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# **Islamic Banking and Finance: Fundamentals and Contemporary Issues**

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# Islamic Banking and Finance: Fundamentals and Contemporary Issues

Edited by  
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## Foreword

Islamic finance is growing in various parts of the world. It has moved from a mere theoretical concept to a practical reality. A natural consequence of this progress is the opening up of new challenges as well as more avenues for its advancement. Islamic finance is therefore confronting some new and some old, but re-formulated, challenges on the intellectual and practical plains. On the intellectual side, refinements in the philosophical underpinnings of the Islamic finance and the financial system are the core issues. While on the practical side, the diversity of regulatory, supervisory and legal environments faced by Islamic financial institutions; the issues of a proper accounting framework; corporate governance; and making available of a complete spectrum of Islamic financial products have evolved as some of the new challenges. These challenges require going back and forth between the drawing board and the reality. Consequently, this approach is reflected in a good number of conferences and research assignments undertaken by IRTI.

The present volume is a collection of selected papers from a conference jointly organized by IRTI and Universiti Brunei Darussalam in 2004. The conference was unique in its inclusion of some educational lectures on Islamic law (*fiqh*) of finance for orientation purpose along with sessions devoted to presentation of research papers in Islamic banking and finance. Both categories of presentations were important in their own right. However, the editors felt that the information content of the first category (the orientation lectures) will find its own currency and circulation because lectures by nature are repeated and their information content shared more widely. It is the research papers category that may need support of editing and publishing for broader circulation and knowledge preservation. The editors have therefore put together mostly this second category of papers in this volume. I hope that the readers will find these useful; and that the papers will help in creating further knowledge in the field.

Bashir Ali Khallat  
Acting Director  
Islamic Research and Training Institute



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We also acknowledge with thanks the tedious work of Mr. Sajjad Qurban, Mr. Amanul Hoque, Mr. Mohammad Asiri and many others at IRTI who helped us at different stages of typesetting and final production of this volume.



## An Overview

*Salman Syed Ali\* and Ausaf Ahmad\*\**

### Background

Islamic jurisprudence (Sharī‘ah) explicitly prohibits interest (*ribā*) in all its manifestations. Islamic Banking and Finance in modern times grew out of the Muslims’ desire to find out the ways and means to fulfil their financial requirements in view of prohibition of interest. Interest based finance had become the dominant system during the colonial period, and continued to be so in many Muslim countries even after their independence. In this backdrop Muslim intellectuals and economists started to write about Islamic economics and financial system, notably in the Indian Subcontinent and Egypt.<sup>1</sup> The early writings expounded the philosophy and the concepts of interest-free finance along with its effects on the socio-economic welfare of the society. During that era commercial banks had occupied centre stage of the finance industry in mobilization of savings and providing of loans. Naturally, the first models of Islamic finance purported to explain how a banking system could work without interest.<sup>2</sup> These theoretical models perceived two tired *muḍārabah* finance structure, in which the Islamic bank on one hand would receive deposits as agent (*muḍārib*) of its customers; and on the other hand provide finance to enterprise as principal [sleeping partner] (*rabb al-māl*). In this early period (1930s to 1960s), developments in Islamic finance took place on the intellectual side only. The first practical realization of a bank-like Islamic financial institution, on a small scale, was that of Mit Ghimar in Egypt which started in 1963 and closed down in 1967. Another independent experiment of Islamic finance started in Malaysia in the form of Sharī‘ah

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compliant savings and investments scheme for prospective pilgrims (*hujjaj*) called Tabung Haji. The experiment remained unknown in the academic circles only to be discovered much later and recognized in the 1990s as a successful institution.

In the 1960s and early 1970s the developments were mostly on the theoretical plane devoid of any practical experimentation. However, the accumulated theoretical knowledge prepared the ground and developed sufficient collective will for the emergence of first Islamic banks one in private sector (Dubai Islamic Bank) and another as a multilateral organization (Islamic Development Bank) both of which came into being in the early 1970s. Many more Islamic banks and financial institutions were created in the following years (for details see Ahmad 2000). A combination of practical realities of the business and constraints of the regulatory environment forced the Islamic banks to rely mostly on *murābahah* and leasing contracts for the financing activities instead of the originally conceived *mudārabah* contract in the second tier. So much is the use of *murābahah* that some authors referred to this practice as *murābahah* syndrome<sup>3</sup>.

Islamic finance has grown beyond banking since 1990s and expanded to the realm of capital markets. Now Islamic financial industry comprises of Islamic banks, investment funds, asset management companies, house financing companies, and insurance companies. The industry is growing in double digits since last decade. This expansion has brought up a number of practical issues and problems that serve as guiding posts for determining the direction of applied research in the field. Such research has become more active. For example, we see that a larger proportion of the *fiqh* questions and issues discussed by OIC Islamic Fiqh Academy during the last decade pertain to financial matters rather than other social issues. Similarly, the number and frequency of practitioners' conferences have increased which on one hand results in wider dissemination of existing knowledge, networking among professionals from various geographical regions, and on the other hand also contribute to some addition to the body of knowledge.

The academic institutions most often remain unrepresented in such gatherings for a variety of reasons, hence their research focus elsewhere. In short, the practice of Islamic finance has outpaced theoretical development. As a result: (i) much of the development is focused on solving the immediate problems with lesser attention to the long-term direction setting basic research. An indication of low level of basic research is the decline in the number of theses and dissertations written on Islamic banking and finance each year. The impact of such decline in the basic research will show up after 10 to 15 years. There is, therefore, a danger of blurring of the distinction

between Islamic and conventional finance in the future. There is a need to strengthen academic research in this field as well as to envisage a future role and place for Islamic finance. This will also give direction to the industry for its future growth.

The present volume is a selection of papers that were presented at the International Conference on “Islamic Banking and Finance: Fundamentals and Contemporary Issues” held in Brunei from January 5 to 7, 2004; jointly organized by Islamic Research and Training Institute (IRTI) of Islamic Development Bank Group and Universiti Brunei Darussalam. The conference was an effort to disseminate the existing knowledge as well as to add some thing to it. Further, the conference had great significance for Islamic finance in Brunei: (i) It coincided with the creation of Center for Islamic Banking and Finance at the Universiti Brunei Darussalam, which is to become a centre of excellence and training in the country in near future, (ii) The conference also provided boost to the activities of Islamic Bank Brunei, (iii) The program of the conference was set in such a way as also to address the training needs of the finance professionals working in Islamic finance, (iv) Lastly, it provided networking opportunity to the professionals in the region.

In selecting the papers for this volume we have tried to keep a balance between theory and practice. The volume is divided into four parts. Part one deals with the fundamentals and the issues faced by Islamic finance at theoretical level. Part two addresses to various contemporary issues empirically through case studies. Part three deals with some legal issues in the practice of Islamic banking and finance. Part four gives an overview of the Islamic banking efforts in Brunei—the host country of the conference.

## **2. Conceptual Issues**

**Mabid Ali Al-Jarhi** takes up the issue of philosophical underpinnings of Islamic finance. According to him, “The *philosophy of Islamic banking and finance* is a set of theories and ideas related to its understanding”. He identifies three building blocks related to its understanding. First, the Islamic law (Shari‘ah) from which the very idea of Islamic banking has been drawn. Second, monetary and macro theory which helps explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of this prohibition. Third, banking theory itself, which helps to explain the nature of Islamic banking and finance as well as to assess its comparative performance.

**Umer Chapra** discusses the economic case against interest and asks why should we try to replace the interest based conventional system when it has been in existence for such a long time and has become highly sophisticated in its serving the society. Is the case against interest compelling and is there a strong enough rationale for a changeover to interest-free financial system? He argues that both on the criteria of equity and efficiency, the interest based system has shown a poor record. Poor performance of this system on socio-economic or equity considerations is well known and recognized by many. It is however, the efficiency criteria on which the interest based system is thought to be superior to interest-free financial system. However, recent financial crises in many parts of the world and their persistence bring into question the so called superiority of this system even on the criterion of efficiency. Economists have discussed various factors as the causes of such crises but no consensus seems to have emerged in identifying the cause of all causes. In absence of such a consensus conflicting remedies have been proposed and no effective reform program has emerged. Chapra argues that inadequate market discipline is the main cause of financial crises; but is it the ultimate one? What causes the erosion of market discipline? He points to the ‘absence of risk sharing’ as the root cause of all crises: “easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial market as a result of the absence of risk sharing.” He substantiates this position by discussing the cases of (a) the East Asia Crisis, (b) the collapse of Long Term Capital Management (LTCM), and (c) Foreign exchange market instability. He concludes that while sound macroeconomic policies and better regulation and supervision are always required, their effectiveness can be increased “if they are complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors as well as the banks share in the risks of business.” The paper concludes that there is a strong rationale behind prohibition of interest, not merely for prevention of exploitation of the poor but also to make the financial system healthier and more stable. Increasing the share of equity and reduction of the share of debt can make the financial system more stable. The result may even be better if the credit is tied to purchase or lease of real goods and services instead of untied loans that contribute to speculative trade in society.

One of the objectives of Shari‘ah is protection of wealth or property.<sup>4</sup> Prohibition of interest is one of the manifestations of this objective. Other manifestations of this purpose can be seen in the Qur’anic prescription to write out a contract<sup>5</sup> to avoid dispute; in disallowing of some forms of

financial contracts (such as contracts involving *gharar* and gambling etc.); and in negation of unjust conditions in a contract. Financial contracts and the conditions stipulated in them are important in banking business as well as in financial markets because these affect the rights and obligations of each party. Financial engineering rests on combining and repackaging of contracts in manners that suit all the involved parties for distribution of risk and return. In conventional markets financial options are used to hedge the risk of one party at the cost of others. How can options (*khayyār*) in a contract effect savings and investment. What are the different *khayyār* discussed in *fiqh* literature? How similar or different they are from the financial options bought and sold in the present day financial markets? These are the types of questions raised in **Burhan Arbouna's** paper entitled, “*Option Contracts and The Principles of Sale of Rights in Sharī‘ah*” (Chapter 3). He divides *khayyār* into two classes: those that are legal rights associated with a contract by default, and those rights or options which are contractually created in a contract such as *khayyār al-shart*. It is this second type which are focused in the paper. He finds that these Sharī‘ah options have many similarities with the conventional financial options but the differences are much greater in substance.

The paper contains an informative discussion on financial options and forward contracts; financial options and inconclusive contracts (*bay‘ muallaq*); difference between financial options and *arboon* sale; are financial options a form of tangible wealth or only rights; why the rights are not transferable through trade? The author proposes Sharī‘ah compatible combination of contracts to create call and put option type results. For example, combining a contract for search services (*ijārah*) [to search and find a particular type of goods or a particular price for it] with a supply or sale contract [of that good] a kind of put option is created in the sense that the service charge is definite to keep in lieu of the search services; and it reduces the price risk for the goods seller—which, is the ultimate economic purpose of any put option. This setup, however, cannot be used for speculating on price movements and the size of its secondary market will depend on the extent of the market for such search services. The discussion in the paper identifies at least two new areas for further research. (1) The concept of sale of rights and the extent of its (non) permissibility with implications for risk management. (2) Combination of contracts and the cross-market effects of one contract on the market for the other.

In the context of banking, utilization of funds (through various financial contracts) is only one side of the business. The other side is mobilization of deposits. **Sayyid Tahir** addresses this side in his paper on “*Unresolved Issues In Islamic Banking and Finance: Deposit Mobilization*” (Chapter 4). He points out

that most of the theoretical and applied work so far has been confined to Islamic financing. “The deposit mobilization side has been taken for granted. It is, therefore, not surprising that a closer look reveals little difference between workings of interest-based banks and Islamic banks on the deposits side.” He asks the question: “Is the difference between Islamic and interest-based banking really thin on the deposit mobilization side? Or, is there some thing that is being missed?” Since the depositors have a variety of motives and risk preferences it is optimal to offer different categories of deposits. Each of these deposit categories will create a different kind of liability, responsibility and return for the bank.

More importantly, the paper argues that the present method used by Islamic banks, of pooling all types of deposits for investment and then distributing the generated profits to deposit holders is Shari‘ah incompatible and violates the principle of equity and justice enshrined in the rules of *mudārabah*—the contractual basis on which investment deposits are collected. In order to avoid inappropriate asset transfer between current and future investment depositors as well as between various categories of depositors and the bank; he proposes use of segregated *mudārabah* investment pools with separate accounting and profit distribution for each such pool. This is an innovative idea that requires further careful and detailed analysis.

While the segregated treatment will increase transparency and justice it will, however, also increase accounting and investment costs. The positive effects of separate treatment of different deposit categories on bank stability are clear, but the effect of segregation across time of the past and current depositors will require further study before its general acceptance. Supply and scope of investment opportunities and size of the individual banks all would have to be considered in determining the viability of such a proposal.

Banking regulations in the conventional system are predominantly for avoiding systemic risk. However, depositor/investor protection, enhancement of efficiency, and other social objectives are not totally ignored. Shari‘ah considerations give rise to issues of a different sort in which equity and justice acquire central role in establishment of stability, depositor/investor protection, efficiency, and other social objectives. Recently, Islamic Financial Services Board (IFSB) has issued (i) capital adequacy and (ii) risk management standards for Islamic banks. However, both pertain to solvency and stability. Moreover these pertain to prudence in banks’ investment not with deposit mobilization and its treatment. Much work is still needed on the subject.

A useful first inquiry in this direction would be to assess how relevant for Islamic banks are the causes of financial distress identified for the conventional banking system. **Salman Syed Ali** contributed to this end in “*Financial Distress and Bank Failure: Relevance for Islamic Banks*”, (Chapter 5). The analysis shows that while some causes do affect Islamic banks equally as they affect conventional banks, there are some others which are of lesser consequence. This is due to the particular sharing structure of Islamic banks with their clients and/or depositors which positively contribute to more stability of these banks. However, the small size and narrow ownership of Islamic banks pose its own problems as a source for financial distress.

There are also new dimensions to some of the conventional causes of financial distress when applied to Islamic banks. For example, moral hazard problem is at two levels in the two tier *muḍārabah* structure of Islamic banks which leads them to prefer *murābahah* financing and hence generates credit and liquidity risk. However, as opposed to interest based financing the *murābahah* contract does not contribute to credit cycles. This is owing to non-saleable nature of debt or its discounting. At the same time the financing cycle can operate in cases of *muḍārabah* and *shirākah* contracts through counter-cyclical monitoring costs and pro-cyclical incentives to monitor for the banks.

An important finding is that the despite inherent stability features financial distress in Islamic banks can stem from the current structure of these banks, the regulatory environment that restricts them from owning or equity participation in businesses and trading, and from the lack of support infrastructure institutions. Islamic banks can be indirectly affected if a generalized crisis occurs in the conventional banking sector which erodes confidence of depositors in the banking sector in general.

### 3. Empirics

The next three papers are empirical in nature describing the behavior of Islamic banks, their depositors, and evaluation of the performance of Islamic financial market indices.

**Monzer Kahf** in “*Success Factors of Islamic Banks*” (Chapter 6) points out that Islamic banks are profit oriented organizations with the difference that they have enjoined on themselves to conduct their affairs within the limit of the rulings of Sharī‘ah and to comply with its overall objectives. These objectives imply that the Islamic banks would be eager to boost all forms of deposits, improve the quality of customer services, expand the base of

banking services, protect capital, provide humanitarian and social services, as well as work towards the other factors that raise the profit margin. However, Shari'ah compliance will also induce a different kind of relationship among the stakeholders (owners, depositors, and financed parties). The paper analyzes the experience of seven Islamic banks in achieving their objectives and measures their performance in assets growth, growth of invested assets, the growth of cash and deposits in other banks, the growth of customers' deposits in Islamic banks, changes in earnings, expenses, and net profits, and the commitment to the Shari'ah and charitable and social contributions.<sup>6</sup> The analysis is based on the information obtained from the annual reports of these banks for three years 1999-2001.

The above relative performance results are then used to theoretically discuss various factors and considerations that may prove useful for success of Islamic banks. Among them are the role of banking efficiency, confidence in a bank, efficiency in investment management, financial engineering and marketing, preservation of shareholders and depositors' equity, provision of humanitarian and social services and other factors.

Some useful suggestions on the method of relative evaluation also propped up in the paper which have implications for the growing empirical literature on Islamic banking efficiency. For example, the study suggests that in order to compare relative profitability among Islamic banks the profit of the shareholders as well as the profit distributed to the depositors both should be considered as output. This is due to special nature of Islamic banks who are to work for the benefits of shareholders as well as the depositors.

**Mahmood Ahmad** in his paper "*The Attitude of Bank Customers and Professional Bankers towards Islamic and Conventional Banks in Bangladesh*" (Chapter 7) takes up the question whether the Islamic banking practices are any different from the conventional banking system. He examines apparent similarities and differences between both Islamic and conventional banks, which frequently tend to equalize both the systems. The analysis is supplemented by an opinion survey among 200 bankers and 200 bank customers in Dhaka Bangladesh to examine these apparent similarities and differences of Islamic and conventional banking systems.

The survey found that bankers are more aware than the customers about the nature and working of Islamic banking. While both groups are aware about prohibition of interest and the alternate in the form of profit sharing; the customers generally think that the Islamic banks are not much different from conventional banks in the final outcome. Some contradictory results are also found.

In contrast to collecting deposits as loans or investment (in *mudārabah*), it appears that Islamic banks in Bangladesh are still using *wadiah* and *amānah* concepts.<sup>7</sup> The paper concludes that “Islamic banks have become, to an extent, successful in the field of deposit mobilization, but socially beneficial and development oriented utilization of these deposits did not happen. Employment generation and a flow of resources towards the lower and middle classes, particularly in the rural areas, have not taken place. Still, Islamic banks are involved in the heroic role of eliminating *ribā* from financial dealings in Muslim countries”.

**Abul Hassan** and **Antonios Antoniou** in their paper “*Equity Fund’s Islamic Screening Effects on Financial Performance and Its Performance Analysis*” (Chapter 8) take us away from banking institutions and focus on financial markets. Financial markets would form an integral part of Islamic finance. Academic papers have only recently started to discuss or analyze Islamic ethical equity funds. In the present paper, Hassan and Antoniou examine the potential impact of Islamic screening restrictions on investment performance by comparing the performance characteristics of a diversified portfolio of Islamic screened stock index Dow Jones Islamic Market Index (DJIMI) with conventional benchmark Dow Jones Global Index (DGI). The paper also assesses the degree of correlation in price movement and volatility among the Islamic stocks (DJIMI), Islamic technology related stocks (DJIM-Tech Index) and UK Islamic stocks (DJIM-UK).

The methodology builds upon the fact that “being an index, the DJIMI provides a unique opportunity to assess the impact of the constraints on performance free of other considerations such as investment style, fund objects and timing that have clouded the analysis of the performance of ethical mutual funds.” The data used is for the period January 1996 to March 2003 during which an up- and a down-turn of the market had occurred. Sharpe and Treynor measures, Jensen Alpha, and volatility are calculated. The study shows that the impact of Islamic screens is not adverse. However, the Islamic index tended to be biased towards technology stocks during the sample period which helped it when that sector was progressing; but the same negatively affected it when price bubble of technology stocks collapsed. Overall, the performance of Islamic index is closely related to the performance of stock markets worldwide.

#### **4. Legal Issues**

The Islamic banking system without the law is futile and meaningless. The legal system is supposed to regulate and license the Islamic banking

business, besides imposing control and supervision on the affairs of the Islamic banks. The legal framework is also important for defining the characteristics of contracts and their enforcement. Thus, it helps in development and introduction of new financial products. With the rapid development of the Islamic banking and finance in different places, the law must also be able to keep up with the speed of that development. Thus the study of development of legal regime becomes an important area.

The next two papers provide case studies of the legal framework for operations of Islamic finance and raise the issues therein respectively in the context of Malaysia and Indonesia.

**Norhashimah Mohd. Yasin** in her paper “*Legal Aspects of Islamic Banking: Malaysian Experience*” (Chapter 9) covers the legal framework governing Islamic finance in Malaysia. She describes the relevant laws and delves into various issues in the development of law and its application to Islamic banking. The paper highlights the difficulties of present legal framework in implementation of Islamic finance contracts.

It informs us that Islamic banking in Malaysia is governed by two laws: (i) the Islamic Banking Act 1983 (IBA) which exclusively governs full-fledged Islamic banks (Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad), and (ii) the Banking and Financial Institutions Act 1989 (BAFIA) which regulates conventional banks and their Islamic Banking Divisions (IBDs) or Windows. The nature of both laws are different.

A difficulty with the legal framework for Shari‘ah laws in Malaysia is that the application of Islamic law is limited only to family law and religious offences; and it is the jurisdiction of individual States. The law relating to commerce and business (*mu‘amalāt*) is still either the statute law or the English law. Shari‘ah Courts only have jurisdiction over matters falling under the State list. Consequently, Shari‘ah compatibility in enforcement of financial contracts and dispute resolution becomes uncertain—a legal risk. The author quotes that two leading cases of Islamic banking relating to *Bay‘ Bithaman Ajil* (BBA) were decided by the Civil Court (High Court) and not by a Shari‘ah court. In the absence of a fully comprehensive legal framework for Islamic banking, precedence becomes important source for law. Thus far, there are very few cases which could be used for reference.

While the author has focused only on Malaysia, but her conclusions are generally valid for other Muslim countries as well, that “in spite of the rapid development of Islamic banking and finance in Malaysia, the legal regulatory regime is lagging behind. Legal reforms are urgently needed in order to facilitate the smooth running and operation of the Islamic banking system.”

**Reza Djojosingito's** paper focuses on Indonesia. The paper “*Legal Aspects of Islamic Project Finance and Asset Securitization in Indonesia: A Vehicle for the Development of Islamic Banking*” (Chapter 10) reviews existing laws, as well as the one in draft form, related to Islamic banking, project finance and asset securitization. The paper emphasizes the importance of project finance and asset securitization for Islamic banks, as this combination is closer to the participatory modes and open to a lower degree of moral hazard problem than found in two tier *murābahah*. However, the legal framework in Indonesia, which is based on Civil Law, does not provide enough support or legal basis for such combination to work. The paper discusses various legal issues and unresolved *fiqh* issues related to leasing and asset securitization which can form a bridge between conventional and Islamic banking. It proposes some reforms in the legal framework which include: introduction of principle of equity and imposition of the doctrine of the binding force of precedent.

**Cecep Maskanul Hakim** in his paper “*Islamic Bond: Indonesian Experience*” (Chapter 11) informs that there has been a number of *murābahah* bonds issued in the Southeast Asia., but very few *muḍārabah* bonds have been issued so far. Cecep argues for promotion of *muḍārabah* bonds. The primary initiative for profit sharing bonds, so far, has been driven by (i) need of Islamic banks for investment alternatives to manage their excess liquidity, and (ii) to develop Islamic capital market. Cecep's paper highlights the multiple impacts of issuing *muḍārabah sukūk*.

## 5. Review of Islamic Banking Activities in Brunei

Finally, the paper by **Hajjah Salma** “*Islamic Banking in Brunei and The Role of CIBFM*” (Chapter 12) discusses the history and development of Islamic banking in Brunei. Highlighting the need for training of the professional bankers in the field of Islamic banking and finance it informs us about the new initiative of Brunei in the form of Center for Islamic Banking, Finance and Management that has been established at Universiti Brunei Darussalam with academic and industry partnership.

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## Notes

<sup>1</sup> For details on the history and intellectual evolution of modern Islamic economics and finance, see Islahi (1997) and Kahf (2005).

<sup>2</sup> Qureshi (1946), and Siddiqi (1967) and (1983).

<sup>3</sup> See Yousef (2005).

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<sup>4</sup> Other purposes are protection of life, progeny, intellect, and faith. For details, see Masud (1995).

<sup>5</sup> Sūrah al-Baqarah, Ayyah 282.

<sup>6</sup> These banks are: Jordan Islamic Bank, Islamic Bank of Qatar, Shamil Bank of Bahrain, Bahrain Islamic Bank, Dubai Islamic Bank, Arab Banking Corp Islamic Bank and Kuwait Finance House.

<sup>7</sup> Sayyid Tahir (Chapter 4) in this volume explains why this is not a suitable concept for deposit mobilization. AAOIFI also advocates using *mudārabah* or loan contracts for deposit mobilization.

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## Islamic Banking and Finance: Philosophical Underpinnings

*Mabid Ali Al-Jarhi\**

### Introduction

Islamic banking and finance can be described as a system through which finance is provided in the form of money in return for either equity or rights to share in future business profits, or in the form of goods and services delivered in return for a commitment to repay their value at a future date.

By now, a good deal of intellectual effort has been undertaken by a number of specialists in Islamic economics to explore different aspects of Islamic banking and finance. Even some conventional economists, intentionally or unintentionally, have dealt with the subjects, which may be considered closely akin to it. It is an undeniable fact that Islamic financial institutions have had only a marginal existence during the last 300 years. They did not get the same chance as western financial institutions to gradually evolve their institutional structure, tools and *modus operandi* to their full potential. Therefore, such evolutionary process of Islamic banking and finance must be done through serious intellectual work by economists rather than observing institutions at work. However, Islamic banking and finance has now been in the arena for more than a quarter of a century. It has taken a

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\* This paper is derived from the keynote address delivered by Dr. Mabid Ali Al-Jarhi, the then Director of the Islamic Research and Training Institute, at the Conference on Islamic banking and finance held at Brunei, Darussalam, Brunei and jointly organized by IRTI and the University of Brunei during 5-7 January 2004.

contemporary shape. Whether it has sufficiently approached the Islamic paradigm *par excellence* or not, is a different question.

The *philosophy of Islamic banking and finance* is a set of theories and ideas related to its understanding.<sup>1</sup> In this regard, we must first start with the rules of Islamic Shari'ah from which the very idea of Islamic banking has been drawn. Second, monetary and macro theory is required to explain why Islam considers dealing through the rate of interest as totally unacceptable, and the economy-wide consequences of such practice. Third, banking theory itself would be necessary to figure out the behavior of Islamic banking and finance as well as to assess its comparative performance.

## 2. Shari'ah

Islamic teachings in the fields of *mu'amalat*, or transactions, prohibit selling a certain quantity of any present goods or service for a different (presumably larger) quantity of the same good or/and service delivered in the future. This is understood to apply to money as well as to all other goods and services. As a result, any amount of present money cannot be exchanged for a larger amount of money in future. In addition, there are other rules of transactions that must be applied to insure fairness of dealing to both the contracting parties concerned. Mainly *al-ghabn*<sup>2</sup> and *al-gharar*<sup>3</sup> are strictly prohibited.

## 3. Monetary and Macro Theory

Until the middle of the twentieth century, most economists found no fault with the fact that the present banking and financial system is interest-based. In the mid sixties of the last century, some economists noticed that the current macroeconomic theory is devoid of any satisfactory and acceptable rationale for holding money. As a result of this realization, attempts were made to introduce money explicitly into theory, while building the micro foundations of macroeconomics. During such process, it was natural to look into the issue of optimal monetary policies. Only then, they stumbled on the Friedman's *monetary rule* that a zero nominal interest rate is a necessary and sufficient condition for optimal allocative efficiency.<sup>4</sup> In a fiat-money world, adding one marginal unit of real balances costs no real resources to the community. Imposing a positive price on the use of money would lead traders to economize on its use, by using real resources. However, when the rate of interest is zero, traders will have no incentive to substitute real resources for money. More real resources can therefore be directed to

consumption and investment. These results imply that the long forgotten Christian and Jewish teachings as well as those of Islam and Hinduism that prohibit the charge of interest on loans are not an aberration.

In a conventional market economy the rate of interest can be brought down to zero only through deflating the economy at a rate equal to the real rate of interest, which can be attained by steadily contracting the money supply at a rate equal to the representative household time preference.<sup>5</sup> Such policy rule clearly implies that central bankers should implement a long-run policy of deflation, something that they would never accept.<sup>6</sup>

With deflating the economy, some economists would worry about the existence of a liquidity trap when the rate of interest is zero.<sup>7</sup> Other economists advise to exercise deflationary policies only asymptotically in order to apply the Friedman's Rule.<sup>8</sup> Others point out that monetary authorities would have less leeway with adjusting the interest rate downwards in the face of recession<sup>9</sup> if the rate of interest is very low. Certainly, deflation has efficiency problems parallel to those of inflation, even at very low interest rates.<sup>10</sup> While many economists believe that problems involved with zero interest rates are all surmountable, monetary authorities are not yet impressed.<sup>11</sup>

The fact that Islamic banking and finance avoids the use of interest-based lending has significant implications to monetary policy. In managing the money supply, the monetary authority would monitor the real rate of growth and set the rate of monetary expansion to the level consistent with price stability and expected real growth. Some Islamic economists propose a 100 per cent required reserve ratio in order to give the authorities absolute control of the money supply and to appropriate all seigniorage resulting from monetary expansion to the government instead of banks' shareholders.<sup>12</sup> The fact that the economy is as close as possible to price stability implies that the rate of monetary growth is optimal, and there is no need to divert real resources to monetary use. Therefore, Pareto optimality is assured without problematic deflationary policies.

Meanwhile, people can use their cash balances to carry out spot purchases. Those with insufficient cash balances for their current purchases of assets and/or commodities can revert to finance. The rate of interest is replaced by the rate of profit on equity and profit-sharing finance, by markups on credit-purchase finance and by rental rates on leasing finance. While the time-value of money is maintained, there is no need to handle the complicated questions of how to bring the rate of interest down to zero in order to reach the optimal allocation of resources.

In case of profit sharing modes of Islamic finance, focus would be on the profitability and rate of return of the concerned investment. Financial resources would be directed to the most productive investments. This would increase the efficiency of the financing process and also reinforce efficiency in the real sectors. In credit-purchase and leasing modes of Islamic finance, money is not given outright, but rather commodities are given in return for debt obligations. Credit expansion in the face of increasing credit-purchase of assets and commodities would be tied directly to higher demand for assets and commodities, which would have a direct bearing on aggregate supply. Consequently, credit finance under Islamic finance would be less inflationary in comparison to conventional banking and finance.

### **3.1 Behaviour of Credit Markets**

An important part of macro theory relates to the behaviour of credit markets. In conventional finance, present money is traded against future money either in integrated debt or in bond markets, where huge sums of debt are traded daily. Debt markets act as an easy conduit to move short-term funds at will from one country to another, more often than not, in reaction to factors that are only nebulously related to economic fundamentals. Such flows threaten the world economy with the spread of instability that might start in one single debt market in a fashion that economists have come to call “contagion.”

In contrast, debt is created in Islamic finance through selling goods and services on credit, which by itself is not readily tradable. We can visualize the existence of a credit market for each commodity and service in which the demand and supply to buy it on credit determines an equilibrium mark-up rate. Such credit markets would be fully segmented. There is no room for sudden and mass movements of funds. Possibilities of instability and contagion would therefore be remote and there would be no pressing need to choke capital movements with restrictions.

Institutional participants in conventional credit markets carry out huge speculative transactions which most often turn out to a major source of instability. In contrast, Islamic banking and financial institutions are strictly prevented from carrying out such gambling activities. Thus, it seems reasonable to deduce that destabilizing speculative activity would significantly be curtailed in Islamic financial markets. Speculative activities related to interest rate expectations would become out of place. Change in spending would be reflected directly on change in demands and supplies of goods and services, causing quantities of output produced to respond more quickly to market forces.

### **3.2 Risk-sharing**

Another important aspect of micro theory is that of risk-sharing. Conventional finance can be likened to a spectator's game where few skilled players stay in the playground and a big crowd is watching from outside. Islamic finance, meanwhile, is similar to participatory sports, where everyone is playing and no one is mere watching. In addition, there is a moral side to Islamic finance that seems to be in the back of everyone's mind.

Risk is known to be one of the most important ingredients of making investment. In Islamic finance, those who finance investment share a good part of the risk with those who carry out actual investment activities. Conventional finance leaves risk to be borne by specialists and traded among them. Banks and financial institutions provide investors with loans guaranteed by collateral. In this fashion, they keep themselves shielded from certain kinds of risk, like those attached to production, marketing and distribution, and limit their exposure to risk related to collateral only.

Islamic finance allows savers who deposit their funds to share with banks the risks associated with choosing the right investment and how successful it will be. Banks and financial institutions advancing funds share risk with those receiving finance, including producers, traders, and the like. Islamic finance with proper corporate governance allows depositors some influence on banks investment decisions. The banks and financial institutions can also share the decision-making process as their representatives sit on the boards of directors of firms receiving funds.

It, therefore, may be noticed that risk as well as the responsibility for decision-making is spread over a much larger number and wider variety of concerned people. Risk sharing is balanced by sharing in decision-making. This allows for involvement of a wider section of entrepreneur and investors in economic activities, so that people will eventually feel they are partners rather than spectators.

The benefit of wider involvement goes beyond the feeling of involvement. It adds to the stability of banks. Investment depositors share risk indirectly with firms, while relying on banks for monitoring. Having the proxy vote of depositors and other investors, Islamic banks, would be capable of influencing the corporate governance of firms in a way that reduces the risks of failure and promotes profits. In other words, the stability of the banking system will reinforce and be reinforced by the stability of the real sector. The main results of this would be a higher integrity of the whole economic system.<sup>13</sup>

### 3.3 Equity Considerations

An important aspect of macro theory is equity. Islamic financial system is basically viewed as private profit-seeking business enterprises that operate according to the market mechanism. By themselves, they cannot reduce, let alone, eradicate poverty. However, if given the right tools, they might contribute to the efforts taken by the whole society in that direction.

*Zakāh* proceeds are known to be earmarked for several uses including income and wealth maintenance for the poor. Income maintenance is provided within narrow limits to those incapable of working and wealth maintenance is provided to the rest of the poor. The latter policy entails giving the poor enough productive assets, to make them more productive, which in turn contributes to economic development.

Islamic banks can help by acting as custodians of and participants in the disbursement of the *zakāh* proceeds. Government and nongovernmental organizations (NGOs) collecting *zakāh* can deposit part of the proceeds allocated to the poor in special accounts with Islamic financial institutions, to which they may also add a proportion of *zakāh* due on their shareholders' equity<sup>14</sup>. They might even accept direct payments of *zakāh* and other donations on behalf of *zakāh* payer individuals and philanthropic institutions.

As to income maintenance, Islamic banks can credit the accounts of the prescribed poor with monthly payments. Wealth maintenance can be implemented through the establishment of micro enterprises that would be owned and operated by the poor. While, titles to such enterprises are transferred to the poor, certain measures must be taken to insure that the new businesses would not be immaturely liquidated to finance consumption outlays for their owners. The experience of Islamic banking and financial institutions in project financing should come in handy in reducing poverty and increasing equity through proper use of *zakāh* proceeds.

Conventional lending gives utmost attention to the ability to repay loans. To ascertain such ability, it depends overwhelmingly on the provisions of collateral and guarantees. Thus those already rich would have most access to finance. In contrast, Islamic finance providing funds on equity or profit-sharing basis would be more concerned with profitability and rate of return than with collateral and guarantees. In an Islamic financial system those who are not wealthy, but have worthy investment projects, may also have appropriate access to finance.

#### **4. Banking Theory**

Let us first look at the liabilities of Islamic banks of which only demand deposits, placed on the basis of profit and loss sharing, are guaranteed. When such banks face macroeconomic or bank-specific crises, investment depositors automatically share the risk. The bank is less likely to fall bankrupt as bank run is least probable. It can, therefore, be said that an Islamic banking system is relatively more stable than conventional banking.<sup>15</sup>

Banking theory studies finance as a process that runs among three parties: a *principal*, an *agent* and an *intermediary*, where both the principal and the agent jointly finance a project which is managed by the agent and partly financed by the principal.<sup>16</sup> The success of the project depends on the agent putting a minimum effort. Information asymmetry exists between the agent and the principal, and the latter cannot perfectly monitor the former. An intermediary performing monitoring on behalf of the principal would ameliorate the *principal-agent problem*.<sup>17</sup>

Islamic banking and finance relates to banking theory in two aspects. First, Islamic banks perform the function of intermediation between fund owners and firms. Banking theory can justify this role in fashion similar to the role of commercial banking, which intermediates between borrowers and lenders. As monitoring is costly, models containing a costly state-verification problem, CSV, conclude that an efficient solution to the monitoring problem can be obtained when an agent pools deposits to finance investment projects.<sup>18</sup> Second, Islamic banks are supposed to practice equity finance simultaneously with credit purchase and leasing finance. This implies that they are some kind of kin of universal rather than of commercial banks. Banking theory comes again to show that such a role brings extra advantages to Islamic banking.

Models that provide rationale for relationship banking postulate a positive relationship between the severity of asymmetric information between banks and fund users on the one hand and informational distance on the other. When conclusions of such models are applied to Islamic banks, if unencumbered with constricting regulations, they would tend to build relationships in their core markets. Such retrenchment permits them to fend off the competitive threat to their captive market. Outside their core segment, they offer credit-purchase and leasing finance, which bear some similarity to transactional loans. In equilibrium, both forms of relationship and transactional finance compete with each other but Islamic banks would be expected to specialize in a core market with relationship or universal banking.<sup>19</sup>

Islamic banks should, therefore, function as universal banks, which are “large-scale banks that operate extensive networks of branches, provide many different services, hold several claims on firms (including equity and debt), and participate directly in the corporate governance of the firms that rely on the banks as sources of funding or as securities underwriters.”<sup>20</sup>

A bank can be exposed to moral hazard when the firm obtaining finance uses the funds for purposes other than those for which finance was advanced. This could lead to business failure and inability to repay on part of the debtor firm. The bank would be exposed to adverse selection when it fails to choose the finance applicants who are most likely to perform.

Obviously, adverse selection can be avoided by careful screening of finance seekers. When a bank provides equity and debt finance simultaneously, it will have more access to information than in a situation when only debt finance is provided. It could, therefore, be concluded that screening would be more effective and adverse selection less probable with universal banking.

Reducing possibilities of moral hazard requires monitoring of the firm obtaining finance.<sup>21</sup> Equity finance provides the bank with access to information necessary to practice continuous monitoring. It also reduces the firm incentives to substitute riskier for safer assets. Meanwhile, debt finance would reduce the firm incentives to hide its profits. Furthermore, when the firm faces problems, the bank, as an equity holder, will assist in order to protect its investment.

