *Riba* banks pass on their losses to shareholders in the form of reduced dividends, while depositors funds remain safe except in the most extreme situations. Depositors with an Islamic bank are actively investing in that institution's future; failed projects are passed directly on to depositors. Whilst the preceding chapters have indicated the scarcity of PLS arrangements on the balance sheets of Islamic banks, the principle of joint fortune remains the same regardless, of the percentage.

In spite of the efforts made by Islamic banks to develop instruments appropriate to money market activity, their actual involvement has been, at best, peripheral. The overall impression to the regulatory authorities can only be that Islamic banks have little to offer in this sphere and at the same time, they would be immune to primary instruments of monetary control such as foreign exchange regulations. This is not a pleasing prospect for any central bank.

In an interview conducted in 1984, DMI's Prince Mohamed conceded this point, admitting that countries who have opened their doors to Islamic banks have been obliged to adapt their control procedures.² This applies to those Arab countries who have accepted and encouraged the development of Islamic Finance. The creation of Islamic Bank International (IBI) in Denmark and its status as a licensed deposit taker does not mean that the host country has relaxed its tough banking laws. How very much less likely that a country such as Great Britain, already an important financial centre, should bother to alter its legislation simply to guarantee the good behaviour of a non-performer.

After fifteen years of growth, Islamic banks still have not gained a real foothold in western financial centres. Deposit swaps with conventional banks do not really constitute integration between the two systems, IBI has had to meet Danish banking law halfway and is consequently exposed to criticism as a pseudo-Islamic institution, and still no Islamic bank is licensed to solicit deposits in the United Kingdom. Representative offices and carefully-worded nomenclature does not encompass the broader aims of Islamic finance, namely to offer an interest-free banking alternative to Muslim communities around the world.

It is difficult under any circumstances to define the activities of Islamic banks in Great Britain and Europe, but the subject is an important one. There is no doubt that the institutions mentioned in this work are able to provide funding to those that seek it and agree to abide by the terms issued by the bank in question. However, unless they are able to accept 'ordinary' deposits, Islamic banks cannot be self-supporting without their Gulf backers. Furthermore, for reasons listed in the summary to this chapter, it is unlikely funding from this source will continue on the scale of recent years.

With this in mind, it seems logical to examine the different categories of work that Islamic banks presently undertake including that to which they aspire. This latter category should need no explanation — it is banking itself, in terms of deposit-taking and being free to invest those funds as the institution sees fit. In the case of Islamic banks, this also means that deposited funds cannot be guaranteed, the basis of supervisory authorities' unwillingness to grant them a license.

Nevertheless, much of the financing undertaken by institutions such as Dar Al-Maal Al-Islami coincides with the practice of conventional banks. Although a large percentage of financing is directly set aside for trade, it would be inaccurate to describe any Islamic bank as a trading company. The situation whereby an Islamic

bank actually holds title to traded goods is part of the procedure that distinguishes it from a *riba* institution. However, the *shari'a* does not insist on the financier actually holding the goods themselves ; the title to them suffices to allow him to bear the risk of non-purchase. The aim of this process should be understood and not mistaken for speculation in commodities, an activity that may otherwise be taxed.

Finally, a distinction must be made between an Islamic financial institution and an investment company, as defined in the West. Two points are valid to this definition. Firstly, institutions such as Dar Al-Maal Al-Islami or the Kuwait Finance House avoid the term 'bank' in their title only because of the connotations of usury that they believe is involved, not as a result of the activities in which they engage. Secondly, in the West, it is only the restrictions placed upon them by regulatory authorities that prevent Islamic banks from providing similar services to conventional banks — it is not the aim of Islamic banks to conduct the sort of business whereby their only unfailing responsibility is to fill an annual tax return.

As long as this information is borne in mind, then it is reasonable to observe that a certain Islamic bank may seem to concentrate on trade finance, or that another happens to conduct business similar to an investment trust or a mutual fund. Inevitably, these institutions will invest in activities that are both Islamically acceptable as well as profitable. The situation with respect to Islamic finance remains fluid and it is likely that its investment practice and services offered by interest-free banks will change as they gain further experience and the whole concept of interest-free finance becomes more widely recognised and accepted.