In summary, banking theory indicates that Islamic banks should operate as universal banks, and when they do, they would be exposed to lower levels of moral hazard and adverse selection.

Universal banking has recently attracted much writings from both proponents and antagonists.<sup>22</sup> Meanwhile, the arguments levelled against it created much discussion in the beginning but proved unfounded at the end. It has been credited with encouraging industrialization in pre-war Belgium, Germany, Italy and Japan. This confirms Gerschenkron’s and Schumpeter’s opinions that such form of banking spurs economic growth and helps backward countries to catch up with the developed ones.<sup>23</sup> This has also been confirmed by careful review of historical experience.<sup>24</sup>

More recently, Da Rin and Hellmann (2001) have introduced financial intermediation into the *big push* model which has two Pareto-rankable equilibria. They showed that universal banks can induce an economy to move from low to high equilibrium if they are sufficiently large to invest in a critical

mass of firms. The costs of mobilizing the critical mass are reduced, if banks are allowed to own equity that allows them a share in the value they help create by mobilizing the critical mass. This means that universal banks will find it easier to promote investments in new industries. While providing a sophisticated analytical framework for the behaviour of universal banking, Da Rin and Hellmann's model is a good step towards building a macro theory of banking.

Universal banks have been accused of altering the corporate capital structure in favour of debt and against equity, inefficiently combining banking with trade, of concentration to a degree that produces anti-competitive behaviour (what came to be known as the organ bank hypothesis). They have also been accused of benefiting from the inside information about the firms they lend while exercising monopolistic power over access to external finance, leading to conflict of interest between banks and other shareholders, particularly those who have delegated their voting proxy rights. None of such accusations was found credible.<sup>25</sup>

## 5. Conclusion

In conclusion, it may be said that Islamic banking and finance as a discipline has evolved both theoretically and empirically. It has emerged as a lively, provocative and dynamic branch of economics.

It is not an overstatement to say that it may be interpreted as the dawn of the only alternative to the current orthodoxy in banking and finance.

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## Notes

<sup>1</sup> See the definition of philosophy in Cambridge International Dictionary.

<sup>2</sup> *Al-ghabn* in transactions implies deception and misrepresentation or cheating.

<sup>3</sup> *Al-gharar* in transactions implies uncertainty.

<sup>4</sup> Friedman (1969); Cole and Kocherlakota (1998); and Wilson (1979). This result is robust in a variety of models, see Correia and Teles, 1997.

<sup>5</sup> Friedman (1969), p. 34 quoted by Ireland (2000).

<sup>6</sup> Wolman (1997).

<sup>7</sup> Uhlig, Harald (2000).

<sup>8</sup> Cole and Kocherlakota (1998); and Ireland (2000).

<sup>9</sup> For alternative ways to overcome the zero-bound interest rate policy, see Goodfriend (2000).

<sup>10</sup> Lucas (1994). For an assessment of the welfare cost of implementing a zero rate of interest, see Wolman (1997).

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<sup>11</sup> Economists also recommended the application of 100 per cent required reserve ratio. However, policymakers have not been impressed, despite the obvious benefits.

<sup>12</sup> Al-Jarhi (1983).

<sup>13</sup> An important area for further research is how to measure the return of overall risk-sharing in the economy. The approach of Lucas, 1987 and Auffret 2001 would be worthwhile in this regard.

<sup>14</sup> Understandably, there may be other expenditure items which would be financed from *zakāb* proceeds. That is why only a proportion of them would be handed to banks. Such proportion can be determined by society and could change from year to year.

<sup>15</sup> Khan (1986).

<sup>16</sup> Ennis (2000).

<sup>17</sup> Holstrom and Tirol (1997).

<sup>18</sup> Diamond (1984).

<sup>19</sup> Hauswald and Marquez (2000).

<sup>20</sup> Calomiris (2000).

<sup>21</sup> Aoki, Masahiko (1994).

<sup>22</sup> For a dialogue between proponents and antagonists, see Fohlin (1998) and Temin (1998).

<sup>23</sup> Al-Jarhi (2003).

<sup>24</sup> Da Rin, Marco and Thomas Hellmann (2001).

<sup>25</sup> Fohlin (2000); Barth, Caprio and Levine's (2000); and Gorton and Schmidt (1996).

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## The Case Against Interest: Is It Compelling?

*M. Umer Chapra\**

### 1. Introduction

Four of the world's major religions (Judaism, Christianity, Hinduism and Islam), having a following of more than two-thirds of the world's population, have prohibited interest.<sup>1</sup> In sharp contrast with this prohibition, the entire international financial system is now based on interest and has been so for more than two hundred years. However, protests have been, and continue to be, made against interest.<sup>2</sup> These protests have been particularly prominent in the Muslim world where an effort is underway to replace the interest-based system of financial intermediation with the Islamic system.

The introduction of a new model of financial intermediation based on profit-and-loss sharing (PLS) is not an easy task. The difficulties involved in the changeover justifiably raise the question of why should we try to replace the conventional system which has been in existence for such a long time and has by now become highly sophisticated. Is the case against interest compelling and is there a strong rationale behind the transition? One reason for the change is the imperative of abiding by a religious value. This reason, though of prime importance to committed Muslims, may not have any appeal for those who are not so highly committed. It is, therefore, necessary to show that the interest-free financial system is superior to the interest-based system

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on the basis of both efficiency and equity, the two criteria on the basis of which any economic or financial system needs to be evaluated.

The interest-based system was always assumed to be inferior to the interest-free system on the criterion of equity or socio-economic justice. It was, however, considered to be superior on the criterion of efficiency. The persistent instability and crises to which the international financial system has become exposed over the last few decades and the problems that this has created have raised doubts about its superiority on the efficiency criterion. This paper is an attempt to discuss the primary cause of the crises and to show the contribution that the prohibition of interest can make towards greater financial stability as well as socio-economic justice.

## **2. The Financial Crises**

The efficiency argument in favour of the conventional interest-based system of financial intermediation has been substantially weakened by the crises it has experienced over the last few decades.<sup>3</sup> There is not a single geographical area or major country which has been spared the effect of these crises. Hence there is an uneasy feeling that there is something basically wrong somewhere. This has led to a call for comprehensive reform of the financial system to help prevent the outbreak and spread of financial crises or, at least, minimize their frequency and severity. The needed reform has come to be labelled 'the new architecture'.

There is perhaps no one who has challenged this call for a new architecture for the financial system. However, as Andrew Crockett, General Manager of the Bank for International Settlements and Chairman of the newly created Financial Stability Forum, has rightly pointed out: "a grand new design for the international financial system has still to be devised" (Crockett, March 2000, p.13). What could be the reason for the inability to prepare a convincing reform program in spite of so much investment in terms of time and effort? Could it be the failure to determine the ultimate cause of the crises?

## **3. The Roots of the Crises**

A number of economists have made an effort to determine the causes of the crises. Some consider financial liberalization to be the cause in an environment where financial systems of many countries are not sound as a result of improper regulation and supervision (Glick, 1998; Bisignano, 1998).

Others feel that the ultimate cause is the bursting of the speculative bubble in asset prices driven initially by the excesses of financial intermediaries (Krugman, 1998). It has also been argued that the root cause of the crises was the maturity mismatch: short-term international liabilities were far greater than short-term assets (Chang and Velasco, 1998; and Radelet and Sachs, 1998). The available literature indicates a number of other causes as well.

Even though all these factors had some role to play in the crises, no consensus seems to have developed so far in pinpointing the ultimate cause or the cause of all causes. In the absence of a proper understanding of the ultimate cause, conflicting remedies have been proposed. This makes it difficult to lay down an effective reform programme. Hence the proposals for the new architecture have been unable to step beyond the basic principles of conventional wisdom which emphasize sound macroeconomic policies along with sustainable exchange rates, proper regulation and supervision, and greater transparency (for these principles, see Camdessus, 2000, pp.1 and 7-10). These principles are undoubtedly indispensable because, in the last analysis, all crises have their roots in unhealthy fiscal, monetary and exchange rate policies. Hence, no one has ever denied the need for their honest implementation. Nevertheless, these principles have been, and continue to be violated.

The violation of these principles brings to mind a number of questions. The first is about what is it that enables the continuation of macroeconomic imbalances, unsustainable exchange rates, and unhealthy financial practices over a prolonged period. One would expect that market discipline would normally be able to ensure the honest and effective implementation of these principles. However, the persistence of the crises suggests that either the market discipline does not exist or it is ineffective in preventing the continued rise in macroeconomic imbalances in the public sector and living beyond means in the private sector, such that it becomes possible to have excessive leverage and to blow the speculative bubble to the point of bursting.

A second related question is about why some of the countries that have followed sound fiscal and monetary policies have also faced crises. The ERM crisis of the early 1990s challenges the view that foreign exchange market crises stem from undisciplined fiscal and monetary policies. Many of the countries caught up in the crisis did not have overly expansionary policies (IMF, May 1999, p.67). Even the East Asian countries do not convincingly fit into the mould of unhealthy macroeconomic policies.

A third but equally important question is about why some of the apparently well-regulated financial systems like those of United States and the

United Kingdom have also faced crises and whether greater regulation, supervision and transparency will by itself help avoid the crises.

#### **4. The Inadequate Market Discipline: Is This The Ultimate Cause?**

It may not be possible to answer these questions without looking at the underlying reason for the failure to implement the basic principles of the new architecture in spite of their being a part of conventional wisdom. The primary cause in our view is the inadequate market discipline in the conventional financial system. Instead of making the depositors and the bankers share in the risks of business, it assures them of the repayment of their deposits or loans with interest. This makes the depositors take little interest in the soundness of the financial institution. It also makes the banks rely on the crutches of the collateral to extend financing for practically any purpose, including speculation. The collateral cannot, however, be a substitute for a more careful evaluation of the project financed. This is because the value of the collateral can itself be impaired by the same factors that diminish the ability of the borrower to repay the loan. The ability of the market to impose the required discipline thus gets impaired and leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to living beyond means. This tendency of the system gets further reinforced by the bias of the tax system in favour of debt-financing – dividends are subject to taxation while interest payments are allowed to be treated as a tax deductible expense.

The system's inadequate market discipline is, however, not something new. It has existed all along with the development and spread of the conventional financial system. Then, why, one may ask, has there been greater volatility in the last two decades compared with what prevailed before? What has created the difference is the rise in the volume of funds as a result of rapid economic development after the Second World War, the revolution in information and communications technology, and the liberalization of foreign exchange markets. These developments are, however, a manifestation of human progress and cannot be blamed for the crises. When the volume of funds was small and there were also controls on their free movement, inadequate market discipline was not able to create havoc. However, now the position is different.

Therefore, instead of blaming the new developments, it would be more appropriate to examine carefully the fault line in the international financial system resulting from the lack of adequate market discipline because of the

absence of explicit risk-sharing. It is this fault line which makes it possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility thus gets injected into interest rates and asset prices. This generates uncertainty in the investment market, which in turn discourages capital formation and leads to misallocation of resources (BIS, *Annual Report*, 1982, p. 3). It also drives the borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently, there is a steep rise in highly-leveraged short-term debt, which has accentuated economic and financial instability. The IMF has acknowledged this fact in its May 1998 *World Economic Outlook* by stating that countries with high levels of short-term debt are “likely to be particularly vulnerable to internal and external shocks and thus susceptible to financial crises” (p.83).

One may wish to pause here to ask why a rise in debt, and particularly short-term debt, should accentuate instability? One of the major reasons for this is the close link between easy availability of credit, macroeconomic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have a high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period. While there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services by households, firms and governments, an excess of it tends to get diverted to unproductive uses as well as speculation in the foreign exchange, stock and property markets.

The following discussion of the primary factors responsible for the (i) East Asian crisis, (ii) collapse of the hedge fund, Long-Term Capital Management (LTCM), and (iii) foreign exchange market instability will help explain why the easy availability of credit and the resultant steep rise in debt, particularly short-term debt, are the result of inadequate market discipline in the financial markets as a result of the absence of risk-sharing.

#### **4.1 The East Asia Crisis**

The Eastern tigers had been considered to be among the global economy's shining success stories. They had high domestic saving and investment rates coupled with low inflation. They also pursued healthy fiscal policies which could be the envy of a number of developing countries. Since one of the major causes of financial instability is the financing of government deficit by bonds or fixed-interest-bearing assets (see Christ, 1979; and Searth, 1979), the fiscal discipline of these countries should have helped save them from such instability. However, it did not. The rapid growth in bank credit in local currency to the private sector by domestic banks on the basis of easily available short-term inflows in foreign currency loans from abroad created speculative heat in the stock and property markets and generated a mood of "irrational exuberance" which pushed up assets prices far beyond what was dictated by fundamentals.

The large foreign exchange inflows from abroad also enabled the central banks to peg exchange rates. This helped provide the assurance needed by foreign banks for lending and, along with high domestic interest rates, attracted further inflows of funds from abroad in foreign currencies to finance direct investment as well as the ongoing boom in the assets markets. Since about 64 per cent of the inflows in the five seriously affected countries (South Korea, Indonesia, Thailand, Malaysia and Philippines) were short-term (BIS, June 1999, p. 10), there was a serious maturity and currency mismatch. This joined hands with political corruption and ineffective banking regulation to lend heavily to favoured companies, which became highly over-leveraged.

The fast growth of these companies was thus made possible by the availability of easy money from conventional banks who do not generally scrutinize the projects minutely because of, as indicated earlier, the absence of risk-sharing. It was the old mistake of lending on collateral without adequately evaluating the underlying risks. Had there been risk-sharing, the banks would have been under a constraint to scrutinize the projects more carefully, and would not have yielded even to political pressures if they considered the projects to be too risky. Therefore, there is a strong rationale in drawing the conclusion that one of the most important underlying causes of excessive short-term lending was the inadequate market discipline resulting from the absence of risk-sharing on the part of banks as well as depositors. It is very difficult for regulators to impose such a discipline unless the operators in the market are themselves rightly motivated. The assurances of receiving the deposits or the principal amount of the loan with the predetermined rate of return stands in the way.

There was a reverse flow of funds as soon as there was a negative shock. Shocks can result from a number of factors, including natural calamities and unanticipated declines in the economies of borrowing countries due to changes in interest rates or relative export and import prices. Such shocks lead to a decline in confidence in the borrowing country's ability to honour its liabilities in foreign exchange. The rapid outflow of foreign exchange, which would not have been possible in case of equity financing or even medium- and long-term debt, led to a sharp fall in exchange rates and asset prices along with a steep rise in the local currency value of the debt. Private sector borrowers who were expected to repay their debts in the local currency were unable to do so on schedule. There was a domestic banking crisis, which had its repercussions on foreign banks because of the inability of domestic banks to meet their external obligations.

Governments have only two options in such circumstances. The first is to bail out the domestic banks at a great cost to the tax payer, and the second is to allow the problem banks to fail. The second alternative is not generally considered to be politically feasible in spite of the recent calls to the contrary (Meltzer, 1998; Schwartz, 1998; and Calomiris, 1998). In a financial system which assures, in principle, the repayment of deposits with interest and does not, therefore, permit the establishment of Islamic banks because they provide such an assurance on income-earning investment deposits, it would be a breach of trust on the part of the governments to allow the violation of this principle. Moreover, there is also a presumption, right or wrong, that if the big problem banks are allowed to fail, the financial system will break down and the economy will suffer a severe setback as a result of spill-over and contagion effects. Hence the 'too big to fail' doctrine. The governments, therefore, generally feel politically safer in choosing the first alternative.

Since the domestic banks' external liabilities were in foreign exchange and the central banks' foreign exchange reserves had declined steeply, a bail out of external banks was not possible without external assistance, which the IMF came in handy to provide. This has, as indicated earlier, raised a storm of criticism and a call for the reform of the IMF itself by reducing its role (Schwartz, 1998; Meltzer, 1998). The IMF did not perhaps have a choice. Not having any way of assuring its influential members that its refusal to provide resources would not destabilize the entire international financial system, it chose the safer way out. The IMF bailout, however, got the debt unintentionally transferred from the private foreign banks to the central banks and the governments of the affected countries. Professor James Tobin, a Nobel Laureate, has hence rightly observed that "when private banks and businesses can borrow in whatever amounts, maturities and currencies they

choose, they create future claims on their country's reserves" (World Bank, 1998, p.3).

Discussion of the role of excessive reliance on short-term credit or inflow of funds in the Asian crisis need not lead to the false impression that this is not possible in industrial countries with properly regulated and supervised banking systems. The IMF has clearly warned of the existence of such a possibility by stating that "whatever their causes the market dynamics of surges and reversals are not peculiar to emerging markets and it is unrealistic to think that they will ever be completely eliminated" (IMF, Sept. 1998a, p.98). The boom in the U.S. stock market has been fed to a great extent by short-term flows of funds from abroad just as it had been in East Asia. Without easy availability of credit, the stock market boom could not have been sustained for so long. As soon as these inflows started drying there was a steep decline in the stock market. The same had happened in the late 1960s when confidence in the US Dollar declined as a result of the persistent U.S. budgetary and current account deficits. Consequently, there was a substantial outflow of funds from the U.S., leading to a steep fall in the U.S. gold and foreign exchange reserves, a significant depreciation in the Dollar's external value, and the demagnetization of gold. This flight away from the Dollar also fuelled worldwide inflation through a rise in international commodity prices.

#### **4.2 The Collapse of LTCM**

The collapse of the U.S. hedge fund, LTCM, in 1998 was also due to highly-leveraged short-term lending. Even though the name 'hedge fund' brings to mind the idea of risk reduction, "hedge funds typically do just the opposite of what their name implies: they speculate" (Edwards, 1999, p.189). They are "nothing more than rapacious speculators, borrowing heavily to beef up their bets" (*The Economist*, 17 October 1998, p.21). These hedge funds are left mostly unregulated and are not encumbered by restrictions on leverage or short sales and are free to take concentrated positions in a single firm, industry, or sector - positions that might be considered 'imprudent' if taken by other institutional fund managers (Edwards, 1999, p.190). They are, therefore, able to pursue the investment or trading strategies they choose in their own interest without due regard to the impact that this may have on others.

There is a strong suspicion that these hedge funds do not operate in isolation. If they did, they would probably not be able to make large gains and the risks to which they are exposed would also be much greater. They, therefore, normally tend to operate in unison. This becomes possible because

their chief executives often go to the same clubs, dine together, and know each other very intimately (Plender, 1998). On the strength of their own wealth and the enormous amounts that they can borrow, they are able to destabilize the financial market of any country around the world whenever they find it to their advantage. Hence, they are generally blamed for manipulating markets from Hong Kong to London and New York (*The Economist*, 17 October, 1998). Mahathir Muhammad, Malaysia's Prime Minister, charged that short-term currency speculators, and particularly large hedge funds, were the primary cause of the collapse of the Malaysian Ringgit in Summer 1997, resulting in the collapse of the Malaysian economy (September 1997, p.C1). It is difficult to know whether this charge is right or wrong because of the skill and secrecy with which these funds collude and operate. However, if the charge is right, then it is not unlikely that these funds may also have been instrumental in the collapse of the Thai Bhat and some other South Asian currencies.

The LTCM had a leverage of 25:1 in mid-1998, (BIS, June 1999, p.108) but the losses that it suffered reduced its equity (net asset value) from the initial \$4.8 billion to \$ 2.3 billion in August 1998. Its leverage, therefore, rose to 50:1 on its balance sheet positions alone. However, its equity continued to be eroded further by losses, reaching just \$600 million, or one-eighth its original value, on 23 September 1998. Since its balance sheet positions were in excess of \$100 billion on that date, its leverage rose to 167 times capital (IMF, December 1998, p.55). The Federal Reserve *had* to come to its rescue because its default would have posed risks of systemic proportions. Many of the top commercial banks, which are supervised by the Federal Reserve and considered to be healthy and sound, had lent huge amounts to these funds. If the Federal Reserve had not come to their rescue, there may have been a serious crisis in the U.S. financial system with spill-over and contagion effects around the world.<sup>4</sup> If the misadventure of a single hedge fund with an initial equity of only \$4.8 billion could take the US and the world economy to the precipice of a financial disaster, then it would be perfectly legitimate to raise the question of what would happen if a number of hedge funds got into trouble.

A hedge fund is able to pursue its operations in secrecy because, as explained by Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan, it is "structured to avoid regulation by limiting its clientele to a small number of highly sophisticated, very wealthy individuals" (December 1998, p.1046). He did not, however, explain how the banks found it possible in a supposedly very well-regulated and supervised banking system to provide excessively leveraged lending to such "highly sophisticated, very

wealthy individuals” for risky speculation when it is well-known that the higher the leverage, the greater the risk of default. The unwinding of leveraged positions can cause major disruption in financial markets by exaggerating market movements and generating knock-on effects (*IMF*, December 1998, pp.51-53).

This shows that a crisis can come not merely because of improper regulation of banks, as it did in East Asia, but also in a properly regulated and supervised system, as it did in the U.S. Even though the hedge funds were not regulated, the banks were. Then why did the banks lend huge amounts to the LTCM and other funds? What were the supervisors doing and why were they unable to detect and correct this problem before the crisis? Is there any assurance that the regulation of hedge funds would, without any risk-sharing by banks, stop excessive flow of funds to other speculators?

### **4.3 Foreign Exchange Market Instability**

The heavy reliance on short-term borrowing has also injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International Settlements, the daily turnover in traditional foreign exchange markets, adjusted for double-counting, had escalated to \$1,490 billion in April 1998, compared with \$590 billion in April 1989, \$820 billion in April 1992 and \$1,190 billion in April 1995 (BIS, April 1998).<sup>5</sup> The daily foreign exchange turnover in April 1998 was more than 49 times the daily volume of world merchandise trade (exports plus imports).<sup>6</sup> Even if an allowance is made for services, unilateral transfers, and non-speculative capital flows, the turnover is far more than warranted. Only 39.6 per cent of the 1998 turnover was related to spot transactions, which have risen at the compounded annual rate of about 6.0 per cent per annum over the 9 years since April 1989, very close to the growth of 6.8 per cent per annum in world trade. The balance of the turnover (60.4 per cent) was related largely to outright forwards and foreign exchange swaps, which have registered a compounded growth of 15.8 per cent per annum over this period.<sup>7</sup> If the assertion normally made by bankers that they give due consideration to the end use of funds had been correct, such a high degree of leveraged credit extension for speculative transactions may not have taken place.

The dramatic growth in speculative transactions over the past two decades, of which derivatives are only the latest manifestation, has resulted in an enormous expansion in the payments system. Greenspan, sitting at the nerve centre of international finance, himself finds this expansion in cross border finance relative to the trade it finances as startling (Winter 1998, p.3).

Such a large expansion implies that if problems were to arise, they could quickly spread throughout the financial system, exerting a domino effect on financial institutions. Accordingly, Crockett has been led to acknowledge that “our economies have thus become increasingly vulnerable to a possible breakdown in the payments system” (June 1994, p.3).

The large volume has also had other adverse effects. It has been one of the major factors contributing to the continued high real rates of interest which have tended to discourage productive investment. Foreign exchange markets, being driven by short-run speculation rather than long-run fundamentals, have become highly volatile. This impedes the efficient operation of these markets, injects excessive instability into them, and creates pressures in favour of exchange controls, particularly on capital transfers. The effort by central banks to overcome this instability through small changes in interest rates or the intervention of a few hundred million dollars a day has generally not proved to be significantly effective.

The Tobin tax on foreign exchange transactions has, therefore, been suggested to reduce the instability. This proposal needs to be reviewed against the ineffectiveness of the securities transaction tax which is levied on the sale of stocks, bonds, options and futures by a number of major industrial countries, including the US, the UK, France, Germany and Japan. This tax proved to be ineffective in preventing or even diluting the October 1998 stock market crash (Hakkio, 1994). Is there any guarantee that the foreign exchange transactions tax would fare any better? Critics of the Tobin tax have accordingly argued that even this tax would be ineffective. One of the reasons given for this is that the imposition of such a tax would be impractical. Unless all countries adopt it and implement it faithfully, trading would shift to tax-free havens. However, even if all countries complied, experienced speculators may be able to devise ways of evading or avoiding the tax because all countries do not have an effective tax administration.<sup>8</sup>

## **5. The Remedy**

If heavy reliance on short-term debt, is desired to be curbed, then the question is about the best way to achieve this goal. One of the ways suggested, as already indicated, is greater regulation (Edwards, 1999; Calomiris, 1999; and Stiglitz, 1998). Regulations, even though unavoidable, cannot be relied upon totally because they may not be uniformly applied in all countries and to all institutional money managers because of the off-balance sheet accounts, bank secrecy standards, and the difficulty faced by bank examiners in accurately evaluating the quality of banks' assets. In such a

situation, there will be a flight of funds to offshore havens where almost half of all hedge funds are already located (Edwards, 1999, p.1919). Emerging market banking crises provide a number of examples of how apparently well-capitalized banks were found to be insolvent as a result of the failure to recognize the poor quality of their loan portfolio. Even the LTCM crisis shows how banks in an apparently well-regulated system can become entangled in a speculative spree. Thirdly, bringing banks under a water-tight regulatory umbrella may not only raise the costs of enforcement but also mislead depositors into thinking that their deposits enjoy a regulatory stamp of security.

This does not mean that regulation is not necessary. However, regulation and supervision would be more effective if they are complemented by a paradigm shift in favour of greater discipline in the financial system by making investment depositors as well as the banks share in the risks of business. Just the bailing-in of banks, as is being suggested by some analysts (Meltzer 1998, Calomiris 1998 and Yeager 1998), may not be able to take us far enough. What is necessary is not just to make the shareholders suffer when a bank fails, but also to strongly motivate even the depositors to be cautious in choosing their bank and the bank management to be more careful in making their loans and investments. Bank managers are better placed to evaluate the quality of their assets than regulators and depositors, and risk-sharing would motivate them to take the decisions that they feel are in the best interest of banks and depositors.

Therefore, it is necessary to reinforce regulation and supervision of banks by the injection of self-discipline into the financial system. This could be accomplished by making banks as well as shareholders and investment depositors (those who wish to get a return on their deposits) share in the risks of banking by increasing the reliance on equity and reducing that on debt, as is desired by the major religions. It would also be necessary to confine the availability of credit to the financing of real goods and services with some risk-sharing by the lender as well. Making the depositors as well as banks participate in the risk of business would motivate the depositors to take greater care in choosing their banks, and the bank management to assess the risks more carefully and to monitor the use of funds by the borrowers more effectively. The double assessment of investment proposals by both the borrower and the lender would help raise market discipline and introduce greater health into the financial system. The IMF has also thrown its weight in favour of equity financing by arguing that "Foreign direct investment, in contrast to debt-creating inflows, is often regarded as providing a safer and more stable way to finance development because it refers to ownership and

control of plant, equipment, and infrastructure and therefore funds the growth-creating capacity of an economy, whereas short-term foreign borrowing is more likely to be used to finance consumption. Furthermore, in the event of a crisis, while investors can divest themselves of domestic securities and banks can refuse to roll over loans, owners of physical capital cannot find buyers so easily” (IMF, May 1998, p.82).

Moreover, as Hicks has argued, interest has to be paid in good or bad times alike, but dividends can be reduced in bad times and, in extreme situations, even passed. So the burden of finance by shares is less. There is no doubt that in good times an increased dividend would be expected, but it is precisely in such times that the burden of higher dividend can be borne. “The firm would be insuring itself to some extent”, to use his precise words, “against a strain which in difficult conditions can be serious, at the cost of an increased payment in conditions when it would be easy to meet it. It is in this sense that the riskiness of its position would be diminished” (Hicks, 1982, p.14). This factor should tend to have the effect of substantially reducing business failures, and in turn dampening, rather than accentuating, economic instability.

Greater reliance on equity financing has supporters even in mainstream economics. Rogoff, a Harvard Professor of Economics, states that “In an ideal world equity lending and direct investment would play a much bigger role”. He further asserts that: “With-a-better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted” (1999, p.40). However, if, in addition to a better balance between debt and equity, the debt is also linked to the purchase of real goods and services, as required by Islamic teachings, it would take us a step further in reducing instability in the financial markets by curbing excessive credit expansion for speculative transactions. Thus it is not necessary to be pessimistic and to join Stiglitz in declaring that “volatile markets are an inescapable reality” (1999, p.6). The introduction of greater discipline in the financial system, which the prohibition of interest ensures, along with the more effective regulation and supervision and the other reforms mentioned above should go a long way in substantially reducing volatility in the financial markets and in promoting faster development.<sup>29</sup>

## **6. Socio-Economic Justice**

The above discussion has indicated that the absence of risk-reward sharing, which is an intrinsic characteristic of the interest-based financial system, has aggravated financial crises by adversely affecting discipline in the

system. Since stability of the financial system is indispensable for promoting trade and development and since the interest-free risk-reward sharing system has a clear advantage here, it may be considered superior to the interest-based system on the criterion of efficiency. This is, however, only one of the advantages of the interest-free financial system. It was not discussed in the earlier Islamic literature because excessive volatility in the financial markets is a more recent phenomenon.

It is now important to see whether the assumption about the superiority of the interest-free system with respect to the contribution that it can make to the realization of the universally cherished goal of socio-economic justice is realistic. Supporters of an interest-based financial system argue that interest was prohibited to prevent the exploitation of the poor resulting from the usurious rates of interest prevailing in those days. In addition, they argue that rates of interest are now much lower and the modern welfare state has also introduced a number of measures that fulfil the needs of the poor and prevent them from resorting to exploitative borrowing. Even though this is true to a certain extent, the living beyond means that the interest-based system has the tendency to promote leads to an indirect exploitation of the poor in different ways, two of which are their inadequate need fulfilment and insufficient employment opportunities for them.

### **6.1 Need Fulfilment**

Financial intermediation on the basis of interest tends to allocate financial resources among borrowers primarily on the basis of their having acceptable collateral to guarantee the repayment of principal and sufficient cash flow to service the debt. End-use of financial resources does get considered but does not constitute the main criterion. Even though collateral and cash flow are both indispensable for ensuring repayment of loans, giving them undue weight leads to a relative disregard of the purpose for which borrowing takes place. Hence, financial resources go mainly to the rich, who have the collateral as well as the cash flow, and to governments, who, it is assumed, will not go bankrupt. However, the rich borrow not only for productive investment but also for conspicuous consumption and speculation, while the governments borrow not only for development and public well-being, but also for chauvinistic defence build-up and white elephant projects. This promotes living beyond means and does not, thereby, merely accentuate macroeconomic and external imbalances, but also squeezes the resources available for need fulfilment and development.

The ease of borrowing has enabled a number of developing countries to borrow excessively large amounts. This would not be possible in a risk-

reward sharing system. Borrowing, however, does not eliminate the ultimate sacrifice, it only postpones it. The debt-servicing burden continues to rise with the rise in debt and becomes unbearable, particularly if the borrowed amount is not used productively. A number of developing countries have a debt servicing burden exceeding 50 per cent of their total budgetary spending. The result is that they are unable to provide adequate budgetary resources for some of the most important national needs like education, health and rural and urban development. It is primarily the poor and the lower middle classes who suffer as a result of this. Poverty does not get reduced and inequalities of income and wealth continue to rise.

Ease of borrowing also creates problems for rich countries. The squeezing of resources for need fulfilment and productive investment resulting from conspicuous consumption and speculation has made it difficult for even rich countries like the United States to fulfil the essential needs of all their people in spite of their desire to do so and the abundant resources at their disposal. The continued U.S. budgetary deficits in the fifties and sixties, made possible by the interest-based system, led to an international financial crisis in the late 1960s and the early 1970s and the breakdown of the Bretton Woods system. The after-effects of that crisis continue to plague the world until now. There is a lurking fear that the re-emergence of budgetary deficits in the Bush administration in recent years might lead to a destabilization of the international financial system in the same way as it did in the late 1960s.

## **6.2 Full Employment**

One of the most important requisites for generating full employment is the rise in a country's ability to invest. If this is to be achieved in a non-inflationary manner and without a rise in foreign debt, then it is necessary to have a rise in domestic savings. Unfortunately, there has been a decline in savings in almost all countries around the world. Gross domestic saving as a per cent of GDP has registered a worldwide decline over the last quarter century from 26.2 per cent in 1971 to 22.3 per cent in 1998. The decline in industrial countries has been from 23.6 per cent to 21.6 per cent. That in developing countries, which need higher savings to accelerate development without a significant rise in inflation and debt-servicing burden, has been even steeper from 34.2 per cent to 26.0 per cent over the same period.<sup>10</sup>

There are a number of reasons for this decline in saving. One of these is the living beyond means by both the public and the private sectors. This saving shortfall has been responsible for persistently high levels of real interest rates. This has led to lower rates of rise in investment, which have

joined hands with structural rigidities and some other socio-economic factors to reduce the rates of growth in output and employment.

Unemployment has hence become one of the most intractable problems of many developing as well as industrial countries. Unemployment stood at 9.2 per cent in the European Union in 1999, more than three times its level of 2.9 per cent in 1971-73.<sup>11</sup> It may not be expected to fall significantly below this level in the near future because the real rate of growth in these countries has been consistently lower than what is necessary to reduce unemployment significantly.<sup>12</sup> Even more worrying is the higher than average rate of youth unemployment because it hurts their pride, dampens their faith in the future, increases their hostility towards society, and damages their personal capacities and potential contribution. The problem is even more serious in developing countries where the proportion of population below the age of 18 is relatively high. Soon these boys and girls will enter the labour market. If employment opportunities are not created for them, these countries may experience a rise in social turmoil as well as crime.

A decline in speculation and wasteful spending along with a rise in saving and productive investment could be very helpful. But this may not be possible when the value system encourages both the public and the private sectors to live beyond their means and the interest-based financial intermediation makes this possible by making credit easily available without due regard to its end use. If, however, banks are required to share in the risks and rewards of financing and credit is made available primarily for the purchase of real goods and services, which the Islamic system tries to ensure, the banks will be more careful in lending and credit expansion will be in step with the growth of the economy. Unproductive and speculative spending may consequently decline and more resources may become available for productive investment and development. This may lead to higher growth, a rise in employment opportunities, and a gradual decline in unemployment.

## **7. The Islamic Financial System<sup>13</sup>**

It is these weaknesses of the interest-based financial system which create a strong rationale for the introduction of a new system. This brings us to Islamic banking, which tries to remove interest, in step with the teaching of Islam and other major religions, and to introduce in its place the principle of risk-sharing. Since demand deposits do not participate in the risks financing by the financial institutions, they do not earn any return and must, therefore, be guaranteed. However, investment deposits do participate in the risks and must share in the profits or losses in agreed proportions. What this will do is

to turn investment depositors into temporary shareholders. Placing investment deposits in financial institutions will be like purchasing their shares and withdrawing them will be like redeeming these shares. The same would be the case when these institutions lend to, and get repaid by, businesses. They will be sharing in the risks of businesses they finance. This will raise substantially the share of equity in total financing and reduce that of debt. Equity will take the form of either shares in joint stock companies and other businesses or of profit-and-loss sharing (PLS) in projects and ventures through the *muḍārabah* and *mushārah* modes of financing.<sup>14</sup>

Greater reliance on equity does not necessarily mean that debt financing is totally ruled out. This is because all financial needs of individuals, firms or governments cannot be made amenable to PLS. Debt is, therefore, indispensable. Debt however, gets created in the Islamic financial system through the sale or lease of real goods and services via the sales-based modes of financing (*murābahah*, *ijārah*, *salam* and *istiṣnāʿ*). In this case, the rate of return gets stipulated in advance and becomes a part of the deferred-payment price. Since the rate of return is fixed in advance and the debt is associated with real good or services, it is less risky as compared with equity or PLS financing.

The predetermined rate of return on sales-based modes of financing may make them appear like interest-based instruments. They are, however, not so because of significant differences between the two for a number of reasons. Two of these are:

Firstly, the sales-based modes do not involve direct lending and borrowing. They are rather purchase and sale or lease transactions involving real goods and services. The Shariʿah has imposed a number of conditions for the validity of these transactions to ensure that the seller (financier) also shares a part of the risk to get a reward and that these modes do not deteriorate into interest-based borrowing and lending transactions. One of these conditions is that the seller (financier) must also share a part of the risk. This he does because of the second condition which requires that the seller (financier) must own and possess the goods being sold. The Shariʿah does not allow a person to sell what he does not own and possess.<sup>15</sup> Once the seller (financier) acquires ownership and possession of the goods for sale on credit, he/she bears the risk. All speculative short sales, therefore, get ruled out automatically. Financing extended through the Islamic modes can thus expand only in step with the rise of the real economy and thereby help curb excessive credit expansion, which is one of the major causes of instability in the international financial markets.

Secondly, it is the price of the good or service sold, and not the rate of interest, which is stipulated in the case of sales-based modes of finance. Once the price has been set, it cannot be altered even if there is a delay in payment due to unforeseen circumstances. This helps protect the interest of the buyer in strained circumstances. However, it may also lead to a liquidity problem for the bank if the buyer wilfully delays payment. This is a major unresolved problem in Islamic finance and discussions are in progress among the jurists to find a solution.<sup>16</sup>

The share of PLS modes is so far relatively small in the financing operations of Islamic banks and that of sales-based modes is much higher. The reason may perhaps be that in the initial phase of their operations they do not wish to get exposed to risks which they cannot manage efficiently because of the lack of skilled manpower as well as the needed institutional infrastructure.<sup>17</sup> Most scholars, however, feel that, even though the sales-based modes are different from interest-based financing and are allowed by the Shari'ah, the socio-economic benefits of the prohibition of interest may not be realized fully until the share of PLS modes rises substantially in total financing. It would hence be desirable for the use of PLS modes to gain momentum.

In the light of what has been stated above, some of the major characteristics of the Islamic financial institutions may be said to be as follows:

1. Islamic financial institutions reflect the movement directed towards eliminating the role of interest in human society in keeping with the teaching of Islam and other major religions. They try to mobilize resources through a number of Shari'ah-compatible ways. The most important of these are demand and investment deposits as well as shareholders' equity. Demand deposits do not participate in PLS and their repayment must, therefore, be fully guaranteed. The banks should be required to arrange a deposit insurance system for this purpose and the premium to be paid by them should come out of their earnings from the profitable use of these deposits. In contrast with this, investment deposits are mobilized on the basis of PLS rather than interest. This should motivate the depositors to monitor the affairs of their banks more carefully and to punish them by withdrawing their deposits if the banks' performance is not up to their expectations. The banks would, therefore, be under a constraint to manage their risks more effectively. An enabling regulatory and supervisory framework would be very helpful for this purpose. However, even though investment depositors participate in PLS,

there arises the question of whether they should bear only the market risks or also the risks related to fraud, carelessness, mismanagement and loan concentration. It may be desirable to protect them against these risks to raise their confidence in the financial system and to make the insurance provider as well as the supervisory authorities more careful in their assessment of the banks.

2. They render all the normal banking services which conventional banks are expected to render; and
3. Even though they require collateral just like conventional banks for extending finance, they cannot rely on it heavily because of risk-sharing. They will, therefore, be under an obligation to carry out a more careful evaluation of the risks involved.

It is this reform which Islamic banking is trying to bring about in the financial systems of Muslim countries to remove the role of interest in financial intermediation. The task is not easy. Nevertheless, substantial progress has been made by Islamic banks worldwide, even though the niche that they have been able to create for themselves in the total volume of international, or even Muslim world, finance is very small. This was to be expected because they are trying to make headway in a new system of financial intermediation in spite of an unfavourable environment without the help of the auxiliary or shared institutions that are needed for their successful operation.

What counts, however, is not the volume of their deposits and assets, but rather the respectability that the interest-free financial intermediation has attained around the world and the positive evidence that it has provided about the workability and viability of this new system. While in the 1950s and 1960s Islamic banking was only an academic dream, of which few people were aware even among educated Muslims, it has now become a practical reality. It has also attracted the attention of Western central banks like the Federal Reserve Board and the Bank of England, international financial institutions like the IMF and the World Bank, and prestigious centres of learning like the Harvard and Rice Universities in the United States and the London School of Economics and Loughborough and Durban Universities in the United Kingdom. It has also received favourable coverage in the Western press. Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate and leads to a realization that the instability cannot be removed by making cosmetic changes in the system but rather by injecting

into the system greater market discipline of the type that all the major religions emphasize.

## **8. Conclusion**

Thus we see that there is a strong rationale behind the prohibition of interest by the major religions of the world. The rationale is not merely to prevent the exploitation of the poor but also to make the financial system healthier and more stable by injecting in it greater discipline. If the share of equity is increased and that of debt is reduced substantially, the volatility now prevailing in the international financial markets will hopefully be substantially reduced. The result may be even better if credit is confined primarily to the purchase or lease of real goods and services. As a result of this a great deal of the speculative expansion of credit may be eliminated. The ultimate outcome may be not only reduction in financial instability and greater socio-economic justice but also better allocation of resources and faster economic growth.

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## **Notes**

<sup>1</sup> For the Judaic and Christian views on interest see Johns, et. al., and Noonan (1957); and for the Hindu view, see Bokare (1993), p. 168.

<sup>2</sup> For some of these protests, see Mills and Presley (1999), pp. 101-113.

<sup>3</sup> The instability started with the breakdown of the Bretton Woods System in 1971. Since then there have been a number of crises. The more important of these are the US stock market crash in October 1987, the bursting of the Japanese stock and property market bubble in the early 1990s, the breakdown of the European Exchange Rate Mechanism (ERM) in 1992-93, the bond market crash in 1994, the Mexican crisis in 1995, the East Asian crisis in 1997, the Russian crisis in August 1998, the breakdown of the US hedge funds in 1998, the Brazilian exchange rate crisis in 1999, and the steep decline in US stock prices in 2002.

<sup>4</sup> This was clearly acknowledged by Greenspan in the following words: "Had the failure of the LTCM triggered the seizing up of markets, substantial damage could have been inflicted on many market participants, including some not directly involved with the firm, and could have potentially impaired the economies of many nations, including our own"; see Greenspan (1998), p. 1046.

<sup>5</sup> The Bank for International Settlements (BIS) conducts a survey of foreign exchange markets every three years in the month of April. Results of the April 2001 survey became available after the completion of this paper. According to these results, average daily turnover was 19 per cent lower at around \$ 1210 billion compared with

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that in 1998 (BIS, 2001, p.1). The major reason for this fall in the foreign exchange market turnover were, according to the BIS, the introduction of Euro, the growing share of electronic banking in the spot inter-bank market, and the consolidation in banking industry .

<sup>6</sup> World trade (exports plus imports) rose from \$499.0 billion in April 1989 to \$908.7 billion in April 1998 (IMF, *International Financial Statistics*, CD-ROM and November 1998). The average value of daily world trade in April 1998 comes to \$30 .3 billion.

<sup>7</sup> The decline in average daily turnover in April 2001, as indicated in footnote 7 was most pronounced in spot markets, where average daily turnover fell from \$568 billion to \$387 billion. Trading in forwards rose from \$128 billion to \$131 billion while that in swaps dropped from \$ 734 billion to \$656 billion (BIS, 2001, P.1 and Table 1 on p.3).

<sup>8</sup> See the arguments in favour of and against the feasibility of the Tobin tax by various writers in Haq, Kaul and Grunberg (eds.) (1996).

<sup>9</sup> A number of Islamic economists have argued this point. See, for example, Chapra, (1985), pp. 117-22; Chishti (1985); Mohsin Khan (1987); Mirakhor and Zaidi (1987), S. Siddiqi and Fardmanesh (1994). and a number of others.

<sup>10</sup> Figures have been derived from the Table on “Consumption as per cent of GDP” in IMF, 2000 Yearbook, pp.177-79.

<sup>11</sup> OECD, *Economic Outlook*, December 1991, Table 2, p.7; and June 2000, Table 22, p.266.

<sup>12</sup> A question may be raised here about the current low rate of unemployment in the U.S. in spite of a substantial decline in household saving. There are a number of reasons for this. One of the most important of these is the large inflow of foreign funds which “has helped to fund a pronounced increase in the rate of growth of the nation’s capital stock” (Peach and Steindel, September 2000, p.1). Once there is a reversal of, or even a decline in, this inflow, it may be difficult to sustain the high rate of growth in output and employment. In addition the stock market may also experience a steep decline.

<sup>13</sup> This section is based on Chapra and Khan (2000), pp.11-15.

<sup>14</sup> Editors’ comment: For a description of these and other Arabic terms used in this and other papers in this volume, see the Glossary.

<sup>15</sup> Exceptions to this rule are *salam* and *istiṣnāʿ* (see Glossary).

<sup>16</sup> For a discussion of this problem, see Section 3.1 on the “Late Settlement of Financial Obligations” in Chapra and Khan, 2000.

<sup>17</sup> For the needed institutional infrastructure, see Chapra and Ahmed (2002), pp. 79-84.

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## Option Contracts and The Principles of Sale of Rights in Shari‘ah

*Mohammed Burhan Arbouna\**

### 1. Introduction

The Shari‘ah (Islamic law) is a legal system that considers interest or expectations of the contracting parties. It sanctions any mechanism that serves the objectives of the contracting parties. The price risk has become a modern business reality. This axiomatically made risk management a prerequisite for businesses to survive market shocks. A survival of businesses and protection of wealth is a Shari‘ah a requirement. Thus, measures that protect wealth against risks are logically within the teachings of Shari‘ah. This means that a failure to protect investment funds against risks do not comply with requirements of Shari‘ah in which case the entrepreneur may be held liable under the principles of negligence, misconduct and unprofessional management.

In complying with the requirements of protecting wealth, we noted that the jurists had discussed mechanisms of mitigating risks of losses, misrepresentations or product defect. This is exemplified in the number of traditional Shari‘ah options, such as *khayār al-majlis*, *khayār al-shart*, *khayār al-‘ayb*, *khayār al-naqd*, to mention but few. The rationale for allowing these risk management mechanism is to allow the contracting parties a time to think about the contract and to avoid harm that may overwhelm them when the contract continued. The jurists also established principles of guarantees for the same purpose, notably *ḍamān al-dark*, which may be translated as guarantee against market misrepresentation. It is noted that the jurists are not

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in favor of any action that jeopardizes investment objectives so much so that they hold an entrepreneur, such as *mudārib*, liable for embarking on risky investments. Thus, risk management is an evident requirement of Islamic law from various aspects.

## 2. Assumptions

In order to restrict the discussion in this paper, we have to make three assumptions. One assumption is that options have *fiqh* parallel which is manifested in *arbūn*, *khijār al-sharṭ* and similar terminologies. The second assumption is that there is a contract of sale, at least in the case of shares, but the delivery will take place in the future. The third assumption is that options have no *fiqh* parallel and this necessitates finding a solution to the financial options under the principles of Shari‘ah. The paper is limited to the third assumption. This is because contract of options violates a number of principles of exchange contracts. In addition, we do not dispute the importance of financial options in managing complicated risks, such as management of price increases and falls and other benefits.<sup>1</sup> This paper has excluded currency options from the domain of discussion.

## 3. Definition and Classification of Shari‘ah Options

Option or *khijār* in the *fiqh* literature means the right of one or both parties to a contract to make a choice between two opposing events: execution of a contract or suspension of a contract. The buyer or the seller is entitled to maintain the concluded contract or cancel it within a particular period due to a particular event. The termination of the contract based on options have various factors including, among others, the contract being not serving the interest of the terminating party, defect in the subject matter of the contract or violation of a stipulated valid condition. Thus, an option in Islamic law gives a party in a contract the right, within certain circumstances, to reverse the contract. The options change the status of a contract from being binding to being “floating”, i.e. non-conclusive. They make a contract flexible. However, entitlement to options to cancel a contract or to perform depends on the nature of the underlying contracts. In some contracts, options give only one party the right to cancel the contract after the commencement of a contract and prior to completion, such as an option to cancel the contract by the worker in a reward-based contract (*ju‘alah* contract).<sup>2</sup>

Broadly, the Shari'ah options are classified from the perspective of the law and the option stipulator. In other words, some options are created by natural law and others are created following contracting on a tangible subject matter. Options created by the law are those options that exist for the interest of both or one of the contracting parties. These options do not need an agreement for creating them.<sup>3</sup> Options that are created by the law include, among others, *khayār al-majlis* (option of session). The contracting parties are entitled by law to terminate the concluded contract as far as they did not disperse from the place of the contract. This form of option is automatically granted to the contracting parties by the saying of the Prophet (pbuh) "both the buyer and the seller (contracting parties) have an option (to terminate the contract) so far as they did not disperse".<sup>4</sup> Under this category comes the majority of *fiqh* related options, such as *khayār al-'ayb* (option for defect), *khayār al-ru'yah* (on sight option), *khayār al-tadlees* (fraud option) and option for violation of valid conditions stipulated in the contract.<sup>5</sup>

The contractual options are created by the agreement of the contracting parties. These options exist only when the contracting parties choose to attach a particular right to the contract. Example of contractual options is *khayār al-shart* or conditional option. The concept of financial options falls under the category of contractual options, hence many writers on options in Islamic finance tried to compare financial options to contractual options due to their similarities in features and objectives.<sup>6</sup>

#### 4. Basic Features of Shari'ah Options

The large number of options<sup>7</sup> that are discussed in the *fiqh* literature were allowed by the jurists because they serve certain valid and permissible objectives for the contracting parties. These objectives may be summarized in the following:

1. These options are allowed in order to ponder on the viability of the deal and obtain information on the deal. Generally, the jurists interpret the risk to be avoided by introducing these options in the context of fraud (*ghabn*), misrepresentation (*tadlees*) and misconduct as indicated by Ibn Hibban's case.<sup>8</sup> However, the general principles of Shari'ah suggest that options are introduced for various purposes provided the stipulation of an option is within the principles of Islamic law. This is because the need for options will differ depending on the time and commodity.

2. They are meant to allow the contracting parties an ample time to avoid risk and damage to the contracting parties. These options are introduced by Shari‘ah as tools for defeating damage or loss as a result of hastiness in exchanging offer and acceptance. The contracting parties may not necessarily know that the deal they concluded is viable and meet their expectation. Thus, the Shari‘ah has introduced options to deal with regret, damage of injudicious decisions and unpleasant effects and outcome of buying and selling.
3. These options give a party to a contract a legal or contractual right to terminate the contract after its conclusion when it appears not serving the purpose of such a party. On the other hand, some of these options give one of the contracting parties, probably the buyer, a right to acquire discount for defects or a right of settlement.<sup>9</sup> In this context, Islamic banks and financial institutions need these options to meet their desire to avoid risks and manage unpleasant situations of supply and demand.
4. In principle, the outcome or effect of exchange contracts, such as a sale contract, must take place once a contract is concluded. In a sale, for example, the subject matter of the contract must be transferred immediately, either actually or constructively, to the buyer after which the seller becomes entitled to the price. However, the options negatively affect the commitment of the parties to pay and deliver as well as occurrence of the objective and rule of a contract.<sup>10</sup>
5. In principle, Islamic law does not endorse any arrangement that would lead to uncertainty and ambiguity. Uncertainty or *gharar* in contracts means that the subject matter of the contract is not existing. Ambiguity or *jabalah* suggests that the subject matter of a contract certainly exists but its description (*wasf*) or identification (*ta’yeen*) is not clearly known.<sup>11</sup> The principles of options violate the prohibition of *gharar* and *jabalah* in contracts because a contract embedded with option is a hanging (unconfirmed) contract, i.e. the contract stands between two opposing extremes of confirmed acceptance and rejection. The contract may or may not be concluded and the ownership to the subject matter and entitlement to the price are floating/hanging till the conclusion of the contract. In other words, the acceptance does not follow immediately the offer due to the duration of the option. In this respect, options introduce *gharar* in contracts. However, options are allowed despite of being involved in *gharar* and *jabalah* for the need to options in contract. Their permissibility is an exception to the general principles of *gharar* and

*jabālah* because they serve a valid purpose. They defeat the risk of fraud, misrepresentation, loss and damage. Since individuals are in need to defeat the economic impacts of these events, options are legalized for the superiority of defeating these events over the existence of *gharar* and *jabālah* in the contracts. This is because the underlying objective of options is not to deal in *gharar* and *jabālah*, but rather to minimize the impact of these events on the contractual relationships.<sup>12</sup>

## **5. Parameters of a Valid Option**

The jurists are accustomed to mention certain properties or qualities that are necessary for the validity of options. When one explores the *fiqh* literature in respect to options, it becomes clear that a valid option need to meet certain parameters, among others, the following:

- a) The general view of the jurists is that an option should be a quality that exists simultaneously with the subject matter of the contract at the time of its stipulation. This is because an option portrays a contract and it is not practical to agree on the described (*mansuf*) (the contract) without features or qualities. The Hanafis argued that an option may be stipulated before or after the conclusion of the contract.
- b) The option should be beneficial to the contracting parties or either of them.
- c) The option agreement should not be in conflict of the contract in which it is stipulated.
- d) The option agreement should not violate basic principles of Islamic commercial law, such as *ribā*, *gharar* and exploitation.
- e) The option agreement should bring about benefit to the contract even if it is not relevant to the contract such as deferment of payment or delivery and guarantee. The reason is that the law allows stipulation of these events in the contract.

## **6. The Risk Management of Sharī'ah Options**

The above basic features of Sharī'ah options suggest that these options, if put together, manage a wide range of risks including the following:

- Fraud risk.
- Misrepresentation risk.
- Ownership risk.
- Price risk.
- Market risk
- Commodity risk
- Default risk.

## **7. Concept and Scope of Financial Options**

### **7.1 Concept of Financial Options**

In the language of modern economics, the financial option contracts convey the right to buy or sell at a pre-determined and agreed price. There are various types of financial options. However, all exchange-traded options come in two types, namely call option and put option. A call option entitles the holder the right but not the obligation to buy an asset at a pre-determined exercise price in the future prior to or on the maturity. In contrast, a put option entitles the holder the right but not the obligation to sell an asset at a predetermined exercise price prior to or on the maturity.<sup>15</sup>

### **7.2 Basic Features of Financial Options**

From the above concept, one may summarize the basic features of option contracts as follows:

- a) the buyer of option pays as consideration a premium. However, the buyer is not obliged to buy or to sell. This is a mere right that may be exercised or otherwise, depending on whether the deal for which the option is purchased is profitable. When the deal is not profitable, the buyer declines to complete the contract and loose the premium.
- b) Both the seller and the buyer carry market risk.
- c) The financial option practiced in the financial markets is an independent contract from the sale contract. In other words, both the option and the subject matter of the contract are priced independently. The option gives a party a right to buy or sell. In

most cases, the seller of the financial option does not own the subject matter be it share or commodity.

In line with the above concept and features of options, the permissibility or non-permissibility of options may be examined from two Shari'ah aspects. The first principle is to examine options within Shari'ah nominated contracts or concepts that are comparable to options in terms of concept, qualities or properties. The second principle is to consider options as novel financial instrument created due to current circumstances of market volatility and which have no parallel in Islamic commercial law. This means options should be adjusted under the general principle of permissibility and other similar principles.

## **8. Similarities of Shari'ah and Financial Options**

There are similarities between financial options and Shari'ah options. These similarities may be summarized in the following:

1. The Shari'ah and financial options agree on providing a right to either of the parties or both to confirm or to cancel the contract within a stipulated period. In essence, both options give the concerned party some period for re-evaluation of the benefits and costs involved, before giving final consent or accent to the contract.
2. The Shari'ah and financial options are mainly intended to manage a wide range of risks, although it is not ruled out that financial options may be intended for gambling.<sup>14</sup>
3. The Shari'ah options are created as a result of asset-based contractual relationship. This also exists in the transactions of financial options that involve shares.
4. The Shari'ah options and financial options agree on that both give the buyer an upper hand to decide on the direction of the contract.

## **9. The Differences of Shari'ah and Financial Options**

The examination of Shari'ah options shows that they differ in substance and form from financial options from various perspectives, although some of the differences may be eliminated. The following are the main differences.<sup>15</sup>

1. A Shari'ah option consists of three components, namely the option itself, the contract and the underlying assets. In other words, the

option forms an integral part of the contract and its inclusion in the contract follows the conclusion of the contract or during the conclusion of the contract. This alludes to the fact that a Sharī'ah option is an outcome of the conclusion of a contract in which option was made condition for final endorsement of the contract.<sup>16</sup> For this, the Hanafis argued that an option is a description of a contract that does not possess a financial value.<sup>17</sup>

2. In financial option, the subject matter is intangible event against the seller created by a contract of obligation.
3. Sharī'ah options are not subject of speculation and gambling whereas financial options are prone to be used as a gambling mechanism, directly or indirectly. This is because a relatively small percentage of option contracts actually turned to materialize as contracts, as the vast majority prove to be hedging contracts bought or sold back before falling due for settlement. Put simply, financial options are, in general, bought and sold.
4. The investors used financial options to hedge against potential price risks or losses by using the premium as consideration for the party who accepts to bear such risk or losses.<sup>18</sup>
5. The financial options are mechanism of investment whereby investors depend on their expectation of the market and issue or buy such options.<sup>19</sup> This is not the case in Sharī'ah options.
6. The period of option in financial options is actually not part of the contract because it precedes the contract. The period in Sharī'ah options is an integral part of the contract.

#### **10. Is There Parallels to Financial Options in Islamic Law?**

We are often told that contracting on financial options is a new transaction without explaining the exact meaning of this conclusion. Does this mean that there is no contract in Islamic law which can be compared with contracting on options or does it mean that sale and purchase of options cannot be examined under the principles of Islamic law? Firstly, it is true that contracting on, operations of options in modern stock markets is completely a new phenomenon. However, the essence of contracting on options, if looked under the juristic debate on exchange of right and creation of obligation does exist in the *fiqh* literature. Therefore, it is almost not correct to say that options are pure novel contracts. This is because Islamic law or

*fiqh* literature has provided a wide range of principles to deal, in one way or the other, with novel issues, whether financial, social or political. It may be admitted that there are no nominated contracts comparable to existing operations of financial options.

For example, Build Operate Transfer (BOT) deals did not exist during the time of the classical jurists. However, such deals contain features of *istiṣnā'*, *iqta* or *ijārah*, hence they are discussed within the principles of these contracts. Construction contract (*muqawala*) is similar to *ijārah* or *istiṣnā'* and for that matter it is discussed within the principles of *ijārah* or *istiṣnā'*. The governments' award contracts for identifying wanted criminals have features of *ju'alah* contract and they are legalized under the principles thereof. In this sense, contracting on options is a new transaction. However, it will fail to be a new contract under the general principles of human dealings. Under these principles, the ruling of financial options would appear clear. The basic requirements of Shari'ah is that mere consent of the parties and the contract being free of fraud and misrepresentation are not enough to make a contract valid and acceptable. The validity of a contract requires that its arrangement match the general principles of Islamic rules and principles of transactions. An examination of financial options shows that they fall under the rules of pure sale and sale of rights.

## 11. Financial Options and Concept of Sale Contract

The definition of financial options by the experts made them to be associated to a sale contract.<sup>20</sup> If the association of financial options to the group of sale is acceptable, then one needs to examine these options under the principles of sale contract. This will explain as to whether financial options fulfil the conditions and requirements of saleable assets. The definition of the majority of the *fiqh* schools concurred that sale is an exchange of property in consideration for property. In order for an action or a transaction to acquire qualities of a valid sale contract, it must fulfil the following general requirements:<sup>21</sup>

1. The exchanged properties must be lawful in the eyes of Shari'ah and the delivery of them is realizable at the time of signing the contract.
2. The exchange must lead to ownership, which means having an actual control over, or ability to use, the subject matter of the sale contract.
3. An exchange between property and usufruct is not called sale in the strictest sense of the word sale (*bay'*, rather this is an *ijārah* contract, although *ijārah* involves sale of usufruct as termed by some jurists.

4. The properties exchanged must not be currencies in which case it is called currency exchange and not a sale contract, in which case the rules of currency exchange must be observed.
5. The subject matter should not be related to cohabiting rights according to Malikis.

## 12. Financial Options and Floating Contracts

The notion of options is similar to the concept of Shari'ah floating<sup>22</sup> contracts, namely *al-ʿaqd al-muʿallaq*<sup>23</sup> and *al-ʿaqd al-muḍāf*. The discussion here would focus on *aqd al-muḍāf* due to being more pertinent to financial option contracts from various aspects. *Al-ʿaqd al-muḍāf* is a contract in which offer is referred to a particular time in the future, such as this item is sold to you in consideration for 1000 *dinars* to be effected at the end of the month.

The majority of jurists, as opposed to Ibn Taimiyya and Ibn Qayyim, disapproved a contract which execution is consequential on a future event or in which the offer is referred to the future. The *ʿillah* or the underlying reasons for this disapproval are as follows:

1. A contract that will be effected when something occurs involves *gharar* or uncertainty. This is because the parties to the contract do not know whether or not the event may happen in which case the contract is finalized or the event may not take place in which case the contract becomes not executable. The parties do not also know as to when the event may happen. Again, the event may happen at a time the parties may have changed their minds. Therefore, consequential contract involves *gharar* from the perspective of whether or not the event on which the contract is tied up could take place. From another aspect, *ʿaqd al-taʿliq* involves uncertainty as to whether the buyer or seller would really fulfil his or her obligation when the event takes place. In this respect, the Hanafi jurists argued that performance of contracts that transfer ownership, such as a sale, a gift, a financial settlement, a marriage etc., cannot be referred to a future event or a condition in the future because such an action involves chance and game.<sup>24</sup>
2. The concept of *idāfa al-ʿaqd* contradicts principles of a sale contract. This is because sale is a contract of transfer of ownership which should be, in principle, concluded on immediate delivery basis so that the sold item would be transferred to the buyer. The concept of

*ta'liq* does not allow this immediate transfer of ownership to take place.<sup>25</sup>

3. In addition, refereeing performance of a contract to future makes the consent of the contracting parties uncertain. This is because unless the date referred to become current the contracting parties are oblivious of whether or not they have consented to the conclusion of the contract. Since this is the case, a contract cannot be concluded on this basis because transfer of ownership cannot be dependent on an uncertain consent.<sup>26</sup>

On the other hand, Ibn Taimiyya and his student Ibn Qayyim see no wrong with a sale contract consequential on a future event provided this is beneficial to society and the sale does not contradict any explicit source of the Qur'an and Sunnah. The basis for this is their principle that contracts are, in principle, except if explicitly prohibited by the Lawgiver. Therefore, *mudāf* contract is a form of stipulation that is relevant to a sale contract like any valid stipulation. In addition, Ibn Taimiyya argued that there is no report from his contemporaries of the Hanbali school and others that prohibits a sale consequential on a future event. Thus, *mudāf* contract does not involve *gharar* because the *gharar* that is prohibited is that which is related to the subject matter and not the contract, i.e. *gharar* does not occur in contracts per se. Moreover, the *gharar* that is prohibited is the *gharar* that lead to devouring of property of others. This is not happening the sale consequential on a future event. All in all, *mudāf 'aqd* is a contract that takes place on the basis of a particular description in which case if the description happens there is a contract and if not there is no contract. Ibn Taimiyyah further argued that there is no text showing that an immediate delivery of the subject matter is a must in a sale contract, but rather the law allows delay in delivery in accordance with the interest of the contracting parties. Therefore, Ibn Taimiyyah and Ibn Qayyim are of the view that a sale may be concluded on something that is not available at the time of the contract.<sup>27</sup>

Al-Darir commented that *mudāf* contract may lead to devouring of property of others because the contract would be concluded in the future in which case the contracting parties are not aware of the consequences of the subject matter at the time. The exact price of the contract would fall under *gharar*. One may sell commodities worth 100 dinars on the basis of *mudāf* contract. At the occurrence of the consequential event, the price may fall drastically or increased significantly. In this case, one of the contracting parties is devouring property of others unjustly.<sup>28</sup> This is where *mudāf 'aqd* becomes relevant to the financial options. The operation of financial options involves devouring of property of others unjustly because the premium paid

for the option is taken, according to the opponents of financial options, without consideration whatsoever in addition to gambling on price fluctuations.

### 13. Financial Options and *Arbūn* Sale

Some modern writers on Islamic law and finance maintained that the objectives of financial options might be achieved through the principle of *arbūn* sale.<sup>29</sup> Others argued that the rationale of financial options resembles the concept of *arbūn* in the sense that both manage price risks.<sup>30</sup> Some writers even argued that *arbūn* sale is the same as call option.<sup>31</sup> This necessitates a discussion on the principles of *arbūn* to see whether it is comparable with financial options.

By definition, *arbūn* sale refers to a sale contract in which the buyer reserves a commodity, pays a small part of the price and agrees to forfeit the paid portion of the whole price when the buyer fails to turn up on a particular date for taking the goods and payment of the remaining price. In this respect, AAOIFI Shari'ah standards defined *arbūn* as "an amount of money that the customer as purchase-orderer pays to the institution after concluding the *murābahah* sale, with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the price. If the customer fails to execute the *murābahah* sale, then the institution may retain the whole amount". The basic elements that this definition encompasses are: (a) *arbūn* takes place after effecting a sale contract, in which the sold item is defined and (b) the effective date of the *arbūn* must be defined.

The jurists differ on this concept from the perspective of the validity of *arbūn* sale itself and on the definition of the period of *arbūn*, i.e. whether *arbūn* may be an open contract or a period for exercising it should be defined. On the first aspect, the majority of jurists, including the Malikis, the Shafi'is and the Hanafis, did not permit *arbūn* sale. It is the view of Ibn Abbas and al-Hassan al-Basry.<sup>32</sup> The basis for rejecting *arbūn* sale is that it involves some invalidating factors of a sale contract. One factor is that when the buyer did not to buy the commodity, the amount paid by the buyer would be retained by the seller for no consideration. In this case, *arbūn* sale is a form of devouring of others' property, which is strongly condemned by the Shari'ah.<sup>33</sup>

The Hanbalis opted for the validity of *arbūn* sale. They cited a number of legal cases for the validity of *arbūn* sale. This was the practice of Umar Ibn al-Khattab, Ibn Sireen and Justice Shuraih. It is reported that Nafi' Ibn al-Harith

bought a building for using it as prison from Safwan Ibn Umayyah in consideration for four hundred dirham on the condition that the deal would be closed when Umar (R.A.) consented or the four hundred would be retained by Safwan if Umar refuses to endorse the deal.<sup>34</sup> Ibn Sireen and Ibn al-Musayyib were reported to have said that “if the buyer did not want the commodity, he or she may return it together with some money. This view was viewed by Imam Ahmad as basis for the concept of *arbūn*.<sup>35</sup>

Al-Bukhari reported that Ibn Sireen reported that a man requested from Kurayh, a man who operates a caravan for transportation, to prepare a riding camel for a journey. The former promises to pay a hundred *dirhams* if he fails to use Kurayh's services on the designated date for the journey. This case was tested in the court of Justice Shuraih. His judgments was that any party who have voluntarily committed himself is obliged to honour what the other party expects from such a commitment.<sup>36</sup> This reveals that Justice Shurayh is of the view that consent of a party to pay, in the absence of duress, an amount of money for violation of the terms of a contract is valid and enforceable. This is the essence of sale of *arbūn*. In addition, the majority of the modern scholars have opted for the validity of *arbūn* sale because it is supported by a number of cases and is the view of a number of *tabi'ūn*. This is reflected in the International Islamic Fiqh Academy when the Academy endorses the validity of *arbūn* sale.<sup>37</sup> Therefore, the validity of *arbūn* sale is not disputed in the modern times. The controversy is whether *arbūn* is similar to option contracts, hence their validity on this basis.

### **13.1 The Similarities and Differences Between Arbūn and Financial Options**

As explained earlier, the validity of *arbūn* sale is not disputed by the modern scholars. Now, the question is whether *arbūn* sale is similar to financial option contracts in that whether financial options may be accepted on the basis of *arbūn* sale. Although there is similarity between *arbūn* sale and financial options, the differences between the two is too wide so much so that they are not comparable. The financial options and *arbūn* sale are similar in the following:<sup>38</sup>

- a) *Arbūn* contract consists of an option that is exchanged with money in case the contract over an asset or usufruct is not concluded.
- b) Among the objectives of *arbūn* contract is the management of market risk or price risks.

- c) The *arbūn* sale entitles the buyer to gain a binding offer from the seller while the buyer is at discretion to accept or reject the offer within the period of offer in consideration for the *arbūn*. This is similar to the call option where the option holder is entitled to buy shares or refrain from doing so against losing the paid premium.

However, the above similarities are not strong enough to make *arbūn* sale a basis for financial options. This is because there are very important differences between *arbūn* sale and financial options, including the following:

- a) The amount that is described as *arbūn* form part and parcel of the price of the sold item<sup>39</sup> whereas the premium of financial options is not considered part of the price, but rather a consideration for granting an option to buy or sell.
- b) In the *arbūn* contract, there exists a contract whereas the contract in financial options would be categorized under Shari‘ah principles as a mere promise because it does not fulfil the requirements of contract.
- c) The *arbūn* is not tradable and financial options may be traded.

#### **14. Financial Options and the Concept of Property (*Māl*)**

It is a necessary requirement that both counter-values of a contract enjoy a proprietary value. Thus, contracting on financial options depends on whether options enjoy monetary value. In this respect, the identification of monetary value of financial options is necessary in order for them to qualify as property, hence tradable. In Islamic law, there are a number of qualities necessary for an object to qualify as subject matter of a sale, some of which have been stated earlier. The jurists differ on these qualities. The Hanafis suggest that an object is qualified as property (*māl*) when such an object fulfils the following conditions:<sup>40</sup>

1. capable of being stored (hoarded)
2. capable of being put to some use
3. capable of being owned and possessed
4. has some value by law
5. such that humans are inclined towards it

6. not prohibited by the Sharī'ah to be owned and used. In this case, wine and pig, for example, are property for Muslims
7. Recognized as property by customary practice prevalent in an area or country
8. Not things of common use of everyone, such as light, air, grass, water, common pasturage and public roads.

The majority of jurists, the Malikis, the Shafi'is and the Hanbalis, have defined property in a very comprehensive manner to include usufructs and rights. The scholars of these schools concurred that the definition of property includes ownership of the thing itself or its usufructs. This is because property is what gives benefit. In this respect, al-Shatibi writes that property "is a thing on which ownership is conferred and the owner, when he assumes it, exercise absolute control over it against interference of others".<sup>41</sup> Imam al-Shafi'i said, "the terminology *māl* should not be construed except as to what has value with which it is exchangeable; and the destructor of it would be made liable to pay compensation; and what the people would not usually throw away or disown, such as *fiṣ* (valueless currency) and similar things that people would usually throw away".<sup>42</sup> By this definition, al-Shafi'i made two important points. Firstly, whatever is evaluated as effectively giving rise to benefit is regarded as financially valuable property. This means, on the other hand, that whatever is incapable of showing the effect of giving rise to benefit is excluded from the definition of financially valuable property.<sup>43</sup>

The Hanbali jurist, al-Khiraqi, defined property "as something in which there exists a lawfully permissible benefit without resulting from pressing need or necessity". In his commentary, al-Buhuti, a Hanbali jurist, maintains that al-Khiraqi's definition means that the following are excluded from the definition of property:

1. the things in which there is no benefit in essence, such as insects;
2. where there might exist benefit but it is prohibited by the Sharī'ah, such as wine;
3. there is lawfully permissible benefit but only in situations of dire need, such as keeping a dog, or in situations of necessity, such as the consumption of a carcass when in dire need of survival.<sup>44</sup>

The definition of the majority of jurists suggest that the term property is used to define anything that (a) has monetary value and usufruct in the eyes of society (b) is allowed by the Sharī'ah and is not assigned value due to necessity and need. Thus, a proprietary value evolved from the relationship

between the need to benefit from a thing and individuals.<sup>45</sup> Therefore, the convincing view is that the usufructs of assets are considered properties that may be exchanged with another monetary value, such as in the case of lease.<sup>46</sup>

## 15. The Concept Right and Financial Options

The definitions of financial options give an impression that these options are considered rights. Thus, there is need to discuss the concept of right in the *fiqh* literature because this will enable us to see whether Islamic law allows trading in rights. A right philologically connotes something that is recognized in the interest of individuals. In other words, the terminology 'right' connotes something that is established by law in the interest of human being. In Islamic legal literature, the term right has general and specific meaning. One usage is in relation to a tangible asset or an interest that has been given to a beneficiary and he or she is assigned an authority to demand it when necessary, to deter others from taking it, to exchange it, in some cases, with consideration, or to forfeit it. In this sense, the term right is used in relation to (a) assets, (b) ownership itself and, in general, (c) to usufructs and interests, such as accommodation of this house is the right of so and so; evidential oath is the right of the defendant; bringing up or nursing a child is the right of his/her mother; sovereignty over the property of a child is the right of his or her father; pre-emption right; right of passage and adjacent right.

In addition, an examination of the statements of the jurists of all schools indicates that the term right has a specific meaning and the number of rules against exchanging rights with consideration revolves around this meaning. The jurists use the term right in contrast to tangible assets and owned usufructs. In this case, they do not mean the general meaning of right, which points to anything or action that envisage a right created either by law or following an existing contract. This specific usage points to legal rights, i.e. rights that do not exist except by the creation of law and which an individual is not entitled to withhold when demanded. These rights include, among others, pre-emption right, right to approve or disapprove a contract (*kuhūl al-shart*), right to demand payment of debt, right to marry a peer, right to drink water, right of passage of water, right to use a road or street (*haq al-tataruq*), polygamy right, divorce right, conjugal (sex) right, retaliation right, and similar rights.

The Hanafis, based on their definition of property, deny these rights a proprietary quality because they cannot be possessed or owned separately. The other *fiqh* scholars see that rights are property but when they are attached to tangible assets, such as the right of the lessee to use the leased property.

This right may be traded because it is attached to tangible property that may be bought and sold.<sup>47</sup>

The majority concurred with the Hanafis that rights that are similar to a conjugal right are excluded from the definition of property, hence non-exchangeable because they enjoy no financial value. They are only rights assigned by the law to certain individuals. In this respect, the rights are divided to two, namely pure right and non-pure rights. The pure right by definition is an event that is associated with a thing which, if exercised or forfeited, would not neither change the structure of the subject matter nor have any legal effect. The beneficiary is not obliged to exercise such a right as any action in this direction would depend on whether exercising such a right would bring about benefit. For example, the right of pre-emption is nothing but an authority given to the beneficiary to own a building in consideration of the same price the outside-buyer would have to pay to the seller. This right does not add to the ownership of the building any value. The ownership per se is the same prior to and after exercising the right. The same rationale applies to the remaining pure rights.<sup>48</sup>

The non-pure right, on the other hand, is the adverse of pure rights. A non-pure right is that which if exercised would change the rule of its subject matter. It is part of the subject matter and if forfeited would affect the direction of the ruling of the subject matter. For example, the right to retaliation in homicide is connected to the life of the murderer. As far as this right is not forfeited then the life of the murderer is at stake. When this right is dropped, the murderer becomes free. The same applies to divorce right. The right of a woman to deny any conjugal relationship is restricted when she is married and this restriction would stay so long as her husband did not exercise the right to divorce. These rights are described as non-pure rights because they can be exchanged with money such as in the blood money and the right of the wife to buy divorce from the husband, although they are not related to what may be described as property. Thus, this right of law is comparable to financial options.

The above shows that a right is either usufruct or interest/benefit for a particular individual. The interest of an individual that constitute a right may be divided from proprietary quality to two categories:

- a) The interest could be attached to a property by definition, such as a right to drink (*haq shurb*) which is attached to land in which case there is no legal objection to sell it, even according to the Hanafis, together with the land. In this case, the right may be assigned price that would be built in the price of the land. The

price of a land together with the right to drink water from its fountain is not the same as the price of a land without such a right.

- b) The interest could be in association to what cannot be defined as property, such as the right to bring up a child and the right to build a higher building adjacent to a neighbour in a manner that would affect the flow of space air to the lower building. These rights are not property by definition as the former is related to the child and the latter is related to a mere stature.

The creation of an interest of an individual may be divided to two as follows:

- a) Legal interest, i.e. interest that are automatically created by law with respect to property or personality, such as the right of pre-emption and bringing up a child.
- b) Interest created by external forces, such as a right of accommodation, right to passage and right to drink water. These rights are created by external forces manifested in the neighbourhood to the land or the will pronouncement.