7.4 An Assessment of Islamic Banking Practice

There are two yardsticks against which a system such as Islamic finance may be measured, the first being between its ideology and reality. A substantial part of the

introduction has helped illustrate the futility of such an exercise; until the strands of religion and economic theory are teased apart, broad interpretation will form the only link between its aims and achievements. A more feasible and valuable examination contrasts the experience of Islamic banks with that of their conventional counterparts.

It would be most unimaginative to suggest that Islamic banking, after its initial rapid expansion, has been an under-achiever. In view of the factors that impede its further progress, the most important consideration is that Islamic banks remain competitive and therefore, in business. Even in countries with Islamised economies such as Iran and Pakistan, the restraints imposed by Islam conspire to make the banking system almost inoperable, even in the absence of conventional *riba*-based competition.

This situation is exacerbated in the West by a number of factors, competition being only one. In those areas where they have been able to be active to the fullest extent,³ Islamic banks have proved that they provide a viable alternative to *riba* finance. This however, gives little cause for celebration: the opportunities where the *shari'a* gives its unreserved approval, demand is at an attractive level and where conventional practice has proved unworkable or unacceptable to its clients, are nil. Hence, to claim that Islamic banking has found a lucrative niche is either over-optimistic, and also places too much emphasis on its attractiveness to Muslims at the expense of conventional banks.

Obviously, the prohibition of *riba* severely narrows the breadth of opportunities available to Islamic banks and, in any case, there is almost always a conventional instrument to satisfy demand.

A number of sections in this study have dealt with the demand for Islamic financial procedures, particularly in the area of participation finance.⁴ However, these projects require careful consideration before implementation which makes strong de-

mands on manpower and experience. Furthermore, even where a project is judged workable, and the *mudarib* of the highest reputation, the returns are inevitably long term.

The investing bank may be willing to bide its time but, acting in the capacity of *mudarib* to its depositors, it must produce worthwhile results to prevent them investing elsewhere. Consequently, a cautious approach to investment has been adopted in an effort to secure a degree of loyalty from investors as well as borrowers. In the West, results are all that matters; the charitable, profit and loss sharing aspect being of little importance to a corporate client seeking the best possible deal with little room for manoeuvre. Unfortunately, from the point of view of loyalty, the best that can be expected at such an early stage is an objective, unsuspecting approach to Islamic finance: approval due to negative reasons. Outsiders tend to make no distinction between the various entities that belong a wider group. This is a very intolerant attitude, where the slightest mistake on the part of one player leads to condemnation or suspicion of the whole concept to which he subscribes.⁵ In the absence of any major management mistakes by Islamic banks in the near future, companies may take advantage of a more attractive financing package offered by an Islamic bank without being prejudiced by its unconventional nature.

Companies such as Al-Rajhi are also endeavouring to package their wares in such a way as to be less demanding for their clients as well as easier to understand. Although this may only mean reducing paperwork to a minimum, it helps to make Islamic finance more accessible to new clients. After all, the greatest and most understandable prejudice against the interest-free financing experiment is the lack of information that is available about it.

The issue of staffing was regularly discussed during the interviews, particularly the two way learning process that is necessary for those involved and the problems

this presents. A serious deficiency for Islamic banks is their inexperience of western financial markets. This problem can be only gradually overcome, for in addition to a thorough understanding of the sphere in which they choose to compete, Islamic bankers must be aware of their own system's potential to succeed there. Difficulties are encountered when recruiting western-trained staff; not only is this an expensive process, but the retraining requirements are equally rigorous, if not more so. It is not possible for any one person to be totally aware of the characteristics and potential of Islamic finance — not only is financial knowledge becoming ever more specialised, but Islamic banking has an added dimension that cannot be ignored if the system is to maintain its identity. This is, of course, the religious connection; there has yet to be a banker with a commanding knowledge of the *shari'a* or a reputable religious scholar who is involved in the day to day running of a financial institution. A consistent flow of information is required, both within each bank as well as between institutions in general if Islamic finance is to emerge as a serious, working alternative to interest-based financing.