As indicated earlier, the Hanafi jurists opined that rights, whether they are associated with what can be described as property or not, are not property but rather a sort of dominion (*milke*).<sup>49</sup> In this respect, they argued that rights couldn't be sold, given out as gift or donation separately because the subject matter of these events must be property and rights are not saleable property when detached from the underlying assets. However, rights may be assigned price when sold together with the underlying assets. This is because a right add value to the assets sold. However, some Hanafis argued that some rights might be separately sold, such as the right to drink. The rationale for this is that the right is considered portion of the water and because there was a need to consider such rights as separable property, especially the right to drink.<sup>50</sup> However, the prevalent view in the Hanafi school and the majority jurists is that rights that are not related to underlying assets are not subject of sale.<sup>51</sup>

Nevertheless, this general approach to trading in rights may be countered by the fact that a financial settlement may be reached for dropping claim to certain rights, such as the right to retaliation and the right to remain married. This is because these are non-pure rights, i.e. these rights are not created for management of harm *per se* against the beneficiary, but rather they exist following certain events, like murder and marriage.<sup>52</sup> For this reason, Ali al-Khafif concluded that:

“Since some rights could be legally dropped by its owner, there would be logically no objection to exchange such rights for a defined amount on the basis of a contract, i.e. the buyer becomes entitled to it separately by contract. There is thus no objection to regard a right in this respect valuable *by contract*”.<sup>53</sup>

Thus, Ali al-Khafif sees that rights may be sold separately when they are established by law in the interest of the beneficiary. But this conclusion may be encountered by saying that these rights, can only be dropped and cannot be exchanged for money because they enjoy no monetary value which is a necessary requirement for exchange contracts. Al-Khafif responded to this by saying rights may be assigned monetary value (*mutaqawwim*) by the contract itself. This suggests that there are forms of rights that were not discussed by the jurists. These are rights created purely by mutual agreement of the contracting parties. The question that needs investigation is whether people can create, based on pure contracts, obligations and rights without underlying assets and be traded.<sup>54</sup>

### **15.1 Why Rights are Not Tradable?**

It noted that the jurists are against trading in rights that are created by law, which were termed by one modern scholar as essential rights, such as the right of pre-emption.<sup>55</sup> In principle, a person is not allowed to interfere with the contracts concluded by individuals on the basis of consent. However, essential rights give the beneficiary a right to interfere in the contract and change the direction of ownership for fear of harm. In other words, essential rights are thus created in the interest of the beneficiary as a defence against any harm that may befall on him. If the beneficiary chooses to sell these rights, it becomes clear that non-exercising of the right is not detrimental to the beneficiary. Hence, the beneficiary is not allowed to transfer it to another person for consideration because this is a restrictive right.<sup>56</sup>

It is noted that rights that the jurists, especially the Hanafi jurists, declared as non-exchangeable with money are meant to remedy a situation of harm (*darar*). The basic features of these rights is compensation for damage sustained by the beneficiary due to inability to benefit from a right given to him or her by the law. It is thus not relevant to draw analogy between non-exchangeability of rights of financial options and rights that are meant to prevent occurrence of damage to the beneficiary. This is because rights created by agreement are not meant to prevent damage in the same way as

the rights discussed by the jurists and concluded that they are not exchangeable.

## 16. The Shari‘ah Possible Solutions for Options

### 16.1 *Hāmish Jiddiyah* and Call Option

The term *hāmish al-jiddiyah* is usually observed in the writings on *murābahah* to the purchase-orderer. This is a commitment charge which the institution takes from the customer to start processing the transaction even though a sale contract is yet to be concluded.<sup>57</sup> This commitment charge is considered permissible by AAOIFI Shari‘ah Standards on *murābahah* and would be considered part of the contract price when the contract is concluded. If the client experience that the conclusion of the contract will cause him losses, he may forfeit this charge. Some scholars suggested that this commitment fee “form a unique form of a call option”.<sup>58</sup>

However, *hāmish al-jiddiyah* could have been a good example of a call option should there be no difference between it and options. The commitment fee is to remedy damage or loss as a result of the customer’s failure to conclude the contract. The institution holds the commitment fee on fiduciary basis. If the commitment fee is more than the loss incurred by the bank, the remaining balance after deduction of the value of the loss or damage must be returned to the customer. In addition, when the customer has fulfilled his promise and executed the contract the institution is obliged to refund the commitment fee to the customer or to consider it part of the price.<sup>59</sup> On the other hand, the price for options, although it is meant to manage credit risk, is not refundable even if the contract is concluded. Again, the seller is not obliged to show that he or she has incurred losses due to failure of the contract in order to deserve such price.

### 16.2 *Ijārah* and Financial Options

The essence of the options in the international financial market encompasses the features of offer either from a person who is certain of allocating goods or shares for a buyer. This offer would be according to the price agreed upon (call option). A company may see that it is its interest to offer to sell shares according to the agreed price (put option). It would accept premium for such an offer. This service may be done on the basis of fees for management of the documents involved and finding such goods on the basis of *ijārah* without necessarily connecting the premium paid to finding such goods. In this case, the right to the premium is established by virtue of the

contract of the services provided in any case, i.e. whether the payer of the price for service concludes a contract of sale or not. In this case, the issue that the paid premium must be regarded as part of the sale price is eliminated. In this case, we may create a secondary market for options in the sense that the beneficiary of the services of the offering party may sell it to a third party because the subject matter of sale in this case is the liability to provide services. On the other hand, the offer to provide services may be done through *ijarah mumāzija* or parallel *ijarah* contract, which means the offering party may look for another person to provide him with shares or commodities in order to fulfil the obligation towards the first beneficiary.

The above structure is similar to the structure as suggested by Muhammad El-Gari.<sup>60</sup> The difference between the two is that that El-Gari is considering it only to the put option. In our view, this structure may be applied to both put and call option as explained.

### 16.3 *Ju'alah* Contract and Financial Options

It is noted that in *ijarah* concept, the period in which the offer remains valid must be determined as rightly observed by Muhammad El-Gari. This is a basic requirement of *ijarah*.<sup>61</sup> This may be managed by the concept of *ju'alah* because *ju'alah* is possible in a number of transactions that cannot be a subject matter of sale or lease. In this case, *ju'alah* contract may solve a number of future contracts because it is permissible to demand payment of fees prior to submission of the subject matter. In addition, ambiguity (*jahalah*) of the subject matter, i.e. services, does affect the contract of *ju'alah*. The parties may agree on the submission of the subject matter without specifying a date. Therefore, *ju'alah* is a good contract to deal with financial options. In this case, both the buyer and seller may issue a public offer specifying reward (*ju'l*) for those who can find shares for prices they are looking for in which case the subject matter of *ju'alah* is to carry out a certain task that would produce a result. The requirement is to produce result and this stand until the result is achieved. This makes the *ju'alah* contract flexible as far as the premium price is concerned. The reward bidder may also enter into parallel *ju'alah* to look for the subject matter of the first *ju'alah* contract.

### 16.4 Options and Combination of Sale and Contract of Gift

The put option is open for combination of sale contract with gift. If the seller chooses not to sell to the buyer, the amount of money paid to the buyer would be considered as a gift associated with the contract of sale. This involves a combination of contracts that do not conflict in purpose and legal consequences, hence becomes valid. The sale contract is an exchange

contract which is not accepting *gharar* whereas gift contract accepts *gharar*. Hence, put option may be categorized on the basis of combination of sale and gift. This is because the buyer is not entitled to this amount of money except on the basis of gift. Again, association of gift and sale is in line with a case brought before the court of Justice Shuraih. The fact of the case is that a person promises to travel with a transportation company and requested arrangements to be made on the condition that if he fails to travel he is obliged to pay a sum of money. This person failed to fulfil his promise and Shuraih judged that he paid an amount of money as agreed on.

The sale mechanism may be applied in the case of call option. Wahbah al-Zuhaily argued that it is permissible to pay premium, either on the basis of agreement or donation, for the right to exercise call option. This is because Muslims are bound by the agreement they made. Again, payment for exercising call option is in line with the rationale for allowing options in contracts. However, put option cannot be acquired on the basis of payment of money. It is not allowed to pay for blocking the right of option. This is because option is not legalized for trading purposes, but rather it is permitted for management of risk of deceit and price hiking.<sup>62</sup> Another scholar argued that put option is similar to combination of gift contract and sale contract because the buyer is not entitled to the premium except in a way of gift. This falls under prohibition of two contracts in one.<sup>63</sup> However, it is explained above that there is no conflict between exchange contracts and donation based contracts. This combination may be acceptable to deal with put option.

### 16.5 Financial Options and Payment of Price in Sharī‘ah Options

The Hanbali jurists argued that it is permissible for the seller on the basis of *khiyār al-Shar‘* to require that the buyer pays the price during the period of option so far as this is not intended for *ribā*.<sup>64</sup> The same stand was adopted by the Hanafis and Shafi’is, except that the Hanafis allow payment of the price of exchange contract if the buyer makes the payment voluntarily, not dependent on condition.<sup>65</sup> The Malikis disapproved payment of the price during the period of option because, according to them, option makes the contract non-conclusive and any payment leads to combination of sale and loan. It is a sale when the contract is concluded and is a loan when the contract is concluded. This leads to either *ribā* or *gharar* which are prohibited by an explicit source.<sup>66</sup>

In looking for solution to financial options, the view of the Hanbalis and the Shafi’is view may be adopted. This view argued that possession of the price is part and parcel of a contract for which it may be paid during the period of option. Moreover, there is no any harm against the buyer if

payment is made and anything that does not involve damage to either party shall not be rejected as per the principle of Islamic law. This is because the non-delivery of the sold assets is created by the right of option which is chosen by the parties. Thus, it is permissible for the parties to agree on not to deliver or take delivery of the goods for a period. In financial options, this view may be adopted in that the buyer pays full amount for the goods or shares of a particular company. The goods or shares may be identified and delivery is deferred based on options. The seller is given the chance to use the amount of the money for the period of option or before maturity. The buyer is given the chance to think of the deal and measure all risk factors. If the buyer decides not to continue the deal, he may recover his fund without any loss whereas the seller is able to use the money paid during the period of option.

## **17. Conclusion**

The main purpose for the option in Islamic law is risk management in various forms. This objective is available in conventional options. Therefore, there are areas in Shari'ah based options that are comparable to financial options and the differences are many. For this reason, Shari'ah options may not stand strong as basis for financial options. It is necessary to find solutions in other areas of Islamic law. The concept of financial options was examined under the principle of sale. The paper examines the concept of *arbūn* sale that plays a significant role in mitigating risks for both the buyer and the seller. The buyer is given the chance to think about the deal and the seller is protected against the loss of waiting, if a better deal comes up. However, this concept too is not similar to the concept of financial options from many respects.

The concept of sale of rights seems to be a good area of law that may help in the issue of financial options. This area needs thorough investigation from both the Shari'ah scholars and practitioners in order to come up with viable alternatives to risk management tools that are lacking in the Islamic banking and finance. The non-permissibility in exchanging of the rights does not apply without exceptions. Thus, there is possibility to find some principles that meet the objectives of financial options. It is not necessary that we have to allow the financial options in the form they are practiced in the financial markets.

## Notes

- <sup>1</sup> On the details of the benefit of financial options, see El-Gari (1993).
- <sup>2</sup> See AAOIFI (2004), pp. 269-271.
- <sup>3</sup> See Abu Ghuddah (1985), p. 50.
- <sup>4</sup> Muslim, *Sahih*, vol. 3, p. 1164, Hadith No. 1532.
- <sup>5</sup> See al-Buhuti, *Kashshaf al-Qina'*, vol. 3, pp. 200-202. For details of these options, see Abu Ghuddah (1985).
- <sup>6</sup> See Obaidullah (2001); Islamic Fiqh Academy (1990) pp. 1273-1385; and Islamic Fiqh Academy (1992), pp. 73-355. These pages discussed rules of financial markets, including options and some of the papers investigate options from the perspective of *khiyār al-shart*.
- <sup>7</sup> There are more than thirty-five forms of options in the *fiqh* literature. The juristic details of these options are provided in Abu Ghuddah (1985).
- <sup>8</sup> See Ibn Majah, vol. 2, p. 789.
- <sup>9</sup> The jurists did not dispute the fact that option for defect is exchangeable in monetary terms because the defect has an effect on the pricing of the subject matter.
- <sup>10</sup> See Abu Ghuddah (1985), p. 68.
- <sup>11</sup> See al-Qarafi (1923), vol. 3, p. 265.
- <sup>12</sup> See Abu Ghuddah (1985), pp. 87-94.
- <sup>13</sup> See El-Gari (1993).
- <sup>14</sup> See El-Gari (1993).
- <sup>15</sup> See al-Qurahdaghi (1992), p. 181.
- <sup>16</sup> See Abu Sulayman (1992), p. 314.
- <sup>17</sup> Abu Ghuddah (1985) p. 100.
- <sup>18</sup> See El-Gari (1990), p. 1613-1614.
- <sup>19</sup> Ibid.
- <sup>20</sup> See El-Gari (1990) and also Obaidullah (2003).
- <sup>21</sup> See, al-Zailai (undated), vol. 4, p. 2; al-Dassuqi (undated), vol. 3, p. 2; al-Ghazali, Abu Hamid, *al-Wajeez*, vol. 1, p. 80; and al-Buhuti (undated), *Sharh Muntaba al-Iradat*, vol. 2, p. 139.
- <sup>22</sup> By floating it means the contract stands between being executed or being dissolved. The outcome of the contract would depend on the occurrence of an event or a future effective date of the contract.
- <sup>23</sup> This contract is, in legal language, a contract in which performance is tied to occurrence of another potential event in a particular manner, such as this item is sold

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to you with 1000 *dinārs* provided so and so sell to me his house. Thus, a consequential contract revolves around an event that is not in existence at the time of contracting, but which may potentially exist in the future. This is different from *muḍāf* contract which takes place in the future time.

<sup>24</sup> See Ibn Abidin, *Hashbiya Ibn Abidin*, vol. 4, p. 324.

<sup>25</sup> See Ibn Abidin, *Hashbiya Ibn Abidin*, vol. 4, p. 324.

<sup>26</sup> See al-Darir (1990), p. 160.

<sup>27</sup> See Ibn Qayyim (1973), vol. 2, pp. 27-30; and al-Darir (1990), p.p. 157-168. This view is espoused by some modern scholars such as Ali al-Khafif, Mustafa al-Zarqa, and Muhammad Salam Madhkur.

<sup>28</sup> Ibid.

<sup>29</sup> See El-Gari (1993).

<sup>30</sup> See Kamali (2001), p. 357 as quoted by al-Amine (2005), p. 75.

<sup>31</sup> See Vogel (1998), p. 126.

<sup>32</sup> See al-Zuhaily (1982), vol. 4, p. 449.

<sup>33</sup> See al-Zuhaily (2000), p. 10.

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> al-Bukhari, vol. 2, p. 981; Ibn Qayyim (1973), vol. 3, pp. 388-389.

<sup>37</sup> See Islamic Fiqh Academy (2000), the resolution number 72 (3/8).

<sup>38</sup> See al-Amine (2005), p. 75-77.

<sup>39</sup> See al-Shawakani (undated), vol. 5, p. 173.

<sup>40</sup> See Ibn Abidin (1986), vol. 4, p. 501; al-Khafif (1952), pp. 31-32.

<sup>41</sup> See al-Shatibi (undated), vol. 2, p. 17.

<sup>42</sup> See al-Shafi'i (1961), vol. 5, p. 160.

<sup>43</sup> See al-Dabbo (1997), p. 226.

<sup>44</sup> al-Buhuti (2003), vol. 3, p. 152.

<sup>45</sup> See al-Dabbo (1997), p. 227.

<sup>46</sup> See al-Khafif (1952), p. 33.

<sup>47</sup> See al-Marghinani (undated), vol. 3, p. 46.

<sup>48</sup> See al-Khafif (1952), p. 35.

<sup>49</sup> See Ibn Abidin (1986), vol. 5, p. 51.

<sup>50</sup> Ibn al-Humam (1970), vol. 6, p. 428; al-Marghinani (undated), vol. 3, p. 46; Ibn Nujaim (1993), vol.6, p.88.

<sup>51</sup> Ibid.

- <sup>52</sup> See Ibn Abidin (1986), vol. 5.
- <sup>53</sup> al-Khafif (1952), p. 36.
- <sup>54</sup> In our view, *Shari'at al-Wujoob* is similar to trading in obligations.
- <sup>55</sup> See Usmani (1998), p. 77.
- <sup>56</sup> See Ibn Abidin (1986), vol. 4, 518, 520.
- <sup>57</sup> See AAOIFI (2004), p. 134.
- <sup>58</sup> Khan, Tariqullah (2000).
- <sup>59</sup> See AAOIFI (2004), pp. 116-117.
- <sup>60</sup> See El-Gari (1993).
- <sup>61</sup> See AAOIFI (2004), Sharia Standards on *Ijārah and Ijārah Muntabia Bitamleek*.
- <sup>62</sup> See al-Zhaily (1990), p. 1331.
- <sup>63</sup> See al-Shareef (1999), vol. 1, p. 98.
- <sup>64</sup> See Ibn Qudama (1983), vol. 3, p. 593.
- <sup>65</sup> See Shubir, Muhammad, "Khiyār al-Naqd wa Tatbeeqatihi fi Muamalat al-Masarif al-Islamiyyah", in *Bubuth Fiqhiyyah fi Qadayah Iqtisadiyyah Mua'sirah*, vol. 2, p. 698-735.
- <sup>66</sup> See Ibn Rushd (1952), vol. 2, p. 210.

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## Unresolved Issues In Islamic Banking and Finance: Deposit Mobilization

*Sayyid Tabir\**

### Introduction

Islamic banking effectively started in the 1970s with personal initiative of the concerned Muslims to address the problem of *ribā*. There was no initial working model to act upon, except the belief that interest-based banking might be replaced by banking on the basis of profit-and-loss sharing. This effort took place when the financial system at large, as also the regulatory environment, was *ribā*-based.

As against the above, the current position is that Islamic banking and financing has won recognition by international financial institutions, professional bankers and the academia. There are more than 200 Islamic financial institutions all over the world with investment funds in excess of \$250 billion. The annual growth rate of Islamic banking industry worldwide is 16%+. In some Muslim countries, total or partial transformation has taken place in favour of Islamic banking.

With the completion of the phase of creating a niche for itself, Islamic banking is now set to reach new horizons. A lot of work has been done in giving Islamic banking an international standard. AAOIFI has done commendable unification effort. IFSB (International Financial Services Board), established by central banks of several Muslim countries, is expected to take this effort further.

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Main work so far has been done in the area of Islamic financing. The deposit mobilization side has been taken for granted. It is, therefore, not surprising that a closer look reveals little difference between workings of interest-based banks and Islamic banks on the deposits side. Is the difference between Islamic banking and interest-based banking really thin on the deposit mobilization side? Or, is there some thing that is being missed? This paper addresses these questions.

This paper proposes a systematic study of (1) the issues in deposit mobilization, (2) their Shari‘ah-compliant solutions and (3) implications for Islamic banking. It takes note of players on the deposits plane, their legitimate goals/concerns, Shari‘ah -compliant financial products for doing the needful and the Shari‘ah issues in funds management. The argument runs as follows.

In section 2, the issues on the deposit side are outlined. In section 3, the conventional deposits scene is described. In section 4, potential options in the Islamic setup are outlined. In section 5, some practical issues in management of deposits according to the Shari‘ah are addressed.

## **2. Deposits Side of Banking - The Issues**

Other than the banks, players on the deposit scene pursue a variety of goals ranging from mere safekeeping of the funds to seeking stable income flows. There are also those who have other considerations that, in turn, necessitate keeping of funds with the banks. Table 1 gives a catalogue of these players and their concerns keeping in view the existing realities.

Every **instrument** serves a unique purpose for the **Savers**—owners of funds:

1. On one extreme, the owners of funds seek just safekeeping of the funds, presumably for payment purposes, with the help of banks. The instrument for this purpose is “**Demand Deposits**”.
2. At the other extreme, the savers are interested in investment of their funds for a fixed period with one-time settlement at the end. The relevant instrument is a term or fixed deposit, labelled in Table 1 as “**Investment Deposits**”.
3. In between the above extremes, depositors pursue a combination of the aforesaid goals. The banks offer **General Savings Deposits** for this purpose.

4. In a variant of the second case, depositors want an ongoing investment relationship with the banks for stable income flows. Such depositors include pensioners, widows and other vulnerable members of society who want fixed income over a stretch of period. These deposits fall under fixed income schemes offered by interest-based banks, and they usually carry some brand name.

**Table 1: Bank Deposits Scene – Instruments, Players and Their Concerns**

INSTRUMENTS	PLAYERS BY TYPES OF DEPOSITS	
	SAVERS (OWNERS OF FUNDS)	BANKS*
1. DEMAND DEPOSITS	Safe-keeping of funds with maximum flexibility in their withdrawal, but without seeking a return	Flexibility for gainful use of funds
2. INVESTMENT DEPOSITS (Term Deposits)	Investment for a prescribed time	
3. GENERAL SAVINGS DEPOSITS (Saving-cum-Investment Deposits)	Safekeeping of funds with flexibility in the withdrawal along with some return	
4. INVESTMENT DEPOSITS WITH STABLE INCOME FLOWS	Relatively safe Investment for a prescribed time**	
5. OTHERS	Management of payments and receipts	

\* Banks are mainly interested in working with funds without intervention by the owners of the funds.

\*\* These are risk-averse depositors who are willing to trade-off some return for safety of their money.

Last but not least, the clients may engage banks in order to look after their payments and receipts matters. In the process, they hold deposits with the banks.

**Banks**, on their part, want maximum flexibility in the use of the funds at their disposal with no or minimal interference by the depositors. They are commercial concerns interested in their return.

The issues of interest for us are as follows. What are possible contractual arrangements to regulate the bank-depositor relationship? What are their implications for management of funds at the banks' end? Answers to these questions are explored hereunder. We start with a recounting of the factual position in the existing interest-based framework.

### **3. The Conventional (Interest-based) Deposits Scene**

In first four of the aforementioned cases, the **contractual relationship** between owners of funds and banks is a **lender-borrower relationship**. In the **1<sup>st</sup> case**, namely Demand Deposits, the depositors are not interested in any return. The **2<sup>nd</sup>, 3<sup>rd</sup> and 4<sup>th</sup> options** are made attractive for depositors with provisions of interest payments. The return is predictable for the depositors in the case of ordinary Investment Deposits (the **2<sup>nd</sup> case**) as well as other Investment Deposits offering Stable Income Flows (the **4<sup>th</sup> case**). However, rate of return on General Savings Deposits (the **3<sup>rd</sup> case**) is at the discretion of the banks who employ a complex formula to determine the various depositors' entitlements to interest.

In the **5<sup>th</sup> case**, banks render a service, and receive funds for discharging it. But they also invest any idle balances in their own interest. Technically speaking, this implies that the ownership of funds is treated as if vested with the banks until a payment claim against the client arises. In this sense, there is again a lender-borrower relationship between the clients and the banks in respect of the unutilized funds.<sup>1</sup>

Funds in all of the above deposits are shown on the liabilities side of the banks. This is again an acknowledgement of the deposits being "debt" against the banks.

In the management of these deposits, banks follow an aggregative approach (see Figure 1). All funds, regardless of the category of the deposits or depositors, are put together in one financing pool. Banks make all advances from this pool. There is a financial year for accounting purposes. At the end of the year, banks do their financial closures. Income and expense are

taken into account, and profit and loss statements are prepared. Interest paid to the depositors during the course of the financial year is treated as expense for the banks.

#### **4. The Islamic Deposits Scene**

Our concern here is to identify the Islamic options. Direct comments on the existing practices are avoided in view of the sensitivities involved.

The Shari'ah options for deposit mobilization can be worked out by respecting two principles:

1. The aim of the exchange at hand must be recognized in the Shari'ah.
2. The modalities to achieve the said aim must be Shari'ah-compliant.

It is notable that the aims being pursued by depositors as well as the banks, as listed in section I, are not in conflict with the Shari'ah. We, therefore, proceed to the practical possibilities.

##### **4.1 Demand Deposits**

In this case, the depositors' concern is safe-keeping of funds with maximum flexibility in their withdrawal—without seeking any return. Banks, on the other hand, want to utilize the available funds at their discretion. Both these considerations can be accommodated by treating the deposits as (interest-free) “loans” from depositors to banks. A recourse to *amānah* (امانة) or *wadi'ah* (وديعة) is inadvisable for the following reasons:

- i) In the case of *amānah*, banks will not have the authorization to draw benefits from the funds while they are with them.
- ii) The Shari'ah has provided the *wadi'ah* for situations where usufruct of an asset is separable from the main body of an asset.<sup>2</sup> This is not true about money.

Compliance with the Shari'ah requirement of being explicit on the duration of loan can be addressed as follows. The tenure of the deposited sum can be set anywhere between 1-hour and 1-day after which the depositors may claim their money on demand.

It is worth mentioning that banks may offer overdraft facilities (counter-loans) on an interest-free basis to the depositors. This would be akin to giving a counter-loan in a Shari'ah-compliant way. However, the banks ought to respect the Shari'ah constraint of not offering any perquisites to the depositors. This is because, according to the *Hadīth* of Anas B. Malik, the

Prophet SAAWS has prohibited the creditors from drawing even trivial benefits from those indebted to them.<sup>3</sup>

#### 4.2 Investment Deposits

Investment deposits represent the case when owners of funds seek a return on their funds, and are willing to spare these funds for an agreed period. Three arrangements can apply here: *muḍārabah*, *mushārah* and *ijārah*. We explain them one by one.

##### *Muḍārabah* Deposits

A *muḍārabah* transaction requires that the contract be explicit on the following matters: goal or purpose of the *muḍārabah*, its tenure, role function of the concerned parties, profit-sharing ratio, principle for sharing losses, the extent to which indebtedness can be created in the name of the *muḍārabah* and the principle for final settlement.<sup>4</sup> It also requires that unless some payments to third parties become necessary for the discharge of role function of the working partner (*muḍārib*), personal expenses be borne by him and not charged to the *muḍārabah*. Against this backdrop, the following arrangements are conceivable.<sup>5</sup>

There can be more than one line of *muḍārabah* deposits in order to address diverse goals and concerns of the depositors. Each such line of deposits can be for a distinct purpose, and has separate starting and maturity dates.

A separate *muḍārabah* form may be prescribed for every *muḍārabah*. Whereas formula for distribution of the depositors' share in the profits among them may be a part of the general terms, the overall profit-sharing ratio in favor of the depositors must be separately stated for every line of *muḍārabah* deposits. However, if a *muḍārabah* involves rollover, such ratios may be announced periodically, say, at the beginning of every quarter, six months or year.

For illustrative purposes, one may consider a hypothetical example of a 4-month *muḍārabah* for financing, say, export trade:

- i) On some date, say, in the second half of a month, a bank may invite deposits for a 4-month export trade *muḍārabah* that would start operations on the 1st of the next month. The formula for distribution of the expected profits should be announced at the same time.

- ii) Deposits may be accepted one day before the start of the *muḍārabah* operations, and the *muḍārabah* would be truncated at the end of the fourth month. In order to avoid any accounting complications, the *muḍārabah* may be restricted only to those depositors who are ready to keep their funds with the bank for full 4 months.
- iii) Accounts for the *muḍārabah* are to be maintained separately from other accounts of the bank. At the end of the *muḍārabah* period, the bank can calculate the profits, keep its share and distribute the depositors' share among them on a proportional basis along with reimbursement of their respective deposit. This last point presumes that the share of each depositor in total profits would equal the fraction of his deposit in the total *muḍārabah* funds multiplied by the overall profit-sharing ratio in favour of the depositors.

The following points would also be relevant for the *muḍārabah*.

- i) The profit-sharing ratios might be set such that while the bank's concerns are addressed, depositors can also look forward to getting a reasonable rate of return that is consistent with market trends.
- ii) The bank may utilize the *muḍārabah* funds for export financing through both trading and partnership modes. In case the bank operates through a trading mode and some goods remain un-exported, the same can be valued at actual cost basis and treated as property of the bank for the settlement of accounts. If the bank employs money through a partnership mode, the same formula may be used with either the bank or the other partner(s) claiming the output and settling the accounts.

As mentioned above, there can as well be separate *muḍārabahs* for different lines of business. Their starting dates and maturity periods may be the same or different. This will enable banks to accommodate the depositors according to the ability to spare funds as well as their risk-return preferences.

### ***Mushārahah* Deposits**

On the above pattern of *muḍārabahs*, banks may also invite **deposits on *mushārahah* basis**. The wisdom behind such an arrangement is simple: if a bank also commits a part of its equity, this will serve as signal of the bank's seriousness about profitable application of the funds for risk-averse depositors.

In general, the Shari'ah requirements for a *mushārahah* are the same as those noted above for a *muḍārabah*. However, it should be noted that the

*mushārahah* option can be construed as sharing in both capital and effort. There is no hard or fast Sharī‘ah rule for the quantum of effort to be put in by any partner. Therefore, banks may restrict the active involvement of depositors to just receiving the financial reports and reviewing them.

#### **Investment Deposits under Bank Management - The *Ijārah* Option**

This interesting possibility is employed in the Iranian banking system.<sup>6</sup> It can work like the foregoing example of *muḍārahah*, but with following differences.

According to this option, ownership of funds always remains with the depositors, and is at no stage shared with the banks (as opposed to the case of *muḍārahah* or *mushārahah*) or transferred to them (as in the case of a loan). The banks come in the picture as manager (or, *ajeer* (أجير)) of depositors to administer the funds.<sup>7</sup> Under these circumstances, owner of the funds and, hence, all profits belong to the depositors. The banks would be entitled to a fee.

The bank fee needs to be fixed in advance. It can be a lump sum amount or some percentage of the funds involved, to be debited to the various depositors according to some prescribed formula. In any case, this fee cannot be supplemented by a share in the profits. That would tantamount to clubbing an *ijārah* (employer-employee) contract with a partnership agreement. This is not permissible in the Sharī‘ah due to the potential of conflict of interest at the bank’s end.

It is worth mentioning that there is no Sharī‘ah bar on the banks claiming their fee in advance. However, prudent banking practices would require it—or, a larger part of it—to be payable at the end of the deposit period.

#### **4.3 General Savings (or, Saving-cum-Investment) Deposits**

These are hybrid of Demand Deposits and Investment Deposits. The depositors are interested in the safekeeping of their money with flexible withdrawal terms and some return. Two possibilities exist here:

- i) The deposits can be replaced by units of a growth fund—or, a mutual fund—that are encashable at any time. Of course, it would be essential that the growth fund, in turn, represents a Sharī‘ah permissible investment portfolio that is also relatively risk-free. In this case, the depositors would be buying (selling) the units in order to become part of (come out of) the growth fund. However, they may have to forsake the flexibility of withdrawing funds in small

amounts, as at present in the framework of interest-based savings deposits.

- ii) Fresh accounting conventions can be developed that are compatible with the Shari‘ah and allow for daily calculation of profits and losses.<sup>8</sup> Technically speaking, this will enable the conversion of the *muḍārabahs* and the *mushārahahs* into **revolving or perpetual muḍārabahs and mushārahahs**, respectively. This, in turn, would help the depositors get into and, more importantly, come out of the *muḍārabah* or *mushārahah* accounts at their convenience. Along with this arrangement, banks may also offer composite accounts in which one of the two accounts is essentially an interest-free account, technically a loan to the bank, that might be drawn upon to meet the depositors’ emergent cash needs.

#### **4.4 Investment Deposits with Stable Income Flows**

The goals at the depositors’ end in this case are two fold: security of their capital, and stable—rather, fixed—income flows. These twin goals may be achieved as follows:

1. The deposits can be invested in Shari‘ah-compliant fixed income securities, such as those based on leasing. Alternatively, funds can be utilized in relatively low-risk Shari‘ah-compliant investments. There may also be the possibility of having a diversified investment portfolio to minimize risk.
2. The contract between a bank and a depositor may stipulate withholding and reinvestment (by the bank) of any excess profits due in favour of the depositor. And, the contract may have provisions for temporary loan from the bank to the depositor to cover any shortfall when the profits earned fall short of the prescribed amount. Such a loan can be adjusted against the profits realized in subsequent periods.

Both the design and practice of an instrument along the above lines, offer a great challenge for Islamic bankers.

#### **4.5 Special Accounts**

Notwithstanding their role as financial intermediaries, banks have now become the mainstay of the modern payments system. Governments, public sector organizations, companies and businesses of all sizes depend on the banking system in order to pay to their staff and suppliers. Except in cases of

transfer of funds against cash payments, the clients maintain balances with banks for payment purposes. In this regard, the thinking needs to be clear on four issues:

- i) the legal relationship between the banks and their clients;
- ii) the type of account that would serve the clients' needs and suit the banks as well;
- iii) the banks' stake in the arrangement, whether in lump sum or on a transaction-by-transaction basis; and
- iv) the banks prescribing minimum balance requirements for their clients and charging penalties in the event of a default.

Let us consider the case of the government using the medium of banks for making and receiving payments. In principle, the government can have its own disbursement officer in order to give salaries and to make other payments. Quite obviously, efficiency and safety considerations necessitate recourse to the banking system. This perspective immediately draws attention to two points:

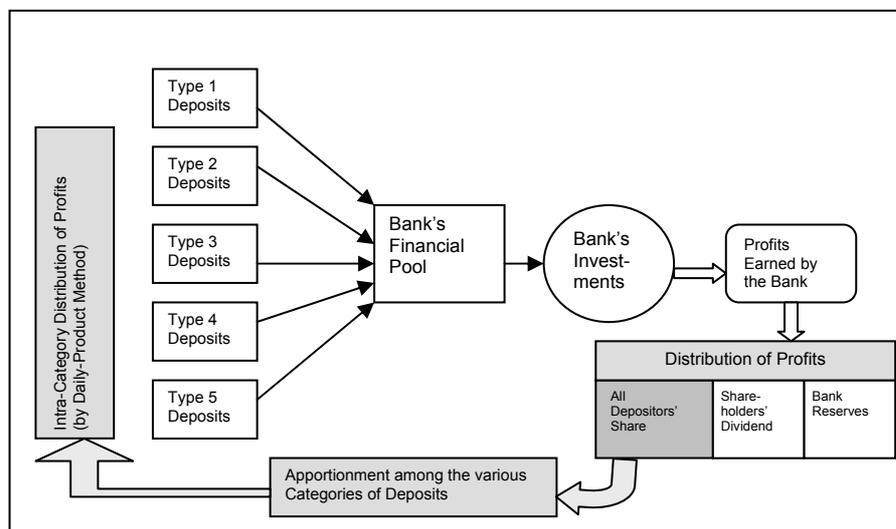
- a) The banks role in doing the needful would be similar to that of an employee of the government. The employee-employer relation between a bank and the government can be accommodated in the framework of the *ijārah* contract.
- b) The banks may claim compensation that can be a lump sum wage, a fraction of the sum involved, a per person fee in the case of disbursement of salaries or a per cheque fees in the case of payments to third parties.

The funds to be kept with the banks ought to be handled as interest-free loan for two reasons:

1. The *amānah* contract will not be feasible and the *wadī'ah* contract not admissible for reasons noted earlier.
2. An *ijārah* contract can be supplemented by a loan contract, though not vice versa. This will also give the banks the flexibility of using any idle funds held with them as loans till such time as they are needed to make the necessary payments.

Keeping in view these factors, payments services can be sought from the banks through supplementing the existing current account medium to an *ijārah* contract, not the other way round, between an interested party and a bank.

As for banks prescribing minimum balance requirements for the said accounts, the idea is admissible for the following reason. The basic framework for the above arrangement is an employer-employee relationship. And, provision of sufficient funds is the client's responsibility. If, therefore, the client defaults, this entitles the other party to abrogate the existing contract and seek a fresh contract. The financial penalty by bank would serve the purpose of compensating the bank for entering into a fresh contract.<sup>9</sup>



**Figure 1: Deposits and Their Management by Conventional Banks**  
 (Type 1, Type 2, Type 3, Type 4 and Type 5 Deposits correspond to the five categories in Table 1.)

## 5. Practical Issues in the Management of the Deposits

In the existing interest-based system, banks' obligations to depositors consist of paying back the principal along with pre-agreed interest, depending on the case at hand, in the framework of lender-borrower relationship. The nature of contractual relationship and obligations thus has the following implications, partially noted in section II:

1. The banks follow an aggregative approach to the management and financing of deposits (*Figure 1*).
2. All deposits appear as liability on balance sheets of the banks.
3. Interest payments to depositors are treated as bank expenses.

Two more points are also noteworthy:

1. In general, initial instalments paid by the borrowers are counted toward recovery of interest, and treated as bank income.
2. Banks can also meet their operating expenses out of funds in the deposits.

Prudential regulations are prescribed by the central bank in order to ensure solvency of the banks. The Shari‘ah, however, gives rise to issues of a different sort for Islamic banking. These are discussed below under three headings: management of accounts, admissible operating costs for partnership-based deposits and reporting matters.

### 5.1 Management of Funds in Various Categories of Deposits

Islamic banks at present follow the aforementioned aggregative approach used by interest-based banks (*Figure 1*) for the management of funds.<sup>10</sup> This practice needs review, especially for investment deposits. Some of the reasons are noted hereunder.

*Ahkām* of the Shari‘ah are given at the micro level. The Islamic position on ownership implies that if someone does business with his money, then the goods purchased, proceeds from their sale and the profits (= sale proceeds minus costs) also belong to him. Others would require his express willing consent (*An-Nisaa’* 4: 29) before they can exercise any claim on these profits. This principle carries over to two-person *muḍārabah* as follows.

As noted in section III.2, *muḍārabah* is a limited purpose arrangement for a specified period. The provider of capital shares its ownership with the *muḍārib*. This enables the *muḍārib* to exercise his discretion on the funds—of course, according to the stipulated purpose of the *muḍārabah*. And, there is no need for fresh approval of the ultimate owner of funds for every action taken by the *muḍārib*. This joint ownership means that profits, if any, belong to both the parties.<sup>11</sup> Accordingly, the *muḍārabah* is consummated with division of the profits between the partners as per the agreed formula, of course, along with the owner of capital getting back his funds.

*Ahkām* for *muḍārabah* or *mushārahah* between bank and its depositors are logical extension of the above principle. Consider first the simple case of there being only one line of *muḍārabah* deposits **Muḍārabah 1** offered by an Islamic bank. The working of this *muḍārabah* is shown under **Muḍārabah 1** in *Figure 2*.

The bank comes in the picture with its effort to invest the Investment Pool-1. Proceeds from the *muḍārabah* operations consist of capital of the *muḍārabah* (contributed by the depositors) and profits. The capital and agreed share of the depositors goes to them, and the bank gets its share of the profits. Ultimately, every depositor gets back his actual deposit and proportionate share in the total profits going to the depositors. Bank's share of profits forms part of its income.

Next, let us bring into picture another line of investment deposits: ***Muḍārabah 2***. The foregoing argument applies separately to this category of deposits. The reason is that depositors in this category are different from those in ***Muḍārabah 1***. With the matters handled in this way, interests of the two groups of depositors do not mix up. And, the bank also achieves its goal of earning income through providing investment services to the respective owners of funds.

The foregoing argument applies to any number of *muḍārabahs* or *mushārahahs* that a bank may enter into with depositors. As against this, the aggregative approach frees the banks from the need for maintaining separate accounts for investments made on behalf of different categories of investment deposits. A redress for the above issues is sought through use of the daily-product method for distribution of profits.<sup>12</sup> However, conflict with the Shari'ah is not resolved for the following reasons:

1. There always remains the possibility of profits actually belonging to one group of depositors being passed on to another, and losses of one category of deposits shifted to another.

This issue cannot be ignored as either trivial or irrelevant on grounds of no objection from the depositors. The Shari'ah is a Divinely-ordained code of acceptable conduct. Where the lines are clearly drawn by Allah SWT and His Prophet SAAWS, there is little room for human discretion (*al-Hujuraat* 49: 1).

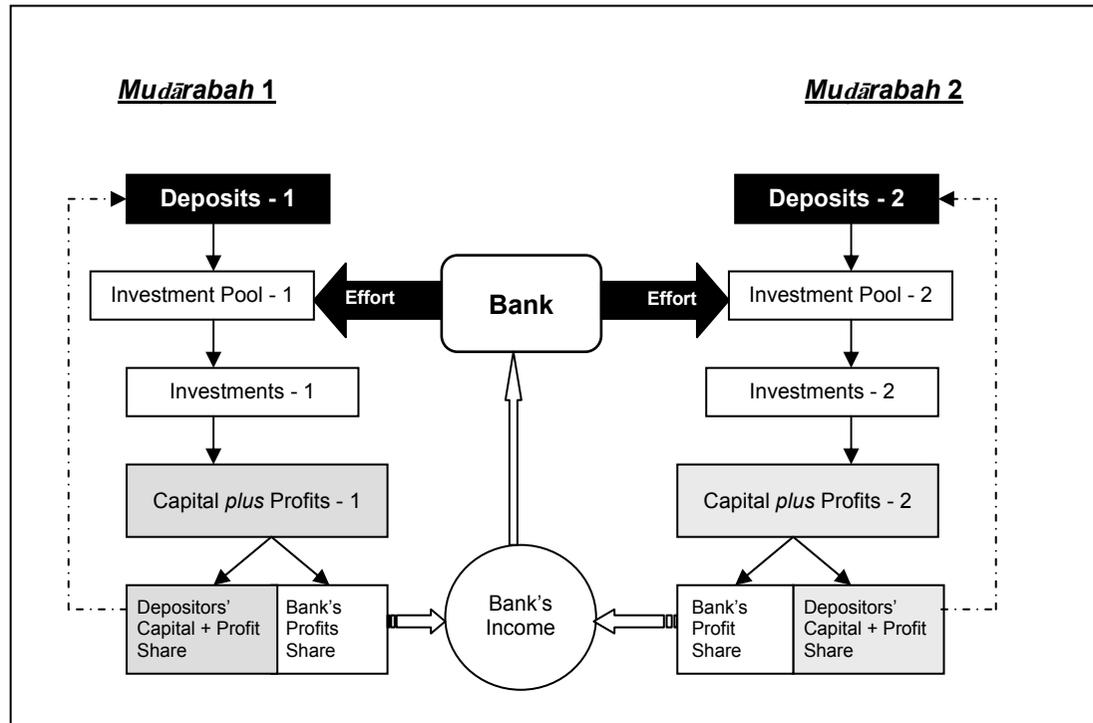


Figure 2: Management of Partnership-based Deposits

2. Application of the daily-product method along with reduction in the period in the calculation of profits and losses may lessen the above problem. But reliance on the daily-product method needs review for the following reasons:
  - i) It is well-known that *ijtebād* in the sense of taking a new position is admissible when the Shari‘ah is silent on a matter. Thus, one could make recourse to daily-product method if the Shari‘ah were silent on principles for settlement of accounts. But, as noted above, this is not the case here.
  - ii) The daily product formula applies *ex post facto*. Thus, a depositor cannot form an opinion about his actual share, in percentage terms, at the time of entering into the contract. In this sense, the daily-product arrangement has *gharar*.
  - iii) The principle of willing consent (*An-Nisaa’* 4: 29) of the actual owners—depositors in the present case—needs to be respected in both letter and spirit in the design of any settlement arrangement. This, in turn, requires that there should be some arrangements for bringing into the picture the depositors’ point of view after profits actually arise, not before. The daily-product method misses this point.

The above problems are avoided if investment of the deposits in different categories and their accounts are separately maintained.

In passing, it may be mentioned that the *fiqhī* principle of *الخراج بالضمآن* warrants that the banks also shoulder the obligations for Shari‘ah-compliance, as proposed above, in order to justify their entitlement to profits allowed to them by virtue of economies of scale.

Notwithstanding the above, however, a disaggregated approach to management of funds has its own advantages. For example, separate handling of deposits in different categories and the maintenance of separate accounts for them will reduce the chances of bank failures, and improve banking stability. It is noteworthy that this may be achieved without limiting the range of financial products for the depositors. For example, there would be relatively low risk deposit schemes like multipurpose *muḍārabahs*, *mushārahahs* with banks committing their own funds and mutual funds type arrangements. Similarly, investment deposits with different maturity periods, ranging from short to long, and mutual funds type financial products may serve needs of short-term as well as long-term investors.

## 5.2 Admissible Operating Costs for Partnership-based Deposits

Banks are legal entities. It is noteworthy that a bank's legal person includes its buildings, furniture & fixtures and permanent staff. Banks perform their promised functions for partnership-based on the strength of these elements. If one takes out these things, a "bank" would lose meanings for the depositors. The following point need to be appreciated against this backdrop.

In principle, in a *mudārabah* personal expenses of the *mudārib*—the working partner—are his personal responsibility. And, only those expenses are admissible as costs of the *mudārabah* that are payable to third parties in lieu of *mudārabah* operations. This principle also applies to working partners in the framework of *mushārahah*.

A corollary of the above principle is that banks should not claim their overhead expenses as costs in the management of *mudārabah* - or *mushārahah*-based deposits. Of course, they can address their concerns in this regard through claim a higher percentage of profits for themselves. Moreover, if need be, they can seek interest-free loans from the *mudārabah* or *mushārahah* pools in order to meet contingencies, and adjust these loans against their share of profits.<sup>13</sup>

## 5.3 Reporting Matters

At present, Islamic banks report all deposits as their liabilities, and all their advances (bank "investments") as assets in their balance sheets. This principle may be adopted for deposits acquired on a loan basis, such as demand deposits, but not for investment deposits mobilized on partnership basis. The reason is that ownership of funds under *mudārabah* or *mushārahah* rests with the depositors. The banks "share" this ownership just for operational reasons. Since their ownership is not transferred to the banks, such deposits are not "liability" of banks in the traditional sense. By the same token, any investments made from such deposits are assets of the banks alone.

The above considerations require that investment deposits and financing from them should be off-balance sheet items for Islamic banks, and only their share of profits should appear in their income statements.

## 6. Concluding Remarks

Islamic banking started with preoccupation with the problem of *ribā* in bank financing. For some reason, the case of deposits did not come up for scrutiny. However, it may not be too long before the depositors start to ask: what is the material difference, from the Shari'ah point of view, between Islamic banks and interest-based banks? This, in turn, requires that some steps be taken sooner than later so that depositors do not lose trust in Islamic banking. It is hoped that the leads provided in this paper will be pursued further in order to establish models of Islamic banking above reproach.

One may claim that treating each *muḍārabah* and *mushārahah* separately for accounting of revenues, costs and distribution of profits may reduce the asset diversification benefits, through an Islamic bank, for the depositors. This need not be so for the following reasons. Firstly, banks may introduce multipurpose *muḍārabahs*. Extension in the scope of *muḍārabah* will have the same risk-reduction implications as are associated with a diversified investment portfolio. Secondly, as noted earlier, *mushārahah* deposits are effectively a signal to depositors about safety of their deposits. Prudential regulations for investments and maintenance of separate bank accounts for the various lines of deposits can further strengthen this purpose. Thirdly, mutual funds type arrangements may come into existence to attract such depositors. Last but not least, competition among Islamic banks will ensure availability of a wide range of financial products for all kinds of depositors.

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## Notes

<sup>1</sup> Absence of this thing would call into question legal justification for the banks investing the funds and keeping the profits unto themselves.

<sup>2</sup> *Amānah*, *wadī'ah*, *bay'ah* (trading), *ijarah* (leasing), *shirkah* (partnership) and *qard* (loan) represent Shari'ah arrangements to address particular situations. For example, a person might want someone to temporarily look after his thing without transferring the ownership or allowing the latter use it. *Wadī'ah* becomes relevant when the thing at hand also needs to be tended to and it yields some benefits as well. For example, a farmer, proceeding to Hajj, may leave his cow with his neighbour for safekeeping. Neither the owner wants to sell, nor the neighbour wishes to buy the cow. The cow needs to be fed, and also gives milk. Simple *amānah* cannot help here. Thus, *wadī'ah* comes in the picture.

It is noteworthy that in the example of cow, the asset and its usufruct are separable. "Money" does not have this attribute. It is fungible: it exhausts itself in the process of use. It can as well be left idle. In view of these factors, money is not fit to

be the subject of a *wadī'ah*. If, however, a bank indeed wants to utilize the depositors' money, it can make invoke the Sharī'ah option of getting it either as a loan or on a partnership basis.

<sup>3</sup> See *Ibne Majah* (Sakhar, 1995), Ḥadīth No. 2423.

<sup>4</sup> See IIIE (1999), pp. 54-7, for these and other practical matters related to modarabah and *mushārah*.

<sup>5</sup> Details of these and other partnership-based arrangements for deposits mobilization are available in IIIE (1999), pp. 60-1.

<sup>6</sup> See Mahdavi (1995).

<sup>7</sup> Of course, when the bank will be acting on behalf of the depositors while managing their funds. In this sense, it would be their attorney or *wakeel*. Notwithstanding this, the legal relationship between the depositors and the bank would be that of *ajir* and *ajeer*, i.e., employer and employees, respectively.

<sup>8</sup> In principle, such a step is also necessary for Sharī'ah-compliant mutual funds.

<sup>9</sup> It should be clear that this logic cannot be extended to ordinary demand deposits because the primary relationship between depositor and bank is a lender-borrower relationship. It also does not apply to partnership-based deposits, because the choice for a bank is between offering or not offering such deposits, and issue of minimum balance does not arise in "loans".

<sup>10</sup> See, for example, Bank Islam Malaysia Berhad, p. 47 and Chapter IV (Accounting Procedures).

<sup>11</sup> The incidence of monetary loss on the owner of capital is for the very reason that funds belong to him. Of course, the *mudārib* too suffers losses in the form of his effort going unrewarded.

<sup>12</sup> See CII (1991) pages 48-51.

<sup>13</sup> See IIIE (1999), p. 55.

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## **Financial Distress and Bank Failure: Relevance for Islamic Banks**

*Salman Syed Ali* \*

### **Introduction**

Banking crises are particularly harmful for the economy and detrimental for the health of financial sector. The cost of any banking crisis is not the fiscal burden on government because it is simply a redistribution within the economy—though, this redistribution can have second order welfare effects in terms of envy and dissatisfaction etc. But the real cost of a banking crisis is (i) the deadweight loss and (ii) the consequence of any diversion in macroeconomic policy forced by the crisis. In context of Islamic banking the cost also is the reputation damage to the nascent industry; a slowdown in new developments towards interest free alternatives for the people; and consequently a drag on realization of potential benefits for the society from Islamic finance.

However, a milder crisis has its advantages too. That it may help avert a more serious crisis. It may improve the efficiency of the banking sector by shaking out the inefficient banks. It may force practitioners and researchers to think hard for better approaches to run the financial system. Thus, theoretically speaking, a few and small crisis are better than no crisis at all because they keep the system on guard such that the long run benefits may outweigh their costs.

The literature on banking crisis identify that the banking structure by its nature is unstable and therefore itself contributes to the occurrence of crisis. Being a deposit taking institution the liabilities of a bank are fixed and a fixed interest is promised on them, while its assets in the form of loans are subject

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to credit risk and earn variable interest leading to interest rate risk. Similarly, its demand deposits are of shorter maturity while its loans are for longer duration. Therefore there always exists a risk of maturity mismatch. These features render the banking sector prone to crisis in wake of any shock or decreased confidence of the depositors.

As opposed to this the literature on Islamic banking show Islamic banks to be more stable in theory. According to this literature (e.g., Khan 1987, Ahmed 2002, etc.) linking of returns on deposits with returns on assets of the bank serves as a disciplinary device and increases the efficiency of the bank and the financial system. It also serves as a stabilization device saving the banks from deposit runs in crisis situation. Because when the value of assets of the bank decline due to some shock the liability of the bank also decreases correspondingly due to profit sharing nature of the deposit contracts. Thus, preserving the net-worth of the bank. This feature adds to the stability of individual bank, and by avoiding a domino effect also adds to the stability of the financial system as a whole.

However of recent, some Islamic banks have shown signs of financial distress and few had been forced to close their operations.<sup>1</sup> Why this has happened? To what extent the causes of financial distress and failures identified for the conventional banks are relevant for Islamic banks? What factors are unique to Islamic banks? To our knowledge, so far there has been no systematic study or analysis on Islamic banks failure. This study is a first step in this direction.

In this paper we survey the causes of bank failure and banking crisis, evaluate their relevance to Islamic banks, identify new dimensions that are particular to the structure of Islamic banks. The paper can be thought of as a backgrounder to more detailed analysis and case studies of causes and consequences of financial distress of Islamic banks.

## **2. Structural Context of Crisis in Islamic Banking**

While the Islamic principles of finance are old and well established, 'Islamic' banking has evolved in modern times in particular circumstances and often in environment unsupportive of its growth. A combination of religious, economic, political and other historical factors have influenced the development of its structure. The structural evolution of Islamic banking itself has bearing on the issue of financial distress of Islamic banks.

Initially the Islamic banks were conceived on the concept of two tiered *mudharabah* or in some cases as investment companies. But they were governed

by regulations made for conventional banks which gave rise to particular structure of their assets i.e., greater proportion of *murābahah* financing. Islamic banks have been few and their competition with the well established conventional banks was intense. They were formed with community efforts, in most cases their capitals were small and the scale and the scope of operations limited. Thus they were not able to diversify and also could not bank on each other. Due to tax advantage and legal reasons many of them came up as off-shore banking institutions and hence subject to different regulations than the jurisdiction that they served.

In many countries, despite the knowledge of prohibition of interest and a desire for its abhorrence among the masses and the ways out pointed by intellectual research, the efforts for practical implementation of Islamic finance did not come from public institutions like governments but from individuals or small groups. Since the practical efforts were only from relatively few individuals – i.e., those who could put up large amounts of wealth in establishment of new institutions – Islamic banks tended to become closely owned entities. And in many instances owned and governed by only one or very few wealthy people. Thus, started as voluntary effort by few wealthy individuals for the noble cause of breaking a new path eventually became one man controlled banks. In such circumstances a third party's ability to influence the owner—chairman of the bank started to matter in decision making instead of collective wisdom or professional management. All these structural features discussed in this and the previous paragraph contribute to susceptibility of Islamic banks to financial distress.

Further, the structure of the conventional banking sector also has bearing on the stability of the Islamic banks. While an ideal Islamic bank operating on profit and loss sharing basis both on its asset and liability sides may be more stable than a conventional bank, a crisis that may develop in the conventional banking sector can potentially affect Islamic banks through contagion effect as well as through a general loss of confidence in the banking sector.

Finally, Islamic banks have some features that are distinct to them. And, there are many other features that are similar to conventional banks both in theory and in practice. Therefore among the causes of financial distress in Islamic banks some unique while many common causes can also be identified.

Future evolution and stability of Islamic banks and financial institutions will be influenced by the trend of financial liberalization; development of other non-bank financial institutions; financial innovations; development in e-banking that has the potential to integrate the geographically dispersed

pockets of areas where demand for Islamic banking exists; and coming into being of support institutions that provide conducive financial infrastructure. Current trend in Islamic banking is to develop new financial products useful for Investment banking and to expand in retail and commercial banking with provision of other financial and payments services to the customers.

### 3. What Distinguishes an Islamic Bank

In order to identify the causes of financial distress for an Islamic bank and possibility of its failure it is important to understand the distinguishing features of an Islamic bank. Islamic banks are financial institutions characterized by:

- Commitment to shun interest based transactions.
- Commitment to promote *ribā*-free alternatives.

Further from the view point of their operations, they are:

- Deposit taking institutions, which are neither the lending institutions nor simply a reseller of commodity on credit; while it does *muḍārabah* it also involves itself in investment banking and financing on profit sharing principles.
- Have two types of deposits, namely demand deposits and investment participation deposits. While Islamic banks' demand deposits are loans from the depositor to the bank, its investment deposits are unsecured, capital-uncertain claims. Instead of a fixed promised return, the bank shares its profits and losses with its investment deposit holders. It therefore implies a strong element of trust and sound business judgment.
- Profit and Loss sharing on the liability side and profit sharing on the asset side is a unique feature of Islamic bank that directly links its asset and liability sides. This feature is thought to make it more stable entity than a conventional bank in which deposits constitute capital certain fixed liability while the asset side is value uncertain.

It is a common observation that clients (seekers of fund), on average, require funds for longer periods of time than that for which depositors, on average, are willing to enter into *muḍārabah*. Thus maturity transformation is one essential function of an Islamic bank like it is an important function of a conventional bank.

Whereas all investment deposit taking by Islamic banks is on *mudārabah* basis. It has been observed that clients who require funds, on average, prefer to get funds on *murābahah* basis than on partnership basis. *Murābahah* cannot be re-priced nor could be sold on a premium or discount at the time of liquidity need by the bank. So, even if the assets and liabilities of the bank are (on average) of the same lengths of time but non-synchronous in period, then there is a liquidity risk for the bank. Thus liquidity synchronization and management is also a function of Islamic bank which is not as important in conventional banks because their loan assets can be sold.

To the extent the banks deposit serves as money—the means of payments, the banks find themselves at the centre of payments system. Its efficiency is vital for the broader economy. To the extent the bank deposits serve as asset swap—privately negotiated value instruments, the banks will find themselves at the centre of valuation system, such as stock and equity markets.

#### **4. What Causes Financial Distress and Crisis in the Banking Sector**

The many experiences of the financial distress of individual banks and crisis of the banking sector as a whole in the conventional banking industry has taught us many lessons. Various causes of financial distress and banking crisis have been identified in the policy oriented literature on the subject. The clinical picture, to use the terminology of medicine, is similar in all such episodes that the affected banks are infected much earlier than realized by the regulators. Once the problems magnify they are realized and cause financial distress for the bank. It some times develop into a generalized crisis if other banks also get affected. The future course of the problems depend upon how accurately the regulators can identify the exact causes and what actions they take. The speed of corrective action, resources available in the system for this purpose, and contingency arrangements in place before the crisis also matter.<sup>2</sup>

Caprio and Klingebiel (1996) point out the reasons for the delayed realization of a bank's troubles. They point out that the banks are different from non-financial firms in that the output and production processes of non-financial firms are more transparent than that of banks; where most of the banking products or services include a promise to pay in the future. While the bad performance of the non-financial firms are immediately passed on to the shareholders and its debtors take queue from the falling prices there is no such mechanism for the banks who can hide their losses by raising more deposits, betting on high risk high return areas or work a Ponzi scheme.

Opacity of bank loans (and allocations) make them harder to sell at the time of liquidity need hence sales are possible only at deep discounts increasing the losses. Thus banks in trouble have the incentive and ability to delay loss recognition. This also leads to deterioration of incentives of the owners and managers of the troubled banks to manage it efficiently and prudently.

On the side of theoretical literature that tries to explain the banking and financial crisis and its causes a bulk of it addresses the issue at aggregate level (generalized crisis) rather than at the level of individual bank failure. It deals with general financial crisis and attempts to model banking as well as sovereign financial crisis.

Among this category, the older literature seeks explanations in the macroeconomic imbalances.<sup>3</sup> It pins the cause on economic fundamentals in light of the financial crisis that took place in Latin America. However, it is more focused on currency crisis, though the same can be applied to the banking and general financial crisis. The policy implication is to adjust the macroeconomic fundamentals through prudential fiscal and monetary measures. But the financial crisis of East Asian countries occurred despite sound economic fundamentals, which called into question the validity of these models.

A second generation of theoretical models to explain financial crisis suggest the central role of expectations and coordination failure among creditors, so the crisis can occur independent of soundness of economic fundamentals.<sup>4</sup> In context of a banking crisis it means that irrespective of solvent position of a bank (or of the banking sector as a whole) if a random event can adversely change the collective expectations of the depositors (i.e., its creditors) then it can precipitate a run on the bank and on the banking system. Thus there can be a range of economic fundamentals over which this type of a pure liquidity crisis can occur. These models are deficient from policy perspective in two ways. First, they do not predict why and when crisis may strike because it is based on some random event generating a sudden coordination of expectations. Second, they do not inform us what to do to contain the crisis.

A third generation of theoretical models attempt to overcome the above shortcomings by redefining the fundamentals more broadly to include micro incentives and policies.<sup>5</sup> Some other models allow interaction between fundamentals and beliefs so that a crisis is triggered by both factors working together not by any one in isolation.

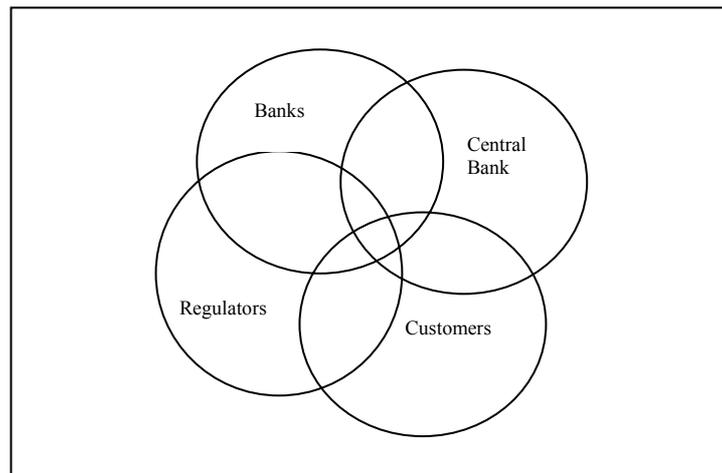
Among the category of theoretical literature that deals with individual bank failure (or runs) are (i) the models that show instability of fractional

reserve banks on account of early withdrawals by depositors in response to changes in inter-temporal relative returns obtainable from the bank and from elsewhere (say asset markets). These are closer to the first generation models discussed above pertaining to category 1. (ii) There are models that explain bank failures (bank runs) arising from game situation between depositors and the bank with inefficient equilibrium. The inefficiency arises when there is a coordination failure among the depositors and they lose confidence in their bank.<sup>6</sup> These are closer to the second and third generation models of category 1 discussed above but pertain to individual bank failures.

## **5. Causes of Financial Distress—Policy Oriented Classification**

In this paper we want to approach the subject with policy perspective in identifying the causes of financial distress and banking crisis, and highlight the differences and similarities in importance of these causes for Islamic banks. We therefore take a more basic (fundamental) approach of listing the causative factors and comparing the relevance of each for Islamic banking.

Fundamentally, four important economic agents take part in shaping the banking environment; namely, the government, the central bank or the supervising authority, banks themselves and bank customers be they depositors or clients who borrow.



**Figure 1: Four Types of Economic Agents - Shapers of the Banking Environment**

Therefore, the causes of financial crisis in the conventional banking industry can be classified accordingly into following categories:

1. Those emerging from macroeconomic situation and policies which are mostly in control of the governments or planners.
2. Those emerging from microeconomic situation of individual banks and those arising out of the structure of the financial sector. This can further be divided between what is internal to the bank (i.e., bank's control) and what is external to the bank.

These are summarized in the following table.

**Table- 1: Causes of Financial Distress: A Classification**

CAUSES OF FINANCIAL DISTRESS AND BANKING CRISIS

<b>Macroeconomic Factors</b>	<b>Microeconomic Factors</b>	
<i>External to the Bank and the Supervisory Authority</i>	<i>External to the Bank (but in the direct control of the supervisory authority, central bank and government)</i>	<i>Internal to the Bank (i.e., in control of bank)</i>
<ul style="list-style-type: none"> <li>• Macroeconomic situation</li> </ul>	<ul style="list-style-type: none"> <li>• Supervision problems</li> <li>• Inadequate infrastructure</li> <li>• Financial liberalization policies</li> <li>• Political Interference</li> <li>• Moral Hazard due to deposit insurance</li> <li>• Lack of transparency</li> <li>• Fraud and corruption</li> </ul>	<ul style="list-style-type: none"> <li>• Banking strategy</li> <li>• Poor credit assessment</li> <li>• Taking interest rate or exchange rate exposures</li> <li>• Concentration of lending</li> <li>• Connected lending</li> <li>• Entering in new areas of activity</li> <li>• Internal control failures</li> <li>• Other operational failures</li> </ul>

The role of bank customers (depositors and clients) is also important. However, being large in number their decisions are not coordinated (except in situations of panics and mania when actions get coordinated in the form of a herd behaviour) therefore, for the time being we can abstract away from the role of bank customers as cause of banking crisis.

**1. Macroeconomic Situation** and the shocks that emerge in the economy outside the banking sector can be one cause of financial crisis. For example, a large and persistent current account deficit in a country can give rise to depreciation of its currency. If most of the liabilities of the banking sector are in foreign exchange or if the banks cannot adjust their liability—asset structure as fast as the home currency is depreciating, then the costs of carrying such portfolio increases eventually putting the banks in financial distress and can possibly trigger a financial crisis.

Such crisis originating through currency risk are more likely in countries with fixed or pegged exchange rate regimes if they ever face a sudden flight of capital. The central bank of such a country would have to support the home currency by depleting its foreign exchange reserves. Its inability to support the home currency would call for a sharp devaluation of the home currency. It can cause financial problems for the banks because they cannot adjust their portfolios that sharply and quickly.

In third world countries, excessive borrowing by the government creates an unsustainable financial position of the government. Therefore, sudden policy shifts take place by the government in its effort to survive or float the economy. Such sudden shifts change the explicit and implicit (effective) relative prices creating economic and financial squeeze in various sectors. If the bank is particularly exposed to one or more such sectors this can result in financial distress for the bank. Examples of such abrupt policy shifts are a sudden decision to privatize state owned enterprises in response to meet the conditionality for financing facilities from IMF.

Changes in macroeconomic conditions can be viewed as change in the structure and rules of the game. Therefore a portfolio strategy of a bank that was optimal under one situation no longer remains an equilibrium strategy after the change in government policies or change in macroeconomic conditions. Unless the environment changes slowly, the position of banks become precarious and the set of feasible strategies of the bank may not even be sufficient to avoid financial distress.

Theories of credit cycles that accompany economic cycles and operate through pro-cyclic movements in the value of collateral and thus extenuate

the amplitude of recession and boom also fall under the category of macroeconomic factors responsible for bank failure.

**2. Supervision:** Lax supervision allows some shortcomings in the bank escape the scrutiny of supervising authority hence becomes a source of failure. Similarly, over regulation, stringent bank supervision and restrictive rules can stifle the bank and can cause a bank failure.<sup>7</sup>

For example, prohibition of banks to enter into commerce or have their own non-financial subsidiary, the so called narrow banking, can stifle Islamic banking. Narrow banking restrictions makes the banking system more unstable and prone to bank runs. Whereas if the banks are allowed to enter into investment on sharing basis the banking system is more stable not prone to bank runs, however involuntary withdrawal restrictions will apply. Another disadvantage of too much supervision and control is that it reduces opportunities to innovate and puts the system into bureaucratic procedures. In a different context Barth, Gerard, and Levine (undated) in a study of banking systems around the globe have empirically shown that restricting banks from owning non-financial firms is positively associated with bank instability.

**3. Inadequate Accounting and Legal Protection of Contracts:** Shortcomings in accounting methods and auditing procedures at the banks' level can hide and delay the realization of developing problems of illiquidity and insolvency by supervisors and depositors. Similarly, shortcomings in account keeping at the level of bank clients (borrowers) can reduce banks' income and impede recovery of loans contributing to bank failure.

In this context Islamic banks face peculiar problems at all levels. First, until recently, the accounting procedures used by Islamic banks were not standardized leading to difficulty in inter-bank comparison of accounts. Second, the accounting conventions used by the supervisory authorities are, in most countries, still interest oriented leading to wrong classification of various types of incomes of the Islamic banks which have regulatory repercussions. Third, the accounting culture is not firm among the banks' clients in the third world countries – the jurisdictions where Islamic banks operate. Either accounts are not kept meticulously or forged accounts are kept to avoid taxation, which adversely affects the profitability of Islamic banks. Fourth, the legal protection to (financial) contracts is weak or justice is slow to obtain that also contributes to increase in risk of failure.

**4. Financial Liberalization:** Financial liberalization and deregulation of financial sector in various countries have given rise to banking and financial crisis. The experiences have taught the policy makers now to advocate a

gradual approach and to erect proper regulatory and support infrastructure before attempting to liberalize the financial sector. Like other banks, the Islamic banks have also suffered the burnt of ad hoc pursuit of financial liberalization policies by various governments. Since the Islamic banks do not come under similar patronage of the central banks as enjoyed by the conventional banks they are last ones to receive official support when a general panic strikes the banking sector in consequence of hasty liberalization and privatization policies and when the resources for support become scarce. While it can increase the likelihood of financial distress of Islamic banks (e.g. as it did in Turkey during 2000-2001), it also increased the opportunities to innovate and indulge in a variety of activities for the Islamic banks.

**5. Political Interference:** It comes in many forms and hastens the onset of a liquidity or solvency crisis if the banks are privately held, or prolongs the state of financial distress and financial repression if the banks are state owned. Government set credit targets and limits for various sectors; politically motivated/directed loans; very high reserve requirements that are to be held in government securities so as to finance the government are only some examples. These are detrimental for not only the profitability of banks but also cause a reputation damage to Islamic banks by forcing them to hold interest bearing government securities.

**6. Moral Hazard:** is a catch term for all post contractual informational problems. It can arise in conventional banks if the explicit or implicit guarantees of deposit insurance tempt the banks to indulge in risky investments and induces depositors not to care much about solvency of the bank. Such behaviour can magnify the crisis.

In case of Islamic banks the moral hazard problem is double edged sword. The investment deposits of the Islamic banks are share based, where depositors earn a share in profit and share with banks in absorbing losses. This can induce more risk taking by the bank. The moral hazard problem arises further in the second tier of contracts between the bank and its clients when the bank extends financing on profit and loss sharing modes. It increases chance of losses to the banks, a part of which are also transferred to the investment account holders. As opposed to conventional banks it induces depositors to be vigilant and choosy between safe and unsafe banks, and for the banks to discriminate between its clients, which are positive aspects. However, the banks' investments are opaque to depositors and decisions of depositors are generally non-coordinated (except in the form of herd behaviour in wake of bad or good news) therefore the advantage of depositor vigilance becomes smaller.

Under ideal conditions, and given the profit loss sharing mechanism of investment accounts an Islamic bank can never fail, theoretically speaking. But given the imperfections discussed above, Islamic banks increasingly resort to *murābahah* financing in order to reduce losses from moral hazard. This opens them up to unique liquidity risk (in addition to the credit risk) because resale of credit is not sharī'ah permitted. We will discuss more on this as an independent cause of financial distress and bank failure later in the paper.

**7. Lack of Transparency:** If circumstances of a bank lack transparency to its stake holders (depositors, clients, and shareholders) other than the management, then problems can persist until they multiply leading to bank failure. Since the financing by the Islamic banks is either tied to some real asset or based on profit and loss sharing, therefore transparency of circumstances of an Islamic bank allows market forces to work in better way to achieve economic efficiency. As opposed to this, conventional banks that extend untied credit and whose pricing is affected more by speculative pressures than economic fundamentals can benefit to a lesser extent from increased transparency. Thus transparency is more advantageous for Islamic banks; by the same token lack of transparency is more harmful in Islamic system.

Let us now focus on the factors in control of the bank itself as mentioned in the earlier table. These are listed from serial number 8 to 15.

**8. Poor Credit Assessment:** has been found to be an important cause of problems for conventional banks. The poor assessment can be caused by reasons independent of the level of expertise of the credit evaluators but a consequence of the nature of interest based lending contracts used by the banks. An important reason, for example, is the link between macroeconomic cycle and credit cycle. When economy is growing and heading towards a boom the banks find net worth of their clients growing. They tend to lend easily on interest and expand the size of their own balance sheet. During this period competition between the banks lowers their profitability while over optimistic expectations (chances of continuing growth) induces them into risky investment strategies resulting in over-extension of credit at the aggregate (economy wide) level. Note that the receivables of the banks are fixed by interest contract while the receivables of the clients are variable subject to business conditions. As soon as an economic down-turn starts the value of collateral taken by the banks drop; banks not only stop extending the credit but also start recalling their loans from their clients. Hence it hastens and deepens the recession.

Debt recall by a bank rendering its clients go bankrupt adversely affects other banks who had also extended credit to the same client. Therefore, each bank wants to get back its loans before others. This co-ordination failure among banks in the wake of rising expectations of recession hastens the down-turn and makes it deep. This further increases the financial pressure for many banks and results in their eventual failure.<sup>8</sup>

There are asymmetric information reasons too for poor credit assessment that are based on adverse selection argument. If the banks are not careful in pricing the risk they may be tempted towards those clients who are willing to pay higher interest but are more risky and deny the credit to prudent ones who are willing to pay a lower interest.

While the above arguments show weaknesses in interest based system for financial stability of the banking system, these also extend to Islamic banks' financing operations through a different channel.

Take the adverse selection argument first. Islamic banks while using *murabahah* mode face credit risk. If they are not careful in risk assessment of their clients they may be tempted more to those who are willing to pay higher mark-up rates than those who may be more prudent in risk-taking and therefore willing to commit only a lower rate of mark-up.

As for the pro-cyclicality of growth and credit argument, Islamic banks are safe on this side when they use *murabahah* finance. Since *murabahah* is not a re-priceable claim and it has fixed due date (or schedule of dates) therefore banks can neither recall it early nor can offer discounts to induce the clients for early payments. Therefore the likelihood of a 'run on debtors' by the banks, in expectation of a coming recession, is low. However, during the period of economic boom the chances of over-extension of *murabahah* financing still stands because not only the paying capacity of clients but also the value of their collateralised assets are rising.

There is another channel of pro-cyclicality in case of Islamic banks which does not operate through the credit and growth link. Rather, it operates through counter- (or pro-) cyclicality between monitoring costs and economic growth and operates through *mudharabah* and *musharakah* financing modes of Islamic banks. Thus it can be dubbed a financing and growth link. The argument is as follows:

Suppose Islamic banks extend financing on *mudharabah* or *musharakah* basis. There is a moral hazard problem associated with both these contracts. To keep the problem under tolerable limits the banks have to incur some monitoring costs. During a period of economic growth (boom) businesses in

general are profit making. Therefore, if a client tries to deceive the bank by reporting losses it can be readily identified and scrutinized. Thus monitoring costs become less than usual during a boom. On the other hand, during a recession when majority of businesses are making losses, if a profit making client cheats the bank by reporting losses it is hard to identify. Thus monitoring costs increase during recession. This counter-cyclical movements in monitoring costs have implications for the profitability of Islamic banks relying on partnership modes (*musharakah* or *muqarabah*). If the above argument holds, the profitability of Islamic banks will tend to increase during an economic boom and fall with recession.

There is another dimension to the above story, i.e., the behavioural aspect of the banks, how hard the banks should monitor? The benefit of (intensive) monitoring for the banks are greater during boom because to catch a cheater during this period brings more amount to the bank. Similarly, the benefit of (intensive) monitoring are low for the banks during recession, because by catching a cheater the losses can be avoided to a limit. Since intensity of monitoring is associated with higher cost therefore pro-cyclicality of profitability of banks with economic growth becomes debateable.

While the unit cost of monitoring is reduced during a boom the intensity of monitoring (say number of units monitored) is also increased. Therefore, total cost of monitoring may increase (or decrease) depending on which of the two factors is more sensitive to economic growth. Similarly, during a recession the unit cost of monitoring increases but the gain to the banks from monitoring decreases. Therefore, they may monitor less intensively and hence the total cost of monitoring may decrease (or increase) depending upon which of the two factors is more sensitive to economic growth.

**9. Taking interest rate and exchange rate exposures:** These are two separate sources of problems but described here under one heading because of similarity of their consequence on the banks' portfolio. Interest rate risk arises when there is a possibility that a bank will end-up paying more interest to depositors than it is able to earn itself. It arises when most of the lending by the banks is on fixed interest rate while the deposit contract stipulates a variable interest rate which changes with time and market conditions. This disparity was one of the major reasons for failure of Saving & Loan institutions (S&Ls) in USA during the early eighties. When interest rates rose sharply in 1979 the S&Ls found themselves in trouble because most of their lending were longer term and on fixed interest rate while their liabilities were marked to the market rate; eventually they had to be closed (*Economist*, October 28<sup>th</sup> 1999).

Exchange rate risk arises when the assets of the bank are in one currency (say domestic currency) while its liabilities are in another (say foreign currency). Excessive exposure or un-hedged positions in exchange rates can decrease the value of its assets and increase the cost of its liabilities in the wake of a sharp depreciation of domestic currency. Thus the bank ends up paying more to depositors than it earned. This has been judged as an important reason behind the financial crisis of East Asian countries of the late nineties.

In context of Islamic banking the interest rate risk or its likeness would not exist. The financing by Islamic bank is done either on the basis of profit sharing mode or on *murabahah* — which is a contractually fixed mark-up contract, but the payouts to depositors are sharing based rendering the payouts to directly mirror the performance of the bank in its financing operations. As long as the sharing ratio with the depositors is fixed in advance, the banks cannot end up paying more than what they earn.

A rise in the average rate of return available to the depositor at other banks (or in other financial instruments) can start a withdrawal from the bank. It would be stemmed by raising the profit sharing ratio for the new deposits or raising it for the next accounting period in case of the existing deposits. In any case, the bank is exposed to economic (or market) risk but not to the interest risk—i.e., will not end up paying more than what it earned.

Similar is the outcome of an exchange rate exposure for an Islamic bank. By taking excessive exchange rate risk the bank's total profit is at risk. But it cannot end up paying its depositors more than what it earned because of profit sharing nature of the deposit contracts.

**10. Concentration of Lending:** It increases the risk of financial distress for a conventional bank if its debtors are unable to pay a substantial amount on time. In this respect concentration of lending increases the credit risk mentioned earlier. Such concentration arises if the bank has special or long-standing association with some particular customer or if it focuses on a particular sector exposing itself to correlated defaults or in some cases if the bank was created with the purpose of financing a particular enterprise.

All these factors are important and relevant for Islamic banks too. Many of them were created as a financing arm of existing enterprises. In some other cases the concentration is the result of the small capital base of the bank. It is also a result of state's influence on the banking sector. In rare cases the concentration is the result of particular sector-specialization strategy of the bank.

However, there are some differences between factors that lead to concentration of lending in conventional banks and in Islamic banks. Since lending in the conventional bank can be untied and unrelated to the earnings from its use, as long as it is covered by the net-worth (or payback capacity) of the borrower, therefore unproductive concentration of credit is possible. The safeguard to concentration is provided by regulatory limits on loan concentration. And it is relatively easy to abide by such regulation because banks operate only as financial intermediary without getting involved in the business of its client. In contrast, for Islamic banks there is no untied lending but debt arises from credit sale be it *murabahab* or *salam* or through *istisna'* contract. Thus unproductive utilization is amenable to discovery early; but the bank gets involved with the parties and the commodities to a deeper level than arms-length financing of the conventional bank. If the sold commodity is use-specific to the bank's client (i.e., of specialized use) or specially manufactured (i.e., produced by unique firm) then the bank may have invested enough resources of time, human capital, and money over the completion of the deal that it would have developed some expertise in financing such commodities and/or dealing with these firms that a lock-in effect and specialization would naturally lead to credit concentration over the time. Putting ad hoc ceilings on concentration of credit independent of the size and capital of the bank can become a destabilizing rather than a stabilizing measure.

**11. Connected Lending** is defined as lending to companies owned by the bank or in which the members of the board of directors or the executives of the bank have substantial shares. It is discouraged by regulation in the conventional banking environment to safeguard the interests of the depositors.

When banks finance their own/connected companies there can be conflict of interests between that of bank and the depositors whose money it uses. Given the nature of deposit contract whereby the bank is liable to pay a fixed interest to the depositors the connected lending provides an opportunity to the bank to pocket all the residual earnings of the business it own and finance through depositors' money. Therefore, the bank has very high incentives to fund its connected firms even if the firm is riskier than other outside firms. This leads to moral hazard problem in risk taking.

Moreover, there is no significant advantage to the society in terms of any reduction in the monitoring costs affected by the connected lending. Because, the banks do not care to monitor the borrower for performance but care for establishing credit worthiness in the conventional banking system.

Hence, for the above reasons it is not prudent to allow unrestricted connected lending to the banks. The failure to control connected lending can also lead to concentration of lending and bank failure.

Whereas in case of Islamic bank: (i) the bank shares with the depositors the actual outcome of its investments, (ii) monitoring of its clients is a required feature. Thus the conflict of interest between the depositors and the bank is reduced by virtue of the former feature of returns sharing. Further, there is advantage of reduction in monitoring cost in case of financing of own business as compared to financing an outside firm.

Hence, for both these reasons the level of restriction on financing of connected businesses should be lesser in case of Islamic banks. The conflict of interest part can be controlled by ensuring that the contractual conditions are fair and that the bank also invest its own capital in the business. What should be the proportion of own capital of the bank is a policy question with no simple answer.

**12. New Areas of Activity:** Expansion into untested areas of business is one factor that can cause bank financial distress for conventional banks. On the other hand Islamic banks can expect to show more buoyancy when entering new areas of business due to participatory nature of their financing, which does not force premature bankruptcy of the financed party by loan recall on first signs of trouble.

More important factor however, in case of Islamic banks, is the expansion of ownership in too many lines of businesses relative to the capacity of corporate, financial and human resources of the bank that can become a source of their distress. A bad performance of only one business which is owned by a bank can cause reputation damage to the bank and knock over effect leading to its financial distress. Since the nature of participatory financing requires Islamic banks to actively participate in the businesses they finance, therefore it is very important for Islamic banks that they expand very carefully into new businesses in which they plan to have majority share. Unless the business is Shari'ah compatible and bank possesses the required monitoring resources, horizontal expansion for the sake of diversification only is a dangerous prospect that can produce contagion affect for the bank.

**13. Internal Control Failures:** It has resulted in collapse of some reputable conventional banks. Noted example include that of Barings which failed in 1995 because a trader in one of its subsidiaries kept on doing fraudulent trade unchecked by higher management and the parent company until accumulation of huge losses when it was discovered.

Internal control procedures are equally important for Islamic banks and need improvement. These procedures enhance transparency within the organization/management as opposed to transparency for outside stakeholders. They work by defining the rights and responsibilities and putting in place a system of monitoring and reporting; it also cover the control exercised by the Board of Directors of Islamic banks. Thus, these procedures can help avoid some of the above listed causes of bank failure.

There have been cases in which individual Islamic banks came under financial distress or closed down (e.g. Ihlas Finans in Turkey 2001) because of rubber stamp Board of Directors or their acquiesce behaviour that failed to realize the developing problems.

**14. Other Operational Failures:** There can be a number of miscellaneous operational deficiencies that can lead to problems and eventual failure of the bank. For example: Banks may have staff of poor quality or of lesser experience; They may have hired experienced persons but with tainted reputation which will not be a good omen for the bank; The management may be excessively centralized or it may be very lax without proper management and command structure; The bank may be unable to cut costs; etc. These are important both in context of conventional as well as Islamic banks.

**15. Liquidity Problems:** There are two types of liquidity problems for Islamic banks. Some banks have excess liquidity which they do not know where to park for short periods. Thus they incur a high cost-of-carry in the form of forgone earning opportunities on the excess liquid funds. On the other hand, there are banks that run into liquidity shortage when depositors withdraw money, but do not have access to funds for short periods.

## **6. Conclusions**

In this paper we enumerate the various causes of bank failure that have been identified for the conventional banks in the theoretical as well as policy oriented literature. They range from macro to micro causes as well as factors that are intrinsic or extrinsic to the bank. Evaluation of the extent to which each of these factors are relevant for financial distress in Islamic banks reveal that while some causes affect Islamic banks equally as they affect conventional banks, there are some others that are not of concern. This is due to particular sharing structure of Islamic banks with their clients and/or depositors which positively contribute to more stability of these banks.

However, the small size and narrow ownership of Islamic banks pose its own problems as a source for financial distress.

There are also new dimensions to some of the conventional causes of financial distress when applied to Islamic banks. For example, moral hazard problem is at two levels in the two tier *muḍārabah* structure of Islamic banks which leads them to prefer *murābahah* financing and hence generates credit and liquidity risk. Poor credit assessment and the associated pro-cyclical movements in credit extension and business cycle is well known in conventional banking literature. However, the *murābahah* contract does not contribute to such credit cycles during a recession. This is owing to non-saleability of debt or its discounting. At the same time the financing cycle can operate in cases of *muḍārabah* and *shirākah* contracts through counter-cyclical monitoring costs and pro-cyclical incentives to monitor for the banks.

Financial distress in Islamic banks can also stem from the current structure of Islamic banks, regulatory environment that restricts them from owning or equity participation in businesses and trading, and from lack of support infrastructure institutions. Islamic banks are also affected if a crisis occurs in the conventional banking sector which erodes confidence of depositors in the banking sector in general.

This is probably the first such systematic study of the causes of financial distress in Islamic banks with the purpose to serve as background to further deeper study of individual bank cases.

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## Notes

<sup>1</sup> For example, Ihlas Finance House, an Islamic financial institution, in Turkey was closed in 2001 due to liquidity problems and financial distress. Bank Taqwa was closed in 2001. Faisal Islamic Bank closed its operations in the UK for regulatory reasons.

<sup>2</sup> We are using the term financial distress to refer to financial problems of individual banks and the term financial crisis to describe a situation when a large number of banks are affected either directly or through contagion. In this paper, we are concerned with both financial distress and financial crisis.

<sup>3</sup> For example Krugman (1979); Flood and Garber (1984).

<sup>4</sup> For example, Obstfeld (1996).

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<sup>5</sup> For example, Krugman (1999); Chang and Velasco (1999); Morris and Shin (1998); and Chui, Gai and Haldane (2000).

<sup>6</sup> For example, Diamond and Dybvig (1983); Brynat (1980); Von Thadden (1995); Anderlini (1989); and Postlewaite and Vives (1987).

<sup>7</sup> Caprio and Klingebiel (1996) report that out of 29 cases of bank insolvency in their survey, poor supervision and regulation featured in 26 cases (see figure-3 of their paper).

<sup>8</sup> Various debt covenants defining priorities of different debts are some ways through which a 'run on clients' can be dampened but they by themselves are insufficient. Such problems occurred among international lenders during Latin American crisis and solution was proposed by forming a consortium to negotiate rescheduling of loans and payments with the sovereign borrowers (clients) rather than allowing the individual creditors to work out their own negotiated deals with the defaulting states.

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## Success Factors of Islamic Banks: An Empirical Study\*

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### Introduction

Islamic banks, in terms of their legal modalities, structures, objectives and means of achieving those objectives, are not any different from other financial institutions. Their main difference lies in their being described as *Islamic*. This entails that the Islamic banks have enjoined on themselves to conduct their affairs within the limit of the rulings of Shari‘ah and to comply with its overall objectives. This definition of Islamic banks would make our approach easy as we make an attempt to explore the success factors of Islamic banks as financial institutions. It must be realized that maximization of profit is an objective of the highest priority for all private investment institutions. Consequently, all private-sector financing institutions have a fundamental objective: to make as much profit as they can.

However, profit maximization is a general proposition that must be narrowed down and explicated in detail. This has been undertaken in the Section 2 of the present paper. In brief, there are different factors which are important in affecting profit maximization of Islamic banks such as boosting of all forms of deposits, improvement in the quality of customer services, expansion in the base of banking services, protection of capital, provision of humanitarian and social services, etc. and the factors that raise the profit margin, or which may be called the rules of profitability management of an Islamic bank.

The Section 3 will discuss the experience of some selected Islamic banks in achieving their objectives and measure the extent of their success.<sup>1</sup> This

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\* Paper written in Arabic. Translated into English by an anonymous translator. The editors have reviewed it for correction of any gross mistakes and slightly edited for improving the exposition and organization. Heavy editing would have involved a re-rendering of the text.

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has been done through an analysis of their closing accounts and annual reports for the years 1999 to 2001.<sup>2</sup> This section also makes an attempt to present important evidence that would help us deducing the main factors in the success or failures of these Islamic banks. Specifically, this has been done through assessing assets growth, growth of invested assets, the growth of cash and deposits in other banks, the growth of customers' deposits in Islamic banks, changes in earnings, expenses, and net profits, and the commitment to the Shari'ah and charitable and social contributions.

Section 4 will focus on the success factors of Islamic banks which could be derived from the above analysis. This section is divided into a number of subsections devoted for the study of bank's efficiency, factors that Increase customers' trust in the bank, efficiency of departments of investment management, financial engineering and marketing management, protecting shareholders' and depositors' capital, the extension of humanitarian and social services and some other factors.

## **2. Success Criteria of Islamic Banks**

### **2.1 Long Term Considerations**

#### **2.1.1 Increasing Deposits**

In order to realize the greatest possible profit, there is a need to distinguish between the long-term and the short-term objectives. A bank, whether Islamic or conventional, is concerned with making profit in the long-term without sacrificing its short-term perspectives. Long-term profit is influenced by the growth of deposits and other such resource that give the bank the opportunities to generate earning assets. Thus, it is necessary to consider the rate of growth of the various forms of deposits.

An Islamic bank normally has three types of deposits that determine its capacity to raise the rates of shareholders' return. These are: current account deposits, unrestricted investment deposits in savings and *muḍārabah* accounts, and lastly, off-balance sheet deposits in investment funds in special or restricted investment accounts. It is erroneous to think of these deposits as being independent of each other. Numerous researches have proven the existence of usually positive links between them. This has also been confirmed by the reports of the Islamic banks that are considered in this study. Therefore, the banks, in marketing and offering any type of deposit to the clients should also consider its cross effects on other types of deposits offered by it.

Although Islamic banks do not distribute returns to current account holders, this increases not only the rate of profit, but also multiplier of assets/equity rate which is reflected in the form of even a greater increase in the rate of profit. On the other hand, off-balance sheet deposits are considered an attractive way of increasing the number of clients as well as a very important vehicle to increase the rate of shareholders' returns, because it increases the earnings from the agency activities. Moreover, these earnings are less affected by investment risks to which other banking earnings are subjected.

### **2.1.2 Improving the Quality of Services to Clients**

Some Islamic banks may pay little attention to the quality of services they offer to their clients especially if such banks enjoy a position where they can exercise some monopolistic power in the market. Many Islamic banks were once in this situation when they were acting alone in their Islamic financial services' markets. Today, however, the monopolistic position is weakening because of the multiplicity of Islamic banks in many countries and the entry of conventional banks into the Islamic finance markets.

The experience of American banks in the 70s and 80s, when there was fierce competition among them, has taught an important lesson. That is, improved services to customers save cost in the long-term despite the short term cost of higher spending on training and rehabilitation.<sup>3</sup> The improved services create a climate which is conducive both for the clients and employees. It increases clients' enthusiasm for dealing with the bank on one hand and raises the productivity of the employees on the other. This improves the cost effectiveness of each dollar spent on labour.

It may be noted that improving the quality of banking services does not only mean receiving and responding to clients' requests. It also means the ability of the bank to discover a client and to offer him/her a service previously not used. This is a kind of commercial marketing of financial services in full sense of the word as it is familiar in goods and services marketing.

The efforts expended by the bank in improving the quality of clients services depend on the clarity of its vision about the market segment to which it is directing its services. Are the clients big financiers, businessmen or monthly salary earners, middle-level traders and industrialists? Every segment of clients has its own peculiarities. Experience has proven that banks that are able to offer specialized services commensurable with the peculiarities and objectives of every segment can attract the largest amount of deposits.<sup>4</sup>

While it is neither morally wrong nor against the principle of profit maximization that a bank should offer its big clients special services that correspond to the level of profit it makes from dealing with them and their financial transactions, experiences have shown that banks that are able to improve the services they offer to medium depositors and small traders can still make huge profits through economies of scale. Clearly a bank can offer improved services to all clients in addition to the higher segment of clients by offering all of them an enjoyable banking practice. This can be achieved through the following means:

Personalizing the banking services: by that we mean making banking services individually tailored to every client such that he feels a personal link with the bank he deals with.

Raising the professional level of employees who deal directly with clients such that they can offer professional services quickly and efficiently and gain the client's confidence.

Strong concern in the investment department to realize for investors - depositors or shareholder- a rate of profit higher than other banks that operate in the same market serviced by the bank, especially other competing Islamic banks.

Improving the working environment and making it comfortable and enthusiastic for the bank employees.

Providing social services that are noticeable by the segment of the society from which the bank derives its clientele and staff. The word "noticeable" should be underlined because the objective behind services to the social environment is to raise profit and as such the choice of the type of social services has an impact on its returns. For instance, it may be better for a bank to award a scholarships of Dinars 1,000 each to 10 school graduates in a public ceremony that will be talked about by people than quietly awarding a single scholarship of Dinars 10,000 to the best student.

Finally, raising the quality of banking services may depend on improvement of three elements: professionalism, knowledge of clients and establishing personal rapports with them. Correct banking professionalism is the first point of departure for creating confidence in the bank and its employees. Improving professionalism, therefore, centres around improving the bank employees' knowledge and perfection of their jobs, It also focuses on the staff's ability to carry out a client's needs quickly, efficiently and accurately, which would generate a great deal of confidence in the mind of clients regarding the bank and its employees., The knowledge of clients is

based on keeping and maintaining a continuous relation with them which is, to some experts, the most important managerial rule<sup>5</sup>: Success in banking services means the ability to interact with and relate to the client's desires, anticipate their wishes, and to offer such services that are specific to these desires and wishes.<sup>6</sup>

There may be several parameters by which the quality of banking services offered to a customer could be measured. These might include monitoring of customers' satisfaction, which may be done through administration and analysis of periodic questionnaires. Another way is to conduct a time and motion study i.e. computing the time taken to perform services and linking it with the record time. Another parameter may compute the number of new customers whom marketing staff can draw to the bank. The extent of success of the management of direct services to customers as a whole can also be measured by the change in the volume of market transactions the customers conclude with the bank.

### **2.1.3 Expanding the Base of the Banking Services**

Numerous studies conducted by research bodies in the USA have shown that 80-90 per cent of bank customers' material assets are kept outside the banks that customers deal with. This ratio increases every time bank activities are restricted to current accounts, granting loans and issuing credit cards.<sup>7</sup> This means that ample opportunities exist for banks to attract new deposits and investments even without expanding customer base. It is only in the last few years that some Islamic banks have turned their attention towards expanding the base of their services by extending services of agency for investment such as creating investment funds and offering special investment accounts.

However, what cannot be marginalized in contemporary banking is that the ability of the bank to increase its deposits and other investment funds, which largely depends on the strength and activity of its financial engineering department. This is what guarantees continued expansion of its deposits and as such it has the capacity to constantly increase its investments assets.<sup>8</sup> This principle is even more valid for the Islamic banks than other commercial banks because the nature of these banks is based on new innovations in the art of banking that are far from being the prominent pillars of conventional banking operation: lending and borrowing. Inventing a flow of investment products offers customers attractive alternatives that induce them to move their material assets from other banks or from outside the banking sphere to the Islamic bank, while, at the same time, attracting new customers with new deposits. This continuous innovation process is both the foundation and the

assurance of growth of Islamic banking. In this regard, financial engineering management becomes the strong engine that moves banking marketing. Without the engineering activity, marketing management cannot attract new deposits on a continuous basis as to guarantee continuous growth for the Islamic bank's activities and profits.

A measurement of expanding base of banking services is possible by meaning the growth of non-conventional investments, especially off-balance sheet investments through the agency contract with fixed or declining commissions. It can also be done by measuring the growth of new innovations through reckoning the volume of operations in the invented products.

#### **2.1.4 Preservation of Capital**

Protection of capital is one of the important considerations in maximizing profit in the long run because evaporation of capital not only causes banks to lose new deposits, it also deprives them of the means to achieve the very objectives of their existence.

Undoubtedly, two most important elements in capital preservation are the extent of the bank's diversification of its investments and the extent of synchronization between the maturity of its investments and the maturity of its deposits. One of the common errors in the circles of Islamic banking theorists is their continuous call for financing through partnership (*musharakah*) and non-voting equity (*muḍarabah*) that are both of a long-term nature, while the greater part of the banks deposits are short-term deposits in current accounts and short-term investment accounts. Although there are attempts to reduce financing through *murabahah* in favor of an increased financing through *muḍarabah* and *musharakah*, these attempts should take into account that *musharakah* and *muḍarabah* financing should not exceed the safe limit in terms of proportionality with the sources of financing and their maturities.

In addition, protection of deposits requires setting of clear red lines that should not be crossed with regard to the degrees of risks the Islamic bank cannot bear, whether they are investment risks or foreign currency risks. Even though it is clear that Islamic banks are moving towards taking generally conservative positions towards investment risks, some of them have landed investors and depositors into pure failure because of the absence of these red lines and the weakness of check and balance processes in their management style.

One of the most important criteria in capital preservation is the structure and power of the bank's risk management department and its professional conduct. This should not be limited to central bank guidelines and to what is usually known, in a conventional banking, as the rules of banking prudence<sup>9</sup> but should also include tying *mudārabah* and *mushārahah* investments to long-term investment deposits, setting up red lines of potential risks and rules for checks and balances in taking investment decisions. Such rules of prudence must be applicable to all decision makers in the bank including the CEO.

### **2.1.5 Humanitarian and Social Services**

There is no doubt that providing humanitarian and social services to the local community increases the bond between the bank and its local environment. This has a positive effect on the volume of deposits and other banking transactions. We should however note that banks are like other institutions in any society. They are made up of a group of individuals dealing with people in a particular social environment. There is no way that this group will not be influenced by its social environment or affected by the ideas, concepts and events that emerge in that environment. This is why banks participate in many charitable works and set programs of participation in charitable and social work, regardless of, and indeed above the demands of the principle of profit maximization. Banks contribute to public charitable works and set aside funds in their annual budgets for such purposes.

Islamic banks are also looked at to participate in the charitable activities in their societies. In fact, that is more expected from them than from conventional banks because they are governed by the Islamic Sharī'ah which requires the wealthy to contribute to social and humanitarian works. Surely it is possible -and may even be better- that the distribution of *zakāh* is left to the individuals -investors or shareholders- to spend it on causes they consider closer to Allah. But it is erroneous to think that good deeds are limited only to the enjoined *zakāh*. One of the distinguishing factors of the Islamic bank is its commitment to Qur'ānic morals and values all of which are based on goodness, righteousness and benevolence. Islamic banks must portray these values in the same way as required of individuals.

We must note that the social charitable objective is distributive not productive by its very nature. In other words, Islamic banks deal with their customers on the basis of fairness, justice and kindness then spend money on the path of righteousness and charity. Thus spending on charitable social objectives is a form of redistributing net resources, even though the bank, purely for tax purposes, categorizes such expenses as part of its public expenses.

In fulfilment of its Islamic character, the Islamic bank should always set aside for righteous causes some money since it carries the banner and ideals of the Islamic values. Prophet (Pbuh) has promised replacement for every spending and that money is not going to diminish as a result of spending. The compensation or reward may be in the form of customers' confidence in the bank and their conviction about its Islamic characteristics. Consequently, their interest in dealing with the Islamic bank is going to grow.

## **2.2 Short-Term Considerations**

Profits, higher than the competing Islamic and conventional banks, is in the final analysis, are the ultimate objective and the quantitative criterion for measuring the success of any bank. Besides the role that every human being or every group of people plays in participating in righteous deeds in the society, of which the Islamic bank is expected to do more because of its identity and character, any talk about non-profit objectives is either a rhetoric about interim objectives that are mere means to the primary objective or it is a form of marketing or public relations propaganda that serves the objective of profit maximization.

We shall devote the remaining part of this Section to recall the rules of managing the profitability of Islamic banks. These rules can be summarized under the following six points: pricing of banking services, cost/earning efficiency of bank's operation, selecting high return investments, reducing idle assets as much as possible, benefiting from economies of scale, compliance with institutional process for the flow of information to management to make timely decisions.

### **2.2.1 Pricing of Banking Services**

It is usual for new banks to seek to use the pricing list of existing banks. But a bank that is keen on offering quality services must set its own price list on the basis of analytical studies of its own architectural cost, compare it with other banks, set its own fees to be commensurate with the value of banking service provided and the affordability of the proposed price to the average client (statistically it is preferable to take the mode because it is the most frequent), and then work to increase the price of banking services to the highest level possible, without sacrificing the bank's competitiveness. Pricing of banks' services includes setting the range of charges on non-investment services and determining the share of *mudārib*/agent of the returns on unrestricted, restricted and special investment deposits.

### **2.2.2 Cost/Earning Efficiency**

This is measured by the ratio of total expenses to total earning. As the ratio decreases, so does the efficiency of every Dinar spent by the bank. The Islamic bank can increase its profitability by increasing the efficiency of its workforce, through constant training and injecting joy and happiness in the work environment.

### **2.2.3 Selecting High Returns Investments**

Investment selection is linked to risk management because, as it is known, an increase in the expected return is normally linked to an increase in investment risk. But it is to a large extent also linked to the bank size itself. The financial sector is like a jungle where the fatter the prey the larger the predator animal that is needed to devour it. The bank that enters the market with huge capital is able to find higher return investments, in addition to it being able to instill greater confidence in investors, thus making them to come forward to it with their investments. It is not enough for the Islamic bank to start with high investment; rather it should back such an investment with a strategy for continuous growth, either through geographical coverage or through the size of deposits and assets or through mergers or purchase of other financial institutions.

### **2.2.4 Minimizing Idle Assets As Much As Possible**

Every bank needs cash reserves. Some of these needs are compulsory while others are required by the rules of banking prudence. But Islamic banks are known of having higher cash reserves for reasons, part of which are technical caused sometimes by the bank's relations with the central bank, others for purely administrative reasons. The Islamic bank can minimize idle reserves by reconsidering its managerial philosophy, improving its style of applying the rules of banking prudence and seizing the little opportunities available to use its cash assets to increase income.

### **2.2.5 Utilization of Economies of Scale**

This comes about by means of increasing invested assets, because an increase in investment propels the multiplier of the ratio of profit-bearing assets to equities towards profit maximization.

### **2.2.6 Compliance with an Institutional Approach of Information Flow to Management to Enable it to Take Timely Decisions**

Timely decision making and shorter implementation gap are quite important elements in making profit as well as in safeguarding of capital. The time span between a need for a decision and when it is taken cannot be reduced unless information reaches the management in an institutional and regular manner. Banks in the Arab world particularly often aim at getting information to the management for seeking decisions. This approach ties the customer's time directly with the chain of getting to the management, such that her transaction has to be signed by the bank's senior management. Service can be improved by adopting a method of delegating middle-rank management to conclude provision of services to the customer, and then link up with the senior management to ensure that the information reaches there at the appropriate time. There is no doubt that the centralized style of management increases the cost and engages the top management in trivialities that take up the time that is better devoted to planning and drawing up growth programs.

### **3. Experience of Some Islamic Banks in Meeting their Objectives**

This section shall make an attempt to study the experiences of some Islamic Banks in meeting their objectives as well as to measure the extent of their success through a study of their final accounts for the period from 1999 – 2001. Since this period is rather short, hence, it shall not be possible to identify any long term trends.

I must make certain reservations beforehand about the results. It is necessary to do so because this attempt neither covers the totality of Islamic banks nor a random sampling of the Islamic banks has been done in this study. It is merely confined to an analysis of some available financial information and annual reports. The information at hand cannot explain all the causes of differences between banks. Such explanation of the differences requires an identification of the various factors, such as management methods, bank's relations with customers, employees, as well as the employment policies. For example, the employee salary levels and other benefits, the quality of employees' technical qualifications, the levels of their knowledge of banking, particularly of Islamic banking. Also important are the different kinds of services offered to customers, methods of their delivery as well as categories of financial products and their development over time etc. which must also be considered in an in-depth analysis. However, any

information on these variables is generally not available in the published annual reports.

Despite these shortcomings, this section still provides important evidence that will help in identifying the factors that are responsible for the success or the failure of Islamic banks, whether in the countries where the 7 banks are located in Arab and Islamic countries or elsewhere.

### **3.1 Growth of Assets and Invested Assets**

Islamic banks vary greatly in their ability to increase their overall assets in general and their invested assets in particular. Tables 1 and 2, show the growth of assets and invested assets respectively in case of some Islamic banks.

It may be observed at Table 1 that, while one of the banks (bank C) was able to increase its assets by 96 per cent over three years followed by bank G with a growth of 42 per cent, a decline may be noticed in the assets of another bank (bank F) by 18 per cent.

Surely this increase in assets is strongly indicative of the bank's ability to grow and succeed. More importantly, it indicates the bank's ability to generate earnings because growth in asset does not merely increases in the amount of money the bank can invest, but increases the bank's ability to invest in projects with higher returns. In other words, the bank is able to improve the quality of its investment. The two points are reflected in an increased profitability of the Islamic bank.

**Table 1: Percentage Growth of Total Assets in Some Islamic Banks**

<i>BANK</i>	<i>1998/1999</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>1998/2001</i>	<i>Average</i>
A	7.10	9.42	9.56	28.40	9.47
B	0.26	22.25	1.62	24.55	8.18
C	19.34	25.87	30.46	95.96	31.99
D	38.11	-16.06	-5.13	9.99	3.33
E	4.19	1.90	8.77	15.48	5.16
F	---	2.13	-20.03	-18.33	-9.16
G	6.00	14.47	17.27	42.31	14.10
Average	12.50	8.57	6.08	28.34	9.01

When the growth of assets in Table 1 is examined, it is found that the general increase in assets alone does not give the complete picture. We should attempt to understand the phenomena and factors behind this increase. Here we would find two Islamic banks C and G that were able to maintain steady

annual growth at high levels. In other words, these two banks were able to maintain a high and stable annual growth average in assets.

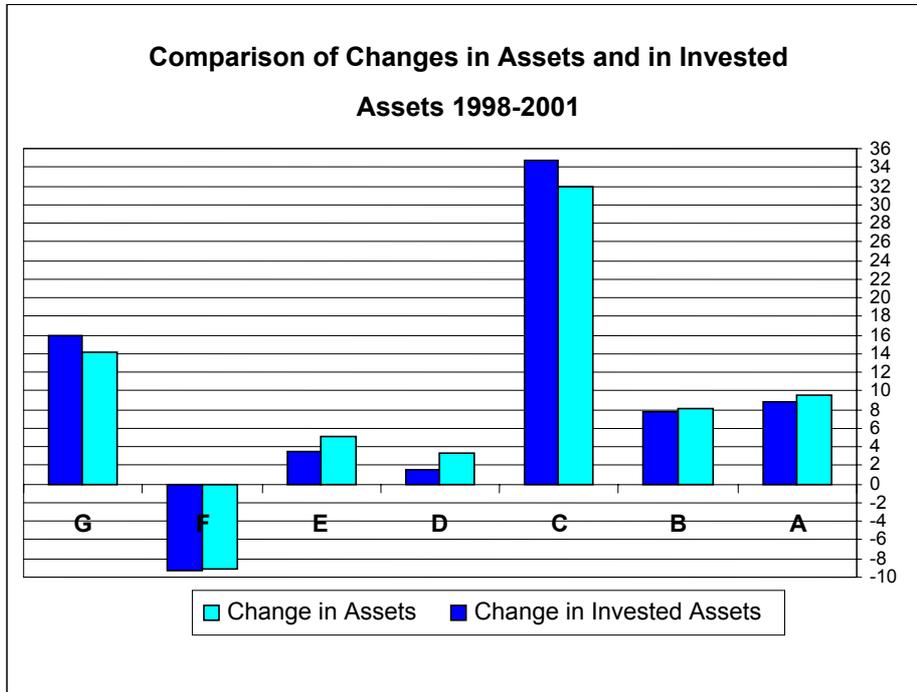


Figure 1

This gives some important indication about the quality of management and method of dealing with customers. It could say something about its ability to keep the bank's customers and to increase them by attracting new ones. In contrast, it may be observed that banks D and E whose assets rose by 10 per cent and 15 per cent respectively over a three year period 1998-2001, recorded their increases mainly during 1999 (bank D) and 2001 (bank E). In other years, the growth was either modest or negative. For bank B whose assets grew by 25 per cent, its boom occurred in 2000 and it was an increase in assets caused by an increase in the paid up capital of that bank. But in the two other years, the bank was only able to register an almost negligible increase. On the other hand, bank A was able to maintain a stable growth rate each year, which was higher than the average taken over all banks each year. Its assets rose by 28 per cent in the three years (see Table 1).

It is also important to search for the causes of asset increase. While we find that the cause of increase in the assets of banks C and G is customers' deposits, the increase in the assets of bank B is an increase in capital. Hence, the banks C and G were really able to relate to customers in ways fundamentally different from other banks, such that they were able to gain the confidence of many of their customers. It is noticeable; however, that bank G is the sole provider of Islamic services in its market while bank C faces strong competition in its domestic market. Also both banks are old in the market; one of them is the oldest Islamic commercial bank and the other is one of the first few banks.

However, the increase in total assets is also a partial indicator of the ability of Islamic bank to achieve high profitability. That is why it is necessary to look at Table 2 to complete that picture. This table shows the growth of invested assets.

**Table 2: Percentage of Increase in Invested Assets**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>1998/2001</i>	<i>Average</i>
A	1.80	14.53	8.53	26.54	8.85
B	0.74	21.07	1.05	23.26	7.75
C	26.73	25.53	28.66	104.09	34.70
D	33.31	-18.56	-3.55	4.72	1.57
E	0.86	4.70	4.79	10.67	3.56
F	---	5.23	-22.70	-18.66	-9.33
G	5.70	15.32	21.18	47.70	15.90
Average	11.46	9.69	5.42	28.33	9.00

An initial look at Table 2 does not give a right picture of the achievements of many of the Islamic banks. With the exception of just two, no bank was able to maintain the same rates of increase in assets when it comes to their investments. In other words, five of these Islamic banks were unable to absorb in their investments the rate of increase in their assets, making the growth rate of their invested assets lower than the growth rate in total assets as illustrated in Figure 1 above.

Bank C, which recorded the greatest increase in total assets, was able to raise its investment index, since it was able to make more increase in its investments than that of the total assets by more than 9 points. Next is Bank G, which was able to raise its investment index during the period under study. Its invested assets grew more than its total assets by more than 5 per cent. To explain the causes of this achievement for bank G, its method of administration needs to be studied. So too should be the qualification of the

managerial levels, especially the middle-level and the way the bank and its employees treat their clients. It is apparent that this bank is able to attract and hold on to its clients, and it knows how to sell itself to potential customers. This is one of the key factors of success. We should however not disregard the monopolistic position enjoyed by the bank in the local market of Islamic services and the fact that it's been well entrenched, as an older Islamic bank, in the international market.

Here, we should note that the least lucky of the five remaining banks in keeping its investments in accord with its assets is bank D, which experienced persistent drop in both its total assets and invested assets in the last two years. Perhaps part of the reason is that the bank was unable to achieve a high rate of investment in 1999, which made investors turn away from it in the next two years. If the gross margin between its assets and investments was big in 1999, it was equally big in 2001. Next is bank E whose investment index dropped by 5 points. As for the 3 other Islamic banks, they share with these two banks a disparity between the growth in assets as a whole and the growth in invested assets, but to a lesser extent. This has serious significance on the level of training and technical qualification in the investment managements and the ability of the management to reach out to businessmen and to attract them to use the bank's services. This phenomenon also casts a shadow on the management method of taking investment decisions and on the accuracy and speed of information fed to the management so as to enable it to make decisions with the appropriate speed and efficiency.

Tables 1 and 2 did not touch on the index of invested assets to total assets. This ratio is undoubtedly influenced by the central bank's monetary policy, the bank's investment approach, its patterns of waiting for opportunities and its adopted limits of banking soundness. The Jordanian central bank for example is known to tend towards extreme conservatism in this regard. Nevertheless Table 3 has important significance: it does not only outline the ratio of investment to total assets, but it also points to the bank's efforts in using its available assets and the changes of these efforts from time to time.

**Table 3: Percentage of Invested Assets/Total Assets**

BANK	1998	1999	2000	2001	Average	98/99	99/00	00/01	98/01
A	68.41	65.02	68.06	67.42	67.22	-4.95	4.67	-0.94	-1.45
B	94.81	95.27	94.35	93.82	94.56	0.49	-0.96	-0.56	-1.04
C	84.88	89.88	89.64	88.40	88.20	5.89	-0.27	-1.38	4.15
D	97.09	93.72	90.92	92.43	93.54	-3.47	-2.98	1.66	-4.79
E	88.64	85.81	88.17	84.95	86.89	-3.19	2.75	-3.66	-4.16
F	---	83.51	86.05	83.17	84.24	---	3.04	-3.35	-0.41
G	89.96	89.70	90.36	93.37	67.51	-0.29	0.74	3.33	3.79
Average	87.30	86.13	86.79	86.22	83.17	-0.92	1.00	-0.70	-0.56

A look at Table 3 reveals that all banks are capable of increasing their investment rates. This is so since for 6 of them, this index in 2001 did not reach the rates they actually attained in the previous years. This reinforces our earlier conclusion that there is a genuine need for these 6 Islamic banks to review their management and investment policies. More important, this index helps understand the success factors because it shows clearly the need and benefit of finding highly qualified investment management as one of the success factors of an Islamic bank. What is required of this management is to continuously work to raise the investment index shown in Table 3.

### **3.2 Increasing Cash and Bank Assets**

Table 4 depicts the growth of cash and deposits with other banks in the 7 Islamic banks during the three years that ended in 2001. It indicates that the efforts of Islamic banks to minimize idleness of their funds have produced uneven results.

While some banks achieved temporary success in some years, only bank G was able to introduce genuine reduction of its available cash during the period covered by the study. But with bank F, despite of the negative value that indicates a drop in its cash assets. This decline was accompanied by a bigger drop in its invested assets, which means that the ratio of cash to total assets has increased instead of dropped. Additionally, three other banks have reached disturbing high figures in the average increase of their cash and deposits with other banks to an extent that one doubts the very existence of departments for liquidity and investment management in these banks!

**Table 4: Percentage increase in Cash and Deposits with Banks**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/01</i>	<i>1998/2001</i>	<i>Average</i>
A	18.83	12.55	11.31	48.87	16.29
B	-10.61	103.39	-39.17	10.61	3.54
C	-26.83	54.60	61.65	82.86	27.62
D	206.98	10.61	-9.59	206.98	68.99
E	31.79	-14.72	54.42	73.56	24.52
F	---	-13.31	0.42	-12.94	-6.47
G	1.47	13.35	-39.53	-30.46	-10.15
Average	36.94	23.78	5.64	54.21	17.76

Ongoing awareness of the need to make reduce funds idling has special interest in the Islamic banks because they can't resort to the money market very short-term investment since it is normally interest-based. As such its liquidity management should take a very different course from what is in

conventional banks. Awareness of the Islamic bank about the importance of liquidity management is a matter that should never be taken lightly. We must understand that the success of liquidity management in the Islamic bank depends on its continuous ability to find profit-bearing uses of any cash injection that reaches the bank. It would be untenable to say that a bank's capital has increased and a huge cash flow has been injected so much as to cause failure of the liquidity management department to absorb it, as happened with bank B in 2000, when it needed a whole year to absorb just a part of the increase in capital!

Part of what could help investing available cash is for the bank to have short-term investment windows, by opening up to markets and short-term financial transactions that are at the same time Shari'ah compatible. This is what a number of Islamic banks did by resorting to short-term international *murabahab* transactions. The leasing instruments which the Bahrain Monetary Agency issued and the government *musharakah* and the banking certificates which are still being issue by the Government of Sudan for the last 4 years are all moving in the direction of facilitating the use of cash in profitable short-term investments rather than keeping it idle.

Table 5 below depicts the index of cash and deposits in banks to total assets. It also shows the annual growth of this index.

**Table 5: Percentage of Cash and Deposits in Banks/Total Assets**

BANK	1998	1999	2000	2001	Agg.	98/99	99/00	00/01	98/01
A	32.72	35.94	35.42	35.59	34.92	9.82	-1.43	0.47	8.76
B	4.23	3.77	6.28	3.76	4.51	-10.83	66.37	-40.14	-11.20
C	10.81	6.63	8.14	10.09	8.92	-38.69	22.83	23.90	-6.69
D	2.56	5.68	7.49	7.14	5.72	122.27	31.76	-4.70	179.10
E	8.65	10.95	9.16	13.01	10.44	26.50	-16.31	41.97	50.29
F	---	12.39	10.52	13.20	12.04	---	-15.11	25.57	6.59
G	6.94	6.65	6.58	3.39	5.89	-4.28	-0.98	-48.44	-51.13
Average	10.99	11.71	11.94	12.31	11.78	17.46	12.45	-0.20	25.10

In this table we find that one Islamic bank (bank G) was able to steadily reduce the cash index throughout the whole three years. This is consistent with our earlier observation about the quality of management in this bank and the market environment of its operation. But bank B has reduced the final figure of this index, even if it was unable to achieve a reduction in all the years. Another bank, D, was able to decrease the rapidity of increase in this index despite its inability to change its course. On the other hand the liquidity index in the four other banks witnessed an increase during the three year period.

### 3.3 Growth of Deposits in Islamic Banks

Customers' deposits are the foundation of a bank's activity and the source of its profitability. Table 6 outlines the development and growth of customers' deposits in the 7 banks we are studying. We find that banks that increased their assets by a high proportion are those that were able to substantially raise customers' deposits, as is the case with banks G and C.

**Table 6: Percentage Growth in Customers' Deposits**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	8.20	14.19	10.79	36.88	12.29
B	-0.22	11.79	-1.69	9.66	3.22
C	20.83	28.12	34.28	107.89	35.96
D	36.13	-5.60	-14.00	10.52	3.51
E	4.33	0.92	10.19	16.02	5.34
F	---	6.33	-25.89	-21.20	-10.60
G	5.79	15.90	14.74	40.69	13.56
Average	12.51	10.24	4.06	28.64	9.04

On the other hand, banks that are unable to realize high increases in their deposits are those that remained at the lowest rank of growth in their assets, as is the case with banks B, D, F and E. We should keep in mind, however, that the other source to increase assets is an increase in equities through bringing new funds from shareholders (bank B) or retaining large chunks of realized profit as done by all other banks without exception.

In addition to retaining profits, bank A started with a modest deposit growth average in 1999, but because it offered new financial instruments it was able to attract new deposits in 2000 and 2001. This re-emphasizes, time and again, the utmost importance of the efforts of the departments of financial engineering and marketing in the success of the Islamic bank, as it is these efforts that determine the bank's ability to attract new customers and to increase its transactions with the old ones.

Yet, Table 6 has some very important significance: the market for Islamic financial services in the countries where these banks operate, particularly in Kuwait, United Arab Emirate and in Bahrain to some extent, still have a tremendous capacity to absorb more Islamic financial services offers. If one bank is able to increase its deposits at a rate of more than 40 per cent or 170 per cent over three years, there must be a sort of market's thirst for such services and a high capacity to accommodate more Islamic financial services institutions.

Before concluding this sub-section we need to look at the components of these deposits. Clients' deposits are either demand (current) accounts, unrestricted short-term investment accounts of 3-6 months, medium-term, 1 year and above, or restricted/special investment accounts. The last type of accounts mostly operate on the basis of agency or hired manager, such that the bank gets a price of its services regardless of the result achieved to the deposit owner. Since returns of investment on current deposits are assigned to shareholders, not to depositors (because these accounts are guaranteed), their impact on shareholders' profit is direct and on a one to one basis. On the other hand, since Islamic banks usually service these accounts free of charge (even though some of them have started to charge monthly service fees), it very important to minimize the cost of these services or at least make it within the limit of their expected return.

Table 7 depicts the growth in current accounts in only 5 banks because one of the banks did not show the volume of its current account deposits in its annual report and the other is an off shore bank, it does not provide current account services.

**Table 7: Percentage of Growth in Current Account**

<i>BANK</i>	<i>1998/1999</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	2.42	24.29	16.06	47.73	15.91
B	3.88	63.55	-14.29	45.63	15.91
C	11.55	16.56	14.91	49.41	16.47
D	---	---	---	---	---
E	-14.57	2.84	2.77	-9.72	-3.42
F	---	36.50	-10.05	22.78	11.39
G	---	---	---	---	---
Average	0.82	28.75	1.88	31.17	11.15

Three banks were able to increase their current account deposits by almost 50 per cent over three years. But this increase was accompanied by an even higher increase in the total deposits of bank C, while the growth rate of current account surpassed the rate of increase in total deposits in banks A and B. This shows the importance of marketing current account services as a means of getting other deposits that would enable the Islamic bank to improve shareholders' profitability. We have pointed out that to a large extent this depends on improving customer relations. It striking that throughout 2000 and 2001 bank E has maintained a modest growth in its current deposits that are significantly lower than the growth of its total deposits.

It is important to bring in Table 8, despite its scanty information, because it points out a significant success factor of Islamic banks; that is the role of deposits in special and restricted accounts, as a factor of a substantial influence both positively and negatively. Whenever a bank is able to increase deposits in these accounts, its profitability rises, even with a weaker growth in its unrestricted deposits; and a failure to promote these ff-balance sheet deposits always reflects negatively on all components of total deposits.

**Table 8: Percentage Growth of Restricted and Special Investments**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	51.91	70.77	16.82	203.06	67.69
B	---	---	---	---	---
C	---	---	---	---	---
D	---	---	---	---	---
E	---	---	---	---	---
F	---	11.05	-37.68	-30.79	-15.40
G	---	---	---	---	---
Average	51.91	40.91	-10.43	86.13	26.15

Before concluding this sub-section, we need to take a brief look at the changes in depositors' share of profit, in terms of absolute changes and depositors' profitability index in relation to the size of deposits. This is what is illustrated in Tables 9 and 10.

**Table 9: Percentage Growth of Depositors' Profit Share**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	-13.92	72.79	10.64	64.56	21.52
B	-15.00	-35.29	12.12	-38.33	-12.78
C	28.91	43.03	-1.91	80.86	26.95
D	12.84	24.55	-25.96	4.05	1.35
E	9.57	5.84	-33.88	-23.62	-7.77
F	---	-11.48	-23.62	-32.39	-16.19
G	3.65	11.39	-12.18	1.39	0.46
Average	4.34	15.83	-10.68	8.12	1.93

From Table 9 we find that the absolute value depositors' share has dropped in three out the seven banks over 3 years. In banks B and F, this drop can be explained in part by the drop in investment deposits. But in bank E, depositors' share dropped despite the increase in investment deposit as

confirmed in Table 10, which shows a rapid drop in the ratio of deposits share to customers' deposits, as indicated by the negative signs in Table 10.

**Table 10: Profit Share of Investors/Customers' Deposits**

BANK	1998	1999	2000	2001	Avg.	98/99	99/00	00/01	98/01
A	2.66	2.12	3.20	3.20	2.79	-20.45	51.32	0.14	20.22
B	4.36	3.71	2.15	2.45	3.17	-14.81	-42.12	14.05	-43.76
C	4.06	4.33	4.83	3.53	4.19	6.68	11.63	-26.95	13.00
D	5.17	4.29	5.66	4.87	5.00	-17.11	31.93	-13.91	-5.85
E	4.02	4.22	4.43	2.66	3.88	5.02	4.88	-39.99	-33.91
F	---	6.66	5.55	5.72	5.98	---	-16.75	3.06	14.20
G	4.56	4.47	4.30	3.29	4.16	-2.03	-3.89	-23.46	-27.93
Average	4.14	4.26	4.30	3.67	4.16	-7.12	5.29	12.48	-16.92

The importance of cooperation between the investment and marketing departments is strikingly shown in these two tables. There is an apparent link between a depositor's share of profit and her desire to keep on depositing in the bank's investment accounts, or even in the current account that he is used to.

If the rate of return is so important to depositors that we find a positive relationship between the size of investment deposits and the profit, though at a lag, Table 10 points out a fact, often forgotten, that through improvement in its services, a bank can lure customers to remain with it – what is called customers' loyalty – even with weak a return on deposits. This may explain why even a smart researcher will not find a perfect correspondence between highest deposits and highest returns. This kind of “second line of defence” is imperative for the Islamic bank should take: improved services and high confidence/reliability can be leaned on if high returns become temporarily scarce.

### 3.4 Change in Earnings and Expenses

A study of the expenses and earnings of the Islamic banks enable us to understand the efficiency of the policy adopted in expenses and in pricing its services. Tables 11 and 13 show the growth of expenses and earnings, separately, while Table 12 ties expenses to investment deposits. Table 14 illustrates the change in the relation between expenses and earnings of the 7 Islamic banks. It should be noted that depositor' share of profits is not considered in an Islamic bank as part of the expenses, in contrast to interests in a conventional bank.

Cost efficiency is usually defined as the gap between the expense of a given bank and the expense of the lowest other bank for providing the same

service under the same economic, environmental and social conditions. Apart from the difficulty of assessing the cost efficiency of a bank, because there is in fact no such thing as “same conditions” for any two banks, its evaluation requires information not available in the annual financial reports.

For this reason, we will assume that Islamic financial services provided by Islamic banks are similar so that we may compare their expenses but we will use changes on expenses instead of absolute numbers as depicted in Table 11.

**Table 11: Percentage of Expenses Growth**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	0.75	2.99	7.25	11.28	3.76
B	14.29	-37.50	133.33	66.67	22.22
C	-25.81	-10.33	32.12	-12/10	-4.03
D	6.25	-5.88	0.00	0.00	0.00
E	-0.87	48.92	9.33	61.40	20.47
F	---	1.92	0.00	1.92	0.96
G	-7.77	-2.46	8.63	-2.27	-0.76
Average	-2.19	-0.33	27.24	18.13	6.09

Consequently, our consideration of the cost efficiency will be in the form of answering the following question. If a bank can reduce its expenses why can't another bank do the same? It is evident from the table that two Islamic banks were able to reduce their costs, and they happens to be the same banks that realized the highest level of deposits and assets during the period covered by the study. In contrast, we notice that two other banks had their costs increased by an annual average of more 20 per cent, despite only a very modest increase in their investments and deposits.

Keeping in mind that the overall objective of spending is to serve the bank' investment, we should quickly move to the ratio of expenses to assets, which is illustrated in Table 12 in an attempt to discover the indication of this index as to how the Islamic bank achieves its objectives.

Four banks were able to reduce their cost/invested assets index. Two of them were able to reduce this index by 56 per cent and 33 per cent respectively during the three years. This index rose in three other banks by 45 per cent, 35 per cent and 25 per cent respectively during the same time! Furthermore, this index as is declining in banks A and G and, to some extent, C as indicated by its yearly changes. This implies that these banks look after their cost efficiency. On the other hand, it takes an upward movement in banks D, E, and F, and, to some extent, B.

**Table 12: Percentage of Expenses/Invested Assets**

BANK	1998	1999	2000	2001	Ang.	98/99	99/00	00/01	98/01
A	2.75	2.72	2.45	2.42	2.59	-1.03	-10.08	-1.19	-12.06
B	1.42	1.61	0.83	1.92	1.45	13.44	-48.38	130.90	35.22
C	3.73	2.19	1.57	1.61	2.28	-41.29	-28.56	2.69	-56.93
D	1.96	1.56	1.80	1.87	1.80	-20.30	15.56	3.68	-4.50
E	3.04	2.99	4.25	4.44	3.68	-1.72	42.23	4.33	45.83
F	---	1.29	1.25	1.62	1.39	---	-3.14	29.37	25.31
G	2.06	1.80	1.52	1.36	1.68	-12.74	-15.41	-10.35	-33.83
Average	2.49	2.02	1.95	2.18	2.12	-10.61	-6.83	22.78	-0.14

It does without saying that the index of expenses to invested assets helps in the bank's investment planning because it measures the cost of managing invested assets: every one hundred Dinars of invested assets costs 2.12 Dinars in the seven banks' average. This cost of investment is above average in banks E, A, C while bank F was able to provide the services with the lowest cost of all.

With regard to revenues (a term used to cover returns to both shareholders and depositors together because our concern here is focused on the bank's ability to generate income) Table 13 shows that revenues increased by an average of 19 per cent in bank C; an expected high rate in line with all other growth indices observed in this bank over three years. The increase in revenues is a sign of one or two measures: rational policy in services pricing and a higher return on investment. The latter is in turn an indication of an increase in the size of invested assets and an improvement in their quality. All these matters are very instrumental in the success of any bank and the success of Islamic banks in particular because they do not have the choice of both attractive and guaranteed investment at the same time as conventional banks do.

**Table 13: Percentage of Growth in Earnings**

BANK	1998/1999	1999/2000	2000/2001	1998/2001	Average
A	-11.65	26.99	1.45	13.82	4.61
B	-4.21	-35.16	69.49	5.26	1.75
C	15.41	23.13	10.32	56.77	18.92
D	11.93	12.30	-21.53	-1.38	-0.46
E	3.69	13.72	-2.01	15.55	5.18
F	---	-6.66	-14.84	-20.51	-10.26
G	1.59	7.46	-0.62	8.48	2.83
Average	2.79	5.97	6.04	11.14	3.23

However, to arrive at a meaningful conclusion regarding the revenues we need to explain the income pattern in other banks too. In this regards, we shall take into account the financial and business boom of 1999/2000 that

had a sizable impact on financial results, especially that the effect of the stock market crisis did not affect the Arab region until late 2000. Except for bank F, the Islamic banks were only little affected because of the scantiness of their investments in the global market. That is why we see high earning figures with all the banks for year 2000 that were not attributable to their management style or to their ability to innovate or market their banking instruments or services.

Additionally, bank A was able to introduce two new types of investment instruments that fetched it 20 per cent and 24 per cent of the total earnings for 2000 and 2001 respectively. This enabled the bank to make up for the drop in the bank's investment earnings, to increase customers' deposits (restricted and special accounts) by 23 per cent and 24 per cent respectively and to improve depositors' share of profit. For bank F, while the average decline in its total deposits was close to the decline in average earning, the drop in its investment deposits exceeded the decline in earning by about one half. In banks B, D and E, there was no visible increment in their revenues other than what was caused by to boost of year 2000. What remains is to focus on bank G.

A careful look at this bank's balance sheet reveals a weakness of its investment selection policy. While the average return on its *murābahah* and *istiṣna'* investments hovers around 10 per cent, revenues on most of its other investments are very weak. This resulted in a drop of the average ratio of total revenues to invested assets from 8.79 per cent to 6.46 per cent, i.e. an average of more than one quarter over three years as shown in Table 14. Perhaps the most important reason of this decline is its dependence on low-yielding investments such as short-term international *murābahah* that increased by more than five and a half times, until it reached almost one half of the bank's investments in 2001.

**Table 14: Percentage of Revenues/Invested Assets**

BANK	1998	1999	2000	2001	Avg.	98/99	99/00	00/01	98/01
A	7.63	6.62	7.34	6.86	7.12	-13.21	10.89	-6.53	-10.05
B	6.42	6.11	3.27	5.49	5.32	-4.92	-46.45	67.73	-14.60
C	8.01	7.32	7.18	6.15	7.16	-8.67	-1.91	-14.26	-23.19
D	13.35	11.21	15.45	12.57	13.15	-16.04	37.88	-18.64	-5.82
E	8.48	8.72	9.47	8.85	8.88	2.80	8.62	-6.49	4.41
F	---	8.75	7.60	8.38	8.19	---	-11.30	10.18	-2.27
G	8.79	8.45	7.87	6.46	7.89	-3.89	-6.81	-17.99	-26.55
Average	8.78	8.14	8.31	7.82	8.24	-7.32	-1.30	2.00	-11.15

Table 14 shows the revenues/investment index. Any conclusion to be made from the table should take note of the different economic and financial

conditions in the countries where the banks are located. Nevertheless, lack of better information has forced us to categorize the banks into three groups: Bank D alone; Banks E and F; and Banks A, C, G, and B. Bank D is very selective in its investments; it chooses high-yield assets. Despite the decline in its assets and deposits, it was able to maintain high returns. The second group, banks E and F, maintained a satisfactory level of return. Bank C contended itself with conventional financing, at an acceptable rate of return without going for international *murābahah* as an easy way to place idle funds since it does not require any detailed study or plan. Bank F benefited from its size to diversify investment. Three of the four banks in the third group relied on international *murābahah* with its low return. As for bank A, it got no more than 4-5 per cent return on its investment in local *murābahah* either because of the pricing of its services or because of the narrowness of the market from which it chooses its customers. That is, despite its non-recourse to international *murābahah* that did not exceed 6.55 per cent and 5.66 per cent of its invested assets in 2001 and 2002 respectively.

Additionally, the average column in Table 14 shows that all banks have weak asset turnover ratios. This is caused by the fact that most of their assets were held in the form of debts that come from *murābahah* and *istiṣnāʿ* contracts. Debt assets cannot be turned into liquid for reinvestment. Efforts to change the financing structure from *murābahah* to *mushārahah*, (an alternative to *murābahah* especially in financing letters of credit which is different from the known production partnership) and to expand the *murābahah/ijārah* combined portfolios would enable the Islamic banks to sell their invested assets to the central bank or to other banks in order to have sufficient liquidity that enable them to raise the rate of asset turnover. Until such efforts take their full scale, we should not be surprised by low and declining revenue indices for all the 7 Islamic banks as shown in Table 14.

We turn now to the index of expenses to revenues which we find in Table 15. Three banks were able to reduce this index while it rose dramatically in three other banks. The two biggest increases in this index (banks B and F) came from a decline in revenues. The third increase was caused by an increase in cost.

However, we can detect the big impact of using advanced technology on cost reduction, which becomes apparent when bank G is compared with Bank A, since both of them are similar in terms of large number of current accounts but are greatly different in deploying advanced technology in banking operations. Finally, we must remember that bank D is an off-shore bank dealing only with few people and is selective in its investments, a factor that enabled it to occupy the best position in the expenses to revenues index.

**Table 15: Percent of Expenses to Revenues**

BANK	1998	1999	2000	2001	Avg.	98/99	99/00	00/01	98/01
A	36.04	41.10	33.33	35.24	36.43	14.04	-18.91	5.71	-2.23
B	22.11	26.37	25.42	35.00	27.23	19.31	-3.60	37.67	58.33
C	46.62	29.97	21.83	26.14	31.14	-35.72	-27.17	19.76	-43.93
D	14.68	13.93	11.68	14.88	13.79	-5.07	-16.19	27.44	1.40
E	35.87	34.30	44.91	50.11	41.30	-4.40	30.95	11.57	39.67
F	---	15.06	16.44	19.31	16.94	---	9.20	17.43	28.22
G	23.41	21.25	19.29	21.09	21.26	-9.21	-9.23	9.32	-9.91
Average	28.79	26.00	24.70	28.82	26.87	-3.51	-4.99	18.41	10.22

### 3.5 Changes in Net Profits

In this sub-section we shall focus on the profitability of the Islamic bank by studying the changes in net profits, the profit to invested assets index and the ratio of profit to shareholders' equity taking the rate of equity growth into account. For a meaningful comparison we have taken profits figures before reserves and tax because our focus is on the achievement of the bank's management itself, though analysis of after tax profit is also possible.

**Table 16: Net Profit/Invested Assets**

BANK	1998	1999	2000	2001	Avg.	99/98	00/99	01/00	98/01
A	0.91	3.44	0.53	1.55	1.61	278.55	-84.55	190.74	70.03
B	1.01	1.21	1.27	1.54	1.26	19.11	5.54	20.47	51.44
C	-0.51	1.20	1.13	1.12	0.74	335.76	-5.94	-0.31	-6.23
D	2.33	2.25	2.26	1.70	2.13	-3.27	0.23	-24.83	-27.12
E	1.92	1.64	1.10	1.79	1.61	-14.87	-32.51	62.10	-6.87
F	----	0.42	0.24	0.55	0.40	----	-43.55	132.87	31.46
G	2.80	2.80	2.60	2.31	2.63	0.01	-7.03	-11.06	-17.30
Average	1.41	1.85	1.30	1.51	1.48	102.55	-23.97	52.85	13.63

Table 16 shows the index of net profits to invested assets. From this table it is observed that two Islamic banks were able to realize profits of more than 2 per cent on their invested assets. A third bank also exceeded the average profitability of the seven banks while three of them hovered around the average, leaving two other banks at positions far below the average.

We should however note the effect of the drastic change that took place in the management concepts, style and approaches to investment and to customer relation that took place in bank C. This made this bank move from low profitability, or loss, to a higher level in one year, 1999. But the bank

could not sustain that big move and its profitability index stabilized around 1.1 per cent to 1.2 per cent over the three years. Also a look at the profitability index of banks F, B, C, and to some extent, E and A, indicates a weakness in their ability to improve profit rates.

Finally, Table 16 emphasizes the result we arrived at earlier: low turnover in all these banks. While it is high turnover rate that is a major factor of profit making in conventional banks.

It is perhaps useful to compare revenues, expenses and net profits indices all together, in such a way as to facilitate an observation of the relationship between them. This would assist the annual planning of the Islamic bank. Figure 2 puts these three indices together side by side. Observing the profitability index alongside the expenses and revenues indices helps understand the phenomenon of chronic weakness of profit making in banks. It is such an important matter in management that Islamic banks should be in constant alert to avoid it. Chronic weaknesses of profit making are characterized by an increase in spending, stagnancy of revenues, slowness in introducing any substantial managerial change, and modality of conducting their affairs pertaining to relations with customers as well as investment policies.

It is noticeable from Figure 2 that there are differences between Islamic banks in concurrence of investment profitability index with the index of their revenues. While bank D achieved the highest revenue index, it was not the bank with the highest profit on investment; just like bank F which was able to squeeze spending but did not make high profit on investment despite attaining a high rate in the revenue index. Also, bank G achieved the highest profitability on investment while its achievement in the areas of expenses and earnings was modest. The reason for this disparity is found in the differences of pricing of services offered by Islamic banks to owners of all kinds of investment deposits and the differences in the ratio of non-investible parts of deposits. These prices belong to the realm of distribution in the Islamic banks and do not appear in Figure 2.

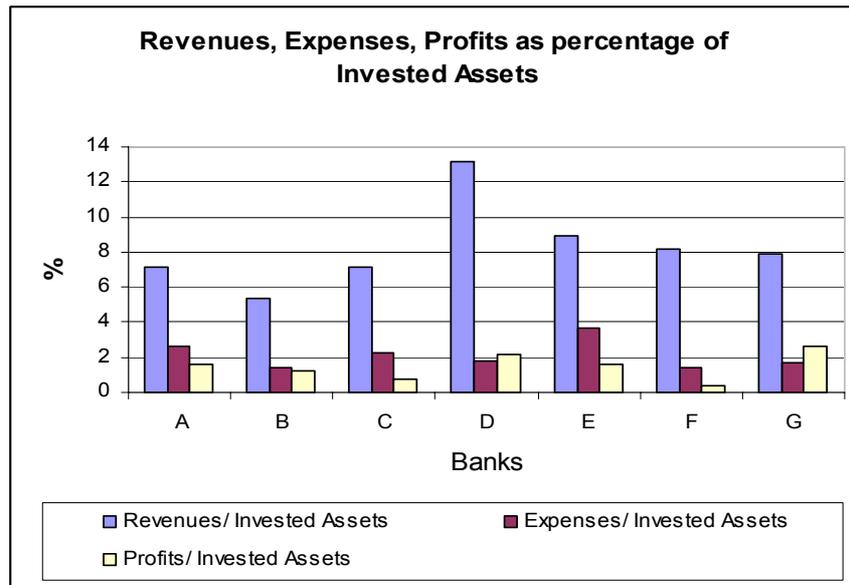


Figure 2

Table 17 shows the trend of change in the net profits, regardless of its relationship to invested assets. What is striking is that bank F was able to raise the rate of growth of its profits from 40 per cent to 80 per cent between 2000 and 2001 despite the decline in its total earnings in the same period. The reason is that the bank re-priced some of its services and was able to increase the bank's share of investment returns from unrestricted and restricted investment deposits from 4 per cent and 12.4 per cent in 1999 to 14.6 per cent and 13.7 per cent in 2000; then to 18.1 per cent and 20.3 per cent in 2001 respectively. This had a big impact on the bank's net profit despite the decline in deposits and investments. What the bank did was very important in affecting the bank's profitability, thus emphasizing the importance and effectiveness of bank's pricing policy in achieving results.

Table 17: Growth Rate of Shareholders' Net Profit

BANK	1998/99	1999/2000	2000/2001	1998/2001	Average
A	-40.91	15.38	-53.33	-68.18	-22.73
B	20.00	27.78	21.74	86.67	28.89
C	26900.00	18.07	28.26	51.44	17.15
D	28.95	-18.73	-27.50	-23.68	-7.89
E	-14.13	-29.34	69.87	3.07	1.02
F	---	-40.59	80.00	6.93	3.47
G	5.71	7.21	7.77	22.14	7.38
Average	4483.27	-2.84	18.12	11.20	3.90

Table 18 relates net profit to equities. Since the profit figures that we are using are those that are before deduction of reserves and *zakāh*, they represent the total return achieved for the year. We preferred not to deduct income tax too so that the comparison can be more just, especially because only one bank is mainly subjected to taxes.

**Table 18: Per Cent of Net Profit/Equities**

<i>BANK</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>98/99</i>	<i>99/00</i>	<i>00/01</i>	<i>98/01</i>	<i>Arg.</i>
A	8.64	4.94	5.50	2.61	-42.82	11.36	-52.55	-69.78	5.43
B	10.20	11.84	5.88	7.25	16.05	-50.33	23.32	-28.91	8.80
C	-3.37	9.59	10.91	13.41	384.59	13.74	22.96	0.40	7.64
D	7.87	9.25	7.09	4.92	17.51	-23.29	-30.69	-37.52	7.28
E	22.87	18.87	11.80	18.10	-17.47	-37.47	53.38	-20.84	17.91
F	---	4.37	2.58	4.46	---	-41.00	72.93	2.03	3.81
G	24.85	23.10	21.92	21.39	-7.05	-5.13	-2.38	-13.92	22.82
Average	11.84	11.71	9.38	10.31	58.47	-18.87	12.42	-24.08	10.52

The index of profit on equity remained high in two of the seven banks. Its average over the four years reached 22.82 per cent and 17.91 per cent in banks G and E respectively. There are two reasons for this: a rise in the ratio of assets to equities, as we shall see later, and the pricing policy adopted by these two banks. On the other hand, the average of this index came within the average range in three banks but was below average in banks A and F, although the average of assets to equities in these two banks was close to the average of the two top banks G and E.

The seven banks recorded an average profit/equity index of 10.51 per cent for the four years and 11.71 per cent for 1999; both figures are less than the achievement of US commercial banks that made an average of 13.5 per cent in 1999, the year for which we have the data. Similarly, while the highest that a US bank achieved was 39.0 per cent, the highest comparable figure for Islamic bank was not more than 23.1 per cent in 1999 and 22.82 per cent average for three years.<sup>10</sup>

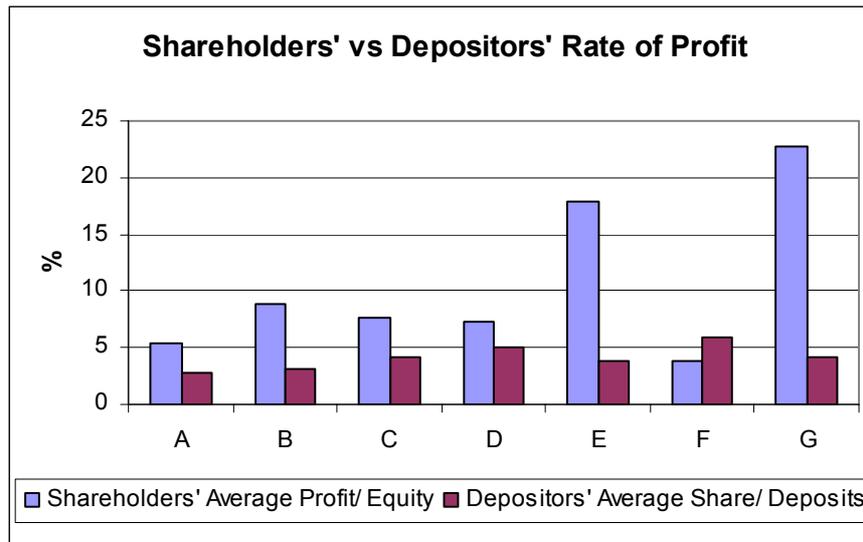
**Table 19: Per cent of Equity Growth**

<i>BANK</i>	<i>1998/99</i>	<i>1999/2000</i>	<i>2000/2001</i>	<i>1998/2001</i>	<i>Average</i>
A	3.34	3.61	-1.65	5.30	1.77
B	3.40	157.24	-1.28	162.59	54.20
C	4.69	3.81	4.31	13.36	4.45
D	9.73	6.42	4.61	22.15	7.38
E	4.04	13.00	10.76	30.21	10.07
F	---	0.69	4.09	4.81	2.40
G	13.73	13.01	10.41	41.89	13.96
Average	6.49	28.25	4.46	40.04	13.46

If equity increase comes about from retained profits under various names and from the increase in paid-up capital, we shall find the effect on banks' profit if we examine retained earnings. Table 19 gives per cent of equity growth. Bank B increased its capital by attracting new funds while banks A and G increased their capital through renaming their retained profits and other reserves.

It is expected that the bank that can assign the highest profit to shareholders from total profit would be the one that would be capable of raising the equities. This was the case in banks G and E, both of which were able to raise equities by 42 per cent and 30 per cent respectively over three years.

It is perhaps necessary, before ending this sub-section to take a look at Figure 3 which compares shareholders rate of profit with depositors' share. Except for bank F, all Islamic banks suffer serious disparity between deposits profit and stocks profit. Stocks profit reached almost five times as much as deposits profit in two of the banks and hovered around twice as much with other three. In bank F where average deposits profit surpassed average equity profit, there are a few factors that are responsible, including pricing policy and the bank's inability to develop its revenues as well as the weakness of its old/inherent returns on the bank's assets investment.



**Figure 3**

### 3.6 Adherence to the Shari‘ah and Doing Good Deeds

In this final sub-section we discuss two issues that distinguish Islamic banks from other banks: (1) The effect on customers of transparency in adherence to the Shari‘ah and (2) contribution to charity and social/community welfare.

The reports of Religious Supervisory Board have always accompanied the annual reports of the management. Those reports have ranged from stunning brevity of less than two lines in the case of bank G to details that reached two pages in the case of bank C. Both in summary and detail, the reports have always carried expressions that do not tell the reader more than “the bank’s operations are in compliance with the noble Shari‘ah”, and nothing on issues that interest the reader such as the relationship between the depositors and the shareholders. The Shari‘ah report on bank C for example says that the management has promised to implement in future the recommendations made to it by the Shari‘ah board. There is no reference to what those recommendations were or why they were made.

With regard to *zakāh*, *ṣadaqah* and other voluntary donations, the Islamic banks have their share in such giving. A number of Islamic banks leave the distribution of *zakāh* to shareholders while only a few take the responsibility of distributing *zakāh* on behalf of the shareholders. Hence, only four banks reported *zakāh* distribution. This does not mean that other banks do not have donations and voluntary charity outside *zakāh* on which shareholders are left to take charge. Table 20 shows these contributions:

**Table 20: Average *Zakāh* and *Ṣadaqah* in Some Islamic Banks 1998-2001**

BANK	Average <i>Zakāh</i> and <i>Ṣadaqah</i>	Average Equity	<i>Zakāh</i> and <i>Ṣadaqah</i> /Equity (per cent)	Average Profits	<i>Zakāh</i> and <i>Ṣadaqah</i> /Profits
B	0.08	26.90	0.29	2.10	3.81
C	2.45	1070.00	0.23	84.30	2.91
D	0.26	54.20	0.48	3.90	6.67
G	2.13	204.55	1.04	46.08	4.62

The ratio of *zakāh* and *ṣadaqah* to equity hovered between less than one tenth to two fifth of the 2½ known rate in the noble Shari‘ah. Also, the ratio of *zakāh* and *ṣadaqah* to profits ranged between 2.9 per cent and 6.7 per cent, whereas *zakāh* rate on those profits should be subjected at a rate similar to

that of farm products which is 10 per cent of the net profit. Regardless of the juristic views, we know that there are needs for much more contributions for humanitarian activities and social aid and assistance. This represents an open area for institutions and individuals; i.e., to give, in order to improve the social environment in which they live. The value of contributions made by the Islamic banks are too little and incomparable to donations made by western companies for humanitarian and social services in their countries.

#### **4. Success Factors of Islamic Banks**

In this section I will try to derive lessons from the theoretical criteria of success and their practical application to seven Islamic banks. This section is divided into six sub-sections: banking efficiency, increasing confidence in a bank, efficiency in investment management, financial engineering and marketing, preservation of shareholders and depositors' equity, provision of humanitarian and social services and other factors.

##### **4.1 Banking Efficiency**

Banking efficiency is the extent to which a bank's management is able to increase its assets and maximize its profits in both the long-run and the short-run. There is no doubt that the Islamic bank is fundamentally different from the conventional bank in the nature of its relationship with its depositors - a relationship of partnership. This different nature of bank/depositor relations suggest that the management policy of an Islamic bank should be fundamentally characterized by the maximization of both shareholders profit and depositors' profit.

While efficiency in conventional banks is defined as the gap between the average profit of a given bank and the highest profit average in other banks, adding the element of depositors' share of profit to this definition is necessary for Islamic banks. Such an addition is also consistent with the long-term consideration for measuring bank's efficiency in all cases, because depositors' share of profit positively influences the size of deposits as we noticed earlier. This addition may be measured, at least in a comparative static manner, by holding one of the two indices constant while we examine changes in the other.

Profit efficiency of a bank is usually measured in the same way as in other productive firms, where we assume that prices and structure of inputs (bank's expenses) and outputs (bank's services) are constant. To examine efficiency we measure the gap between average profit in the Islamic bank and the

highest average profit in other banks, while holding depositors' share constant. We then repeat the same experiment, with fixed average profit and compare the average of depositors' profit share.

Despite the fact that any comparison of numbers between two banks operating in different environments is not free of errors due to the existence of many factors over which the bank management have no control, the power of numbers cannot be overlooked. A numerical exercise to measure efficiency in a community of the 7 Islamic banks will give us a useful insight on their relative efficiency. This will be done once by fixing equity profit at the level of the highest bank and rendering the remainder to depositors (Table 21, column 2). We then repeat the exercise again by fixing shareholders' profit at the level of the lowest bank and rendering the remainder to depositors (Table 21, column 3). We will again repeat the same exercise but with fixing the highest and lowest values depositors shares and rendering the differences to the shareholders (Table 21, columns 4 and 5). Table 21 is given below in which the last two columns depict actual averages of depositors' share and shareholders' profit.

**Table 21: Efficiency in Islamic Banks 1998-2001**

<i>BANK</i>	<i>APD*</i>	<i>APD</i>	<i>APS*</i>	<i>APS</i>	<i>APD/</i> <i>Deposits</i>	<i>APS/</i> <i>Equities</i>
	Shareholder's Profit fixed at 22.82%	Shareholder's Profit Fixed at 3.81%	Depositor's Share fixed at 5.98%	Depositor's Share fixed at 2.79%		
A	1.47	2.92	-36.50	5.43	2.79	5.43
B	0.56	4.09	-6.36	10.83	3.17	8.80
C	2.42	4.63	-7.81	19.64	4.19	7.64
D	2.52	5.55	1.10	21.12	5.00	7.28
E	3.36	5.18	-4.50	28.74	3.83	17.91
F	4.08	5.98	3.81	35.79	5.98	3.81
G	4.16	6.78	9.62	32.70	4.16	22.82
Average	2.65	5.02	-5.81	22.04	4.16	10.52

Note: APD = Average Profit of Depositors  
APS = Average Profit of Shareholders

Column 5 of Table 21 above indicates that if all the 7 Islamic banks were to distribute to their depositors the same returns distributed by the lowest bank, i.e. 2.79 per cent, the best of the banks in terms of managerial efficiency, represented by the average profit realized would be bank F that

realized 35.79 per cent profit, followed by banks G and E, with 32.70 per cent and 28.74 per cent respectively. If we fix the average shareholders' profit at the lowest rate distributed by any bank, i.e. if all the banks realized just that level of profit, 3.81 per cent, as in column 3, the most efficient of them in terms of profit share to depositors would be bank G, followed by banks F and D, which would be able to distribute 6.78 per cent, 5.98 per cent and 5.55 per cent respectively. However, bank A occupies the lowest position of efficiency in the two cases, followed by bank B. The two banks were only able to realize profits not exceeding 5.43 per cent and 10.83 per cent, or shares to depositors not exceeding 2.92 per cent and 4.09 per cent in the two cases respectively.

If we want to measure the distance between the profit of any bank and the best profit realized by a bank that distributed the highest share to depositors, then column 4 shows that if all the banks distributed the depositors shares equal to the best share actually distributed by any bank, i.e. 5.95, the bank with the highest profit is bank G, followed by bank F which realized the closest profit, then bank D, whereas 4 banks would fall below the red line with a loss of more than 36 per cent in bank A, followed by bank C with a loss of 7.81 per cent and then bank B with a loss of 6.36 per cent. But if all the banks realized the shareholders' profit of the most profitable bank, i.e. at 22.82 per cent, distribution of the profit share to depositors will again put bank G in the lead, followed by banks F and D with 4.16 per cent, 4.08 per cent and 3.36 per cent distributed shares respectively. Bank B will have the lowest distribution that is no more than 0.56 per cent, followed by bank A with a distribution of no more than 1.16 per cent.

The importance of a study of bank efficiency in Islamic banks lies in that it allows the measurement of aggregate achievement of management, whether in terms of the profit it offers to shareholders or in terms of the shares of profit distributed to depositors. Needless to say that improving bank efficiency requires management to take three integrated steps: 1)- study the aspects that require improvement; 2)- planning that includes setting out stages for possible changes and identifying responsibilities for executing the plan; and, 3)- monitoring the implementation and measuring achievement. All these steps require speed, accuracy and guarantee that the relevant information gets to, and is received by, the management on time.

One of the very important factors in raising efficiency is continual study of the cost and profitability of every operation and every customer. This can be achieved through a modern method of standard cost accounting that enables the analysis of profitability of every operation before it is commenced. The profitability of every customer can also be analyzed by

bringing together the results of a customer's operations. It is not difficult to rely on the historical average cost, just as it is easy to amend it to incorporate marginal cost changes. Expected revenues are also calculated in light of the historical returns, amended as dictated by changes in the prices of bank services. Banks often rely on a dynamic weighted average model which uses the most recent historical weighted average with an adjustment coefficient that is determined on the basis of price developments after the latest historic period.

Additionally, the following four points are the outcome of several studies on improving bank efficiency. These points are basically related to the behavioural patterns and key strategies of the top management in running the bank. 1) Distribution of authority and avoidance of centrality in decision taking; 2) Registering the bank's stocks in the local and international stock exchanges; 3) Increasing off-balance sheet investment out of total investments; and 4) Cooperation with similar banks. As for delegation of authority, several surveys carried out in the US banks showed that banks that separate between the positions of general manager and the chairman of board of directors usually record higher profitability than those that merge the two positions in one person.<sup>11</sup> The same surveys showed that banks that are established as joint stock companies with stocks traded on international stock markets record high profits than those whose stocks are not traded. The reason for this is that the management pays attention to the market value of the stocks, thus it is more motivated toward expansion and growth. It has also been statistically shown that off-balance sheet investment operations give more profits than ordinary investments.<sup>12</sup> In Islamic banks these operations take the form special and restricted investments and numerous autonomous investment funds. The idea of restricted investments managed on the ancient principle of agency is well entrenched in Islamic banks, although some (Al-Rajhi Banking and Investment Corporation) do not depend on it to such an extent as to make it a strategic part of profitability management, rather it only uses them to attract big deposits. Also some Islamic banks do not encourage restricted investments and investment funds as shown in the reports of banks B, C, D and G. Bank E started the experiment in 2001. On the other hand, bank A and F were able to get 59.5 per cent and 45.3 per cent, respectively, of their gross revenues from off-balance sheet investments. The effect of off-balance sheet investments on their net profits was 42.7 per cent and 141.6 per cent respectively.<sup>13</sup>

The need for cooperation and solidarity among Islamic banks, especially those operating in the same local market, has been proved by events where a bank is affected by the conditions of the other banks as it happened in case

of Egyptian Faisal Islamic Bank when international Islamic banking suffered some extraordinary conditions. Additionally, studies based on accurate data confirms this intuitive conclusion whereby stock prices of all similar banks fall when one of them suffers a drop in its price and most of them suffer depositors' pressure if one them suffers such a run.<sup>14</sup>

In Sections 2 and 3, I mentioned the most important aspects that require improvement and change – reduction of expenses, increasing earnings, increasing the turnover rate of invested assets, improving quality of investments and reducing the amount and ratio of idle funds. Each of these aspects has details some of which will be discussed in the coming sub-sections.

#### **4.2 High Level of Trust**

The reputation of management and founders is an issue that does not need re-emphasis. It is evident that trust is the first foundation for the success of any bank. In addition, the reputation of its Shari'ah board also matters. A tremendous progress has been recorded in the area of financial *fiqh* over the past four decades where numerous studies, symposia and conferences were conducted with the help and support from Islamic banks. Adherence to the Shari'ah in the banking and finance has become a familiar issue that does not require new juristic reasoning, especially after new standards issued by Accounting and Auditing Organization for Islamic Financial Institutions. What every Islamic bank requires today is effective supervision on the implementation of standards and collective religious rulings in their actual deals and transactions with customers, depositors and shareholders, as well as effective Shari'ah supervision on innovations by their financial engineering department. This type of supervision cannot be exercised by bringing together senior scholars "who are pre-occupied with a thousand other things" in the Shari'ah board that presents traditional annual reports at the end of the year. Thus, we consider it very important for every Islamic bank to devise an effective institutional framework of Shari'ah supervision which enables the bank to combine effectiveness with reputation, such that it would be able to get real trust that it can deploy in marketing its services and new innovative financial products. Part of such measures include the appointment of a Shari'ah experts whose main duty would be the supervision of banking operations and deals and assisting the financial engineering and investment departments. He/she would also serve as a link between the bank and other members of the Shari'ah board. Only a few Islamic financial institutions in Sudan, United Arab Emirates, Kuwait, etc. have recently implemented this concept.

Another important aspect in gaining the confidence of clients is the bank's capital strength that induces trust in the bank's future and its commitment. This gives the depositors a sense of security on their investment and current deposits and a peace of mind based on investment of bank's own capital in various projects. The capital strength of the 7 Islamic banks is depicted in Table 22.

Several recent studies suggest that the Islamic bank needs a higher ratio of capital to total assets, i.e. a higher index of capital adequacy, than what is required in conventional banks that deal on the basis of guaranteed loan contracts because the Islamic bank is not merely a commercial bank, but combines the qualities of commercial and investment banks together. Table 22 indicates that capital adequacy in some Islamic banks does not instil enough confidence especially if we take into account their excessive reliance on current and demand deposits. For example, the banks A and E both occupy the lowest ranks in capital adequacy.

**Table 22: Percentage of Equity/Total Assets**

<i>BANK</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>Avg.</i>	<i>98/99</i>	<i>99/00</i>	<i>00/01</i>	<i>98/01</i>
A	7.20	6.95	6.58	5.91	6.66	-3.51	-5.31	-10.23	-17.98
B	9.42	9.72	20.42	19.87	14.86	3.14	110.42	-2.85	110.82
C	12.82	11.24	9.27	7.41	10.19	-12.28	-17.52	-20.05	-42.15
D	28.72	22.82	28.92	31.89	28.09	-20.55	26.77	10.26	11.06
E	7.45	7.44	8.25	8.40	7.88	-0.14	10.89	1.83	12.75
F	---	7.98	7.87	10.24	8.69	---	-1.40	30.15	28.33
G	10.12	10.86	10.72	10.09	10.45	7.29	-1.28	-5.86	-0.29
Average	12.62	11.00	13.15	13.40	12.40	-4.34	17.51	0.46	14.65

While the average index of capital adequacy is not less than 8.2 per cent in the US commercial banks and 30.2 per cent in US investment banks<sup>15</sup>, we find that this index for 2001 dropped to 5.91 per cent in bank A and 7.41 per cent in bank C. Capital adequacy witnessed a continuous decline since 1998 in the two banks, while it revolves around 1/12 in bank E despite its modest rise during 1999-2001. Bearing in mind that the ratio of demand deposits and/or current accounts to total deposits in these three banks is higher than in other Islamic banks as shown in Table 23 it is not a satisfactory state of affair.

Islamic banks should have at least 1/12 capital adequacy. This is very important for maintaining soundness of the bank and for attracting all types of deposits.

**Table 23: Per Cent of Current Accounts to Total Deposits**

<i>BANK</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>	<i>Average</i>
A	16.71	15.82	17.22	18.04	16.95
B	7.48	7.79	11.39	9.93	9.15
C	22.64	20.90	19.01	16.27	19.71
E	25.95	21.25	21.66	20.20	22.26
F	---	1.91	2.45	2.97	2.44
Average	18.20	13.53	14.35	13.48	14.10

Another factor which is needed for confidence building is the ability of the bank in providing integrated high quality services to for all the financial needs of the clients. Apart from some narrowly specialized banks, expansion and diversification of the banking services instil confidence in the bank and build business loyalty of the customers. With expansion and diversification come speed and effectiveness of services provided to the customers as they assure them of the bank's ability to achieve.

Management's attention to things that many consider small and trivial, such as dress, cleanliness, smiling, avoiding queue formation, accuracy and speed in concluding a transaction, should be relentlessly emphasized as some of the key factors of a bank's success.

#### **4.3 Efficiency of Investment, Financial Engineering and Marketing Departments**

These three departments should be well equipped, trained and prepared. The investment department generates revenues for both shareholders and depositors and it is the one that directly influences the bank's profitability. It must be accountable for the task of continuously raising two indices: the investment index (invested assets to total assets) and the index of earnings to assets that measures investment return while it is constrained by the two principles of yield stability and capital preservation.

Additionally, the Investment department needs to adopt a pricing policy that reflects overall circumstances of the bank, the services it provides to customers including the unique services of *mudārib* should be taken into account.

Another success factor of the Islamic bank lies in its financial engineering department. This department must always be able to provide a continuous flow of new instruments, windows and investment contracts that assist the bank to attract new customers and offer new services. It is evident that the

department of financial engineering has a big role to play in inventing new investment vehicles, especially vehicles that fit off-balance sheet investments.

Although most Islamic banks pay little attention to it, the marketing department has a key role in the bank's ability to attract both deposits and investments. It is the department that is directly responsible for the promotion and growth of the bank's business. It formulates the strategy and policies of presenting banking services to clients and potential customers in order to achieve qualitative shifts and continuous increases in the number of customers and the volume of their transactions in a measurable and accountable manner.

#### **4.4 Preservation of Bank's and Customers' Assets**

This is the responsibility of the departments of liquidity and investment under direct supervision of the top management of the Islamic bank. The most important aspect in functioning of this department is a strict commitment to sound banking practices: adherence to self-established red lines that apply to both the departments and the top management, diversification of invested assets, choice of investment opportunities, maintenance of appropriate equities/assets ratio and creation of necessary reserves to stabilize the distribution rates to the *muḍārabah* account holders and to shareholders. An illuminating example is the reserve fund for investment risk that is created by Bank A. This fund enabled the bank to absorb the "ups and downs" in investment returns without violating the tenets of Shari'ah. In 1994, bank A invented another idea by creating an internal mutual insurance fund to overcome the problem of bad debts. This fund insures the bank's debtors against non-commercial risks.<sup>16</sup> Both funds assist the Islamic bank to manage risks and to preserve customers' deposits, just as the general and mandatory reserves provide the same services and play the same role with shareholders' equities.

#### **4.5 Providing Humanitarian and Social Services**

Integration with its local environment and the community is an important factor of success for the Islamic bank. This must be a more emphasized characteristic of Islamic banks than their conventional counterparts, since the *raison d'être* of the former is to accommodate the community's faith and beliefs. Research studies have shown that the more community sensitive a bank is the more profitable it will be in the long run. The social and humanitarian responsibilities of Islamic banks are, no doubt, bigger than their conventional counterpart because of the moral values and societal ideals to which they adhere aside from the ones obligated by

compulsory *zakaāh*. We mentioned earlier that the contributions of Islamic banks are not of the size expected of them. But we would like to add here a word about *al-qurūd al-ḥasanah* (interest-free loans), which is a pioneering project, with a balance close to 10 per cent of paid-up capital or four times its net profit for year 2001 in bank A. This bank granted loans for education, health care, marriage and other social services. It also opened the fund for donors from outside of the bank although external donations were meagre compared with the bank's contribution.

#### **4.6 Other Minor Factors with Substantial Promotional and Moral Impact**

There are some Sharī'ah and moral issues whose neglect had a negative effect on more than one Islamic bank. I consider them important because they are genuine factors that affect the distinguished image of Islamic banking that is the main promotional and confidence building consideration for an Islamic bank.

First, there is a potential conflict of interest between shareholders who are represented by the management and depositors who are represented by no body! For instance, most Islamic banks leave it to the management to decide on: the per cent of *mudārabah* deposits that is kept liquid (un-invested); the share of the bank as a *mudārib*/agent—even in the absence of any competitive conditions in that market; and the ratio of profit distribution between the different types of investment deposits. The report of one Islamic bank states that the management decides on the share of profit assigned to each of deposits in savings, 3 month deposits, 6 months and or one year. Leaving issues like these to the management disturbs the contractual balance that is required in Sharī'ah.

Second, the accounting methods of calculating shareholders' profit sometimes overlook certain important conceptual issues. For instance, several of the Islamic banks calculate shareholders' profit on the assumption that "what does not belong to *mudārabah* depositors is the right of shareholders." Hence the profit of investing funds accumulated in the reserve fund for investment risk and in the mutual debt insurance fund (both are furnished with deductions from customers' accounts) is assigned to shareholders! In 2001, in bank A the total amount accumulated in these two accounts was equal to 60 per cent of net equity. Balance in these two funds should be treated as *mudārabah* deposits and given their share of profit!

Third, the little attention usually paid by the Sharī'ah boards of Islamic banks to fulfilment of justice in distribution of profits between depositors

and shareholders. It is true that *muḍārabah* is based on contractual freedom, but freedom alone does not tell the whole story about distribution when it is not supported by a bargaining power. When the two parties have different powers, contracts are bound to be influenced by the monopolistic power exercised by the Islamic bank vis-à-vis its depositors. The effect of unbalanced contract is apparent in the huge differences between the shareholders' profit and the depositors' share as noticed from Figure 3. Such a huge disparity cannot be justified by the little differences between these two groups in terms of commitments, as it turned out in the cases of bankruptcy/failure of some Islamic banks.

Fourth, some Shari'ah boards rush to defend the bank management even in technical matters that should have been referred to neutral experts.

Fifth, little attention is paid by the Shari'ah boards to the human and labour relations in the Islamic banks including boycotting the companies that use child labour or practice gender or racial discrimination, number of hours imposed on workers in certain Islamic banks and un-equitable pay the workers receive.

Sixth, there is a lack of interest of Islamic banks to create and inculcate a culture of real development and investment among their clientele and public at large. This is manifested in their lack of emphasis on efficiency, hard work, wealth preservation, production growth, etc., instead they are satisfied with financial increases alone.

All these factors accumulate and re-enforce each other towards undesired outcomes. Therefore, there is a dire need for Islamic banks and their Shari'ah boards to consciously reconsider their present approaches and behaviours if they want to provide outstanding services to their customers and consequently gain their confidence and the continued growth of the bank.

## Appendix

The information about the 7 Islamic banks was taken from their annual reports of 1999 to 2001. In the study, I preferred to use letters for the banks instead of their names in order to avoid direct criticism, which is normally not pleasing to managements of the Islamic banks, although the small number of banks in the study and the uniqueness of their situations tell about the bank concerned with each remark. The symbols are as follows:

- A Jordan Islamic Bank
- B Bahrain Islamic Bank
- C Dubai Islamic Bank
- D Islamic Bank of the Arab Banking Corp
- E Qatar Islamic Bank
- F Shamil Bank, Bahrain
- G Kuwait Finance House

The information from their annual reports has been classified in 7 tables as follows:

<b>Jordan Islamic Bank</b>	<b>(million Jordanian Dinars)</b>			
	1998	1999	2000	2001
Invested assets	483.5	492.2	563.7	611.8
Cash and bank assets	194.4	231.0	260.0	289.4
Total assets	706.8	757.0	828.3	907.5
Customers' deposits	594.1	642.8	734.0	813.2
Current accounts	99.3	101.7	126.4	146.7
Restricted and special investments	65.3	99.2	169.4	197.4
Creditor Banks	3.5	4.2	4.0	4.5
Equity	50.9	52.2	54.5	53.6
Revenues	36.9	32.6	41.4	42.0
Expenses	13.3	13.4	13.8	14.8
Net profit	40.4	2.6	3.0	1.4
Depositors' share of profit	15.8	13.6	23.5	26.0

<b>Bahrain Islamic Bank</b>	<b>(million Bahrain Dinars)</b>			
	1998	1999	2000	2001
Invested assets	147.9	149.0	180.4	182.3
Cash and bank assets	6.6	5.9	12.0	7.3
Total assets	156.0	156.4	191.2	194.3
Customers' deposits	137.7	137.4	153.6	151.0
Current accounts	10.3	10.7	17.5	15.0
Creditor Banks	---	---	---	---
Equity	14.7	15.2	39.1	38.6
Revenues	9.5	9.1	5.9	10.0
Expenses	2.1	2.4	1.5	3.5
Net profit	1.5	1.8	2.3	2.8
Depositors' share of profit	6.0	5.1	3.3	3.7

In 2000, Bahrain Islamic bank changed its financial year from the Hijra calendar to the Gregorian calendar and presented the 2000 balance sheet for the period from 17 April 1999 to December 31 2000, about 1 year and 9 months. Thus we adjusted the affected numbers, last four rows, by multiplying the report figures by 4/7, to make comparison easy.

<b>Dubai Islamic Bank</b>	<b>(million UAE Dirham)</b>			
	1998	1999	2000	2001
Invested assets	6642.0	8393.3	10535.9	13555.8
Cash and bank assets	846.0	619.0	957.0	1547.0
Total assets	7825.0	9338.0	11753.4	15334.0
Customers' deposits	6312.0	7627.0	9772.0	13122.0
Current accounts	1429.0	1549.0	1858.0	2135.0
Creditor Banks	88.0	102.0	92.0	216.0
Equity	1003.0	1050.0	1090.0	1137.0
Revenues	532.0	614.0	756.0	834.0
Expenses	248.0	184.0	165.0	218.0
Net profit	-33.8	100.7	118.9	152.5
Depositors' share of profit	256.0	330.0	472.0	463.0

<b>Arab Banking Corp Islamic Bank</b>	<b>(million US Dollars)</b>			
	1998	1999	2000	2001
Invested assets	163.3	217.7	177.3	171.0
Cash and bank assets	4.3	13.2	14.6	13.2
Total assets	168.2	232.3	195.0	185.0
Customers' deposits	286.2	389.6	367.8	316.3
Current accounts	---	---	---	---
Creditor Banks	---	---	---	---
Equity	48.3	53.0	56.4	59.0
Revenues	21.8	24.4	27.4	21.5
Expenses	3.2	3.4	3.2	3.2
Allocations for expected losses	---	---	---	---
Net Profits	3.8	4.9	4.0	2.9
Depositors' share of profit	14.8	16.7	20.8	15.4
Disbursed profits	---	---	---	---

<b>Qatar Islamic Bank</b>	<b>(million Qatari Riyal)</b>			
	1998	1999	2000	2001
Invested assets	3388.8	3418.1	3578.9	3750.5
Cash and bank assets	330.9	436.1	371.9	574.3
Total assets	3823.3	3983.4	4059.1	4415.1
Customers' deposits	3148.6	3284.8	3315.1	3653.0
Current accounts	817.2	698.1	717.9	737.8
Creditor Banks	3.9	8.1	11.2	6.6
Equity	284.7	296.2	334.7	370.7
Earnings	287.4	298.0	338.9	332.1
Expenses	103.1	102.2	152.2	166.4
Net profits	65.1	55.9	39.5	67.1
Depositors' share of profit	126.5	138.6	146.7	97.0

<b>Shamil Bank, Bahrain</b>	<b>(million US Dollars)</b>		
	1999	2000	2001
Invested assets	2416.7	2543.1	1965.7
Cash and bank assets	358.5	310.8	312.1
Total assets	2893.3	2955.4	2363.5
Customers' deposits	2484.0	2641.3	1957.5
(Current accounts)	47.4	64.7	58.2
Restricted and special investment	1705.9	1894.4	1180.6
Creditor Banks	117.7	89.4	88.5
Equity	230.9	232.5	242.0
Revenues	207.2	193.4	164.7
Expenses	31.2	31.8	31.8
Net profits	10.1	6.0	10.8
Depositors' share of profit	165.5	146.6	111.9

The 1999 annual report was not available; thus 1999 figures were taken from 2000 annual report.

<b>Kuwait Finance House</b>	<b>(million Kuwait Dinars)</b>			
	1998	1999	2000	2001
Invested assets	1501.7	1587.3	1830.4	2218.0
Cash and bank assets	115.9	117.6	133.3	80.6
Total assets	1669.3	1769.5	2025.6	2375.5
Customers' deposits	1261.8	1334.9	1547.1	1775.2
(Current accounts)	---	---	---	---
Restricted and special investment	---	---	---	---
Creditor Banks	21.4	5.7	7.6	81.9
Equity	169.0	192.2	217.2	239.8
Earnings	132.0	134.1	144.1	143.2
Expenses	30.9	28.5	27.8	30.2
Net profits	42.0	44.4	47.6	51.3
Depositors' share of profit	57.6	59.7	66.5	58.4

## Notes

<sup>1</sup> These banks are: Jordan Islamic Bank, Islamic Bank of Qatar, Shamil Bank of Bahrain, Bahrain Islamic Bank, Dubai Islamic Bank, Arab Banking Corp Islamic Bank and Kuwait Finance House.

<sup>2</sup> Reservations must be made beforehand on the results to be arrived at because this study is not meant to cover all Islamic banks nor did it make a random choice of them. It is rather a study of the available financial information. Add to it, the fact that information available in the final reports did not account for the reasons for differences between various banks. Undoubtedly, there are explanatory information that are still buried in other reports and records that are difficult to access, just as many of them are stored in the minds of top and middle-level management of these banks, making it difficult to be extracted except through intense interviews with these persons.

<sup>3</sup> Grubbs and Reienbach (1991), pp. 7-8.

<sup>4</sup> Ibid., p. 28.

<sup>5</sup> Gackle (1994), p. 60.

<sup>6</sup> Grubbs and Reienbach (1991), p. 75-86.

<sup>7</sup> Gackle (1994), p.59

<sup>8</sup> Ibid., pp.61-72

<sup>9</sup> There are numerous writings about this issue, including Taylor (1994). In this book, the rules of banking prudence in credit and investment are discussed. Also

discussed are the rules of banking prudence assumed liability and financing commitment, the rules of banking prudence concerning capital adequacy and foreign currency, etc.

<sup>10</sup> Hendershott, Lee and Tompkins (2002).

<sup>11</sup> Isik and Hassan, (2002), they quote Berger and Mester studies.

<sup>12</sup> Ibid.

<sup>13</sup> We took the average for 2000 and 2001 for lack of information on 1998 and 1999.

<sup>14</sup> Scheitzer, Szewizyk and Varma (2001).

<sup>15</sup> Ibid.

<sup>16</sup> It is a fund that pays in full the debts on those who become unable to pay by reason of death or permanent incapacity. For marketing and public relation reasons the bank did not mention the word “debtors” in the fund’s name.

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In addition to the 20 annual reports of the seven Islamic Banks for the period 1999-2001 (except for Shamil Bank, which had reports for 2000 and 2001), the following references were used.

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## **The Attitude of Bank Customers and Professional Bankers towards Islamic and Conventional Banks in Bangladesh**

*Mahmood Ahmad\**

### **Introduction**

An Islamic bank is a financial institution that operates with the objective to implement and materialize the economic and financial principles of Islam in the banking arena. It is defined as “a financial and social institution whose objectives and operations as well as principles and practices must conform to the principles of Islamic Shari‘ah (Jurisprudence), and which must avoid the interest in any of its operations”.<sup>1</sup> It is also defined as “a Company which carries on Islamic banking business. Islamic banking business means banking business whose aims and operations do not involve any element which is not approved by the religion Islam.”<sup>2</sup>

It follows, therefore, that what makes Islamic banking “different” from traditional Western banking is that there can be no interest (*ribā*) paid or charged for any transaction or service to ensure justice, welfare and non-exploitation. Of course, the investments of an Islamic bank must be channeled to the Islamic Shari‘ah approved (*halāl*) sectors by Islamic modes of finance like *muḍārabah*, *mushārahah*, *bay‘-muajjal*, *bay‘-salam*, *ijārah*, hire purchase, etc., which are based on the sharing of risk and profit. Islamic bankers in effect generate “profit and loss” transactions in which the lender or bank shares in gains or losses based on the economic viability of the project and the credit worthiness of the customer.

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The early concept of the Islamic bank can be traced back to the very birth of Islam when the Prophet himself acted as an agent for his wife's trading operations. However, in the present period and in the current sense of a bank like financial institution it was in 1963, in Mit Ghamar, that the first Islamic interest-free bank actually came into being. Islamic banking is now a phenomenon. It has been growing at about 15 per cent per year (Langton, 1995). This pattern of growth has attracted traditional banks such as Chemical Bank, Citibank, Kleinwort Benson, Midland Montagu, ANZ Grindlays and Goldman Sachs to look more closely at joint ventures with their Islamic counterparts for major financial transactions that accord with the Shari'ah.

Despite the phenomenal growth of Islamic banking practices worldwide, there is a debate among scholars about whether Islamic banking practices are any different from the conventional banking system. This debate is not confined to the academic circles only, but has also made its way to the banking community and the banks' customers. We argue that there is a lack of knowledge about the various Islamic-banking practices among the banking community as well as the banks' customers. A question that generally arises is why is the Islamic banking system growing so fast if it is not different from the conventional banking system. Analysis of the deposit and investment mechanisms and the opinions of the bankers and customers of both Islamic and conventional banks would be useful to understand and identify Islamic banking with its separate unique features and its impact on economy and society. The primary objective of this study is to examine the reality of apparent similarities between Islamic and conventional banks, which frequently tend to equate both systems of banking. This is done at the theoretical plane as well as by opinion survey of the users (i.e., bankers and customers) of the two systems.

The paper seeks to identify and clarify the controversial issues between Islamic and conventional banks in order to help remove the misconceptions about Islamic banking. It is due to incomplete and often distorted knowledge about Islamic banking that the civil society remains doubtful about the viability of such a system. As the civil society is an active and potential agent of dissemination of ideas and information in the society, its lack of knowledge and conviction has limited the scope of Islamic banking practices. Once the public is convinced about the utility and uniqueness of the system, Islamic-banking practices will grow further in many Muslim countries. The transformation of the present interest-based financial system into an interest-free Islamic system is one of the objectives espoused by many Muslims.

The paper is divided into six sections. Following this introduction, an overview of the essential features of Islamic banking and finance has been

given in section 2. The survey methodology used in this study is presented in section 3. The deposit and financing techniques of Islamic and conventional banks have been analyzed in section 4. Section 5 analyzes the opinions of the bankers and customers of both Islamic and conventional banks. Section 6 presents the summary and conclusions of the study.

## **2. Principles of Islamic Banking and Finance**

The best known feature of Islamic banking is the prohibition on interest. The Qur'ān forbids the charging of *ribā* on money lent. It is important to understand certain principles of Islam that underpin Islamic finance. The Shari'ah consists of the Qur'ānic commands as laid down in the Holy Qur'ān and the words and deeds of the Prophet Muhammad (s.a.w.). The Shari'ah disallows *ribā* and there is now a general consensus among Muslim economists that *ribā* is not restricted to usury but encompasses interest as well. The Qur'ān is clear about the prohibition of *ribā*, which is sometimes defined as excessive interest. "O You who believe! fear Allah and give up that remains of your demand for usury, if you are indeed believers." Muslim scholars have accepted the word *ribā* to mean any fixed or guaranteed interest payment on cash advances or on deposits. Several Qur'ānic passages expressly command the faithful to shun interest.<sup>3</sup>

The concept and role of money is crucial to any financial system. In an Islamic system, money is primarily and exclusively a measure of value, a means of exchange and a standard of deferred of payment. However, distinct from the ethos of Western economics and conventional banking, money is not regarded as a commodity in itself, to be bought, sold and used to beget money. In an Islamic framework, money has to operate through some real economic activity or service. It is a facilitator and an intermediary, not an active self-contained agent in itself. Capital is productive, not money per se. It is a means towards production, through creative entrepreneurial efforts. It is to be an instrument towards value-added through physical expansion of the economy. In other words, real economic progress and development consist in expansion of physical and human aggregates of the economy via creation of assets, products and services, not merely in the form of fiduciary financial expansion. It is through such a generation of wealth that well being takes place and the relationship between money-economy and physical-economy remains in real equilibrium.<sup>4</sup>

The rules regarding Islamic finance are quite simple and can be summed up as follows:

- a) Any predetermined payment over and above the actual amount of principal is prohibited.
- b) The lender must share in the profits or losses arising out of the enterprise for which the money was lent.
- c) Making money from money is not acceptable in Islam.
- d) *Gharar* (Uncertainty, Risk or Speculation) is also prohibited.
- e) Investments should only support practices or products that are not forbidden or even discouraged by Islam

### **3. Methodology of the Study**

A purposive random sampling was used to collect data on a series of questions regarding Islamic banking practices. Data of the study was collected from both primary and secondary sources. Two sets of the approved questionnaire<sup>5</sup> were used in the survey, through interview method, among the customers and bankers of selected Islamic and conventional banks in Dhaka City. The study includes 4 (four) Islamic and 4 (four) conventional private banks. The four Islamic banks are: Islami Bank Bangladesh Limited (IBBL), Al-Arafa Islami Bank Limited, Social Investment Limited and Al-Baraka Bank Limited. The four conventional banks are National Bank Limited (NBL), International Finance and Investment Corporation (IFIC) Limited, Arab Bangladesh Bank Limited (ABBL) and City Bank Limited (CBL). These banks were established in 1983, so we assume that the officers of these banks and their customers know and understand the similarities and differences in the banking practices of Islamic banks and conventional banks. Ten questionnaires were pre-tested among five bank officers and five customers. The final sample consists of twenty-five bank officers and customers of each bank. As such, 200 bankers and 200 customers were interviewed (Table 3) to record their opinions about some apparent similarities between Islamic and conventional banks. Findings of the study were consulted with the available literature and executives of the banks to confirm their reliability and acceptability.

#### **4. Analysis of Deposit and Investment Mechanisms of Islamic versus Conventional Banking**

##### **4.1 Islamic Interpretation of Similarities and Differences of Deposit services provided by Islamic and conventional banks:**

Various types of deposit services provided by Islamic and conventional banks have been given in Table 1. Although deposit services of Islamic banks look similar to those of conventional banks, a deeper scrutiny will show that they are indeed different. Payment of profit on deposits by Islamic banks is not equivalent to payment of fixed interest on deposit by conventional banks.

The conventional bank accepts deposits to supply money to the income generating activities of entrepreneurs. The major source of funds for conventional banks is customer deposit, on which the bank pays fixed interest rate. This deposit is a form of debt given to the bank by a bank customer. The bank has to pay to the depositor the principle as well as interest, regardless whether the bank makes a profit from the money or not. In case of a bad loan, the bank has to pay the depositor from its own resources. The depositor does not share risk with the bank, but gets paid for his debt to the bank. Islam views such transaction unjust because it allows unequal treatment of creditor (depositors) compared to the debtor (the bank).

On the other hand, Islamic banks accept deposits with the condition that the money will be put to work combined with the skills and management expertise of banks. The depositor would get back his principal amount together with a share of profit after the expiry of the contract. In fact, the depositor agrees to put his money in the bank's investment account and to share profits with the bank. In this case, the depositor is the supplier of capital and the bank is the manager of capital. The depositor does not earn interest on a fixed rate in Islamic banking system, but accepts some of the business risks and earns a share of the profit. The depositor is not guaranteed any pre-determined return on the nominal value of his deposit like interest-bearing banks, but is treated as a shareholder of the bank and as such, is entitled to a share of the profits made by the bank. Similarly, if the bank incurs losses, the depositor shares in these losses and the value of his deposit is reduced. Therefore, any shock to asset positions of Islamic banks is instantaneously reflected by changes in the values of shares (deposits) held by the public in the bank, and therefore, the real values of assets and liabilities of an Islamic bank would be equal at all times.<sup>6</sup> However, in the conventional banking system, because the nominal value of deposits is fixed, such a shock could cause a divergence between real assets and real liabilities. Since the

bank engages in a two-way contract with both depositors and borrowers, the bank does not trade money for money, which is forbidden in Islam. Rather, the bank lends money, which is put to work by the borrower, and shares profit/loss of the invested capital. The Islamic equity system is proved to be a mechanism of efficiency, justice, welfare and fair growth.<sup>7</sup> Therefore, it may be concluded that although monetary benefits are paid to depositors in both Islamic and conventional banks, they are not the same. Payment to depositors by Islamic banks is variable while payment to depositors by conventional banks is fixed.

#### **4.2 Islamic Interpretation of Similarities and Differences of Lending (Investment) services provided by Islamic and conventional banks:**

Table 2 shows comparative financing techniques used by both Islamic and conventional banking system. Short-term trade financing techniques (*bay' murābahah*, *bay' muajjal*, *bay' salam*, and *ijārah*) by Islamic banks are alleged to be similar to interest-bearing short-term lending by conventional banks on the following grounds:

- a) Fixed charges as a percentage increase with time as compensation for violation of agreement for repayment schedule of investment taken by the entrepreneur from the bank;
- b) Dated payment obligations which may not synchronize with a firm's cash-flow;
- c) The borrower has to make payments whether or not he is succeeding in his business;
- d) Security or mortgage is essential for investment;
- e) Returns are practically calculated on the benchmark of an interest-based bank.

Islamic banks earn profit either from investment in trading (*bay'*) and leasing (*ijārah*) or in production/manufacturing. As a result, Islamic banks get directly involved in trade and industry, for which Islamic banks perform functions of both an intermediary and manager. Lack of expertise to appraise and monitor different types of industries and long drawn court procedures for recovery of bad loans in case of default by borrowers make Islamic banks hesitant for long-term *muḍārahah* or *mushārahah* modes of lending. Consequently, '*bay'*' and 'lease' modes of investment become dominant forms of financing by Islamic banks.

Maududi<sup>8</sup> looks into the difference between ‘*bay*’<sup>9</sup> and ‘interest’ in the context of the equitable distribution and efficient management of risk. In interest-based transactions, risk is transferred to the borrowers so that all interest-bearing assets become risk free. This is socially inequitable and economically inefficient. On the other hand, trade by conforming to natural uncertainty is both equitable and efficient. In *ribā*-based transactions, the object of sale is time and its price is *ribā*. This is reemphasized in the context of the time value of money. Al-Masri<sup>9</sup> holds the view that a higher deferred price of an object of sale is legitimate, and it recognizes the time value of money in Islam. This value might be determined ex-ante. However, it is argued that a fixed price in a deferred sale does not mean a fixed return on capital because of the uncertainty and risk incorporated in such transactions. Alternatively, Khan<sup>10</sup> rejects this proposition and suggests that the time value of money can only be determined ex-post. Saadallah<sup>11</sup> also recognizes acceptance of the value of time by Sharī‘ah scholars but only in relation to real transactions.

Therefore, the value of time is related to an actual transaction and its outcome. The postponement of liability justifies a greater return to capital under a *ribā*-based system. However, in actual transactions, the return to capital is linked to ownership of real goods, which carries an element of risk with it. Therefore, profit of Islamic banking consists of several factors including time, which is required to complete the actual transactions. *Ribā* does not consider risk sharing, whereas profit-loss considers risk-sharing. As a result, the capital involved in trade might grow or decline over time, while in *ribā*-based transactions, capital automatically increases over time.

Islamic banking is involved indirectly with commodity trading, as a manager of funds based on the request of the client. The business relationship between the bank and client on an actual basis considers every aspect of assurance of profitability, such as credit risk, liquidity risk, maturity risk and inflation risk. A prudent lending decision on behalf of the bank makes the probability of risk negligible. In case of genuine default, the Islamic bank recovers only the contracted amount (in case of *murābahah*) or remainder of the principal amount (in case of *muḍārabah* and *shirākah*) without any compensation for bearing risk. In case of willful default, there is no alternative to the Islamic bank except demanding compensation for bearing risk. However, Islamic banks do not account this compensation as part of its income, rather they distribute these monies to the poor.

The instruments of ‘*cost plus*’ and ‘*leasing*’ are devoid of interest. Although these two instruments are criticized as being very similar to those of interest-based banking and it is argued that these instruments have not

brought much real change to the banking system, their use does carry an element of risk for the Islamic banks which makes them acceptable to the Shari'ah. The Qur'an clearly states that "**Allah has permitted trade and forbidden usury**" (2:275), and both cost-plus sales and leasing are forms of trade. For example, in the case of sale with cost-plus transactions, there must be a definite period during which the financier actually owns the commodity in question. This does not mean that he takes the physical possession of the commodity. He must be the legal owner for this period, bearing all risks, liabilities and benefits of this possession, which is called the "constructive" possession. He is, therefore, the genuine seller of the commodity and is entitled thereby to make a profit on the sale. It is the risk in trading which makes it an acceptable way of making profit. Fixed interest, on the contrary, carries no such risk and is, therefore, against Islamic principles as a way of making money.<sup>12</sup> Although in face value, a number of Islamic financing modes look similar to those of interest-based banking, we find that these are very different from each other in terms of justice, efficiency, stability and economic growth.

## **5. Questionnaire Survey Analysis of Banker and Customer Perception of Islamic and Conventional Banks**

It is observed from the survey that an overwhelming group of the customers are businessmen. They total 57 per cent of the sample. The remaining groups are: self-employed