7.5 Summary

The experience of interest-free Islamic financial institutions has brought to light a discrepancy between the ideology of Islamic finance and its practice. Inevitably, it is very difficult to achieve a perfect balance between developmental aims and commercial performance as the two are almost diametrically opposed. Experience has shown that emphasis on one aspect tends to be at the expense of the other and this has proved relevant to a commercial bank as much as it is with a development assistance agency such as the Islamic Development Bank.

Although this discrepancy has not prevented Islamic banking from achieving success on a wide scale, further growth in both areas cannot take place without a

significant amount of financial innovation. This fact has been recognised by Islamic institutions, especially in the international banking sphere where competition is extremely fierce and profit margins small. Activity in the Euromarkets highlights this situation; an established reputation for quality is certainly at a premium, but this will not prevent a financial institution from losing business if its service and competitiveness do not remain first class. This reflects a very different atmosphere from the *suq* of Al-Rajhi's origin; customer loyalty and a relaxed co-existence of rival moneychangers is not paralleled in the financial markets in the West. Indeed, even if the initial accusations that attribute the success of Islamic finance in the Arab world to an extremely favourable economic climate were accurate, that situation has changed considerably in recent years. With countries such as Saudi Arabia having experienced budgetary deficits, the uneasy political climate of the Gulf, and the slowdown in financial activity in Bahrain, the Middle East could not be described as an ideal location in which to nurture an unworkable banking system.

Offshore institutions in Bahrain are aware of the restrictions that are placed on their activities by the prohibition of *riba* but they continue to make headway. This is achieved not simply by borrowing conventional instruments and hiding the traces of usury, but by well thought-out plans for the creation of their own banking infrastructure; the development of an inter-Islamic bank market, for example. The outline for such a market, given in chapter five does not claim to be solely inspired by the Faysal Islamic Bank of Bahrain, which is encouraging. An unrestricted flow of information and ideas amongst Islamic banks is as necessary as healthy competition between them. Furthermore, the application of identical standards amongst all Islamic banks would help define the parameters within which they are to operate. In this respect, a standardisation of what is considered *haram* and *halal* would make the implementation of the Islamic Unit Trust a very much easier task for the IDB. A central religious supervisory board may be considered for this task. What is important

is that Islamic finance should not divide into sects, one faction displaying a 'holier than thou' attitude whilst the other offers Islamic finance in name only. Although such an extreme result is unlikely, the dangers of offering a less than united front are easy to understand.

Islamic finance is here to stay. Although the options for Islamic banks are somewhat restricted in comparison to conventional banks, it is circumstances, not dogma, that prevent the achievement of wider objectives such as a more equitable distribution of funding, envisaged by the proponents of PLS financing. At the present time, the impact of Islamic finance on western financial markets has been minimal. It should be understood that the ability of this system to make its mark depends upon its ability to make profits. This is not as facile as it sounds; profits are not set aside for charitable distribution to lame duck entrepreneurs who are ineligible for conventional funding. Instead, they generate confidence on the part of investors and consequently the bank. A successful institution is able to take a longer-term view of its operations without the fear of insufficient turnover for everyday requirements. As efficient liquidity instruments are devised by Islamic banks, the profitable use of short term funds will allow a more flexible attitude towards long term investment. Once this has been achieved, then the real impact of Islamic finance as the practical application of the Islamic ethical code can be assessed. Until that time, the only obvious difference in the day to day operation of an Islamic financial institution will appear in the form of a more restricted range of service than is presently offered by the conventional bank opposition. Undoubtedly, Islamic banks can participate in international financial market activity as the experience of those examined in this work has shown. Although their activity is, so far, quite restricted, it is considered almost certain that the reach of international Islamic finance will increase with the maturity of the interest-free banks themselves.

Footnotes

- 1 Volker Nienhaus, *Le Contrôle Bancaire et la Politique des Banques Centrales: Etude Comparative*, in *Les Capitaux de l'Islam*, CNRS, Ménil-sur-l'Estrée, 1990, p.165.
- 2 *Chalk and Cheese*, in *Arab Banking and Finance*, Banking Journal of the MEED Group. Vol.3, No.1, 1984.
- 3 Due to a lack of harmonisation, the activities that are condoned without reservation by all of the various supervisory boards are remarkably few in number. This has the effect of restricting the opportunities for co-operation between Islamic banks.
- 4 See chapters two, four and six.
- 5 See DMI, chapter four.

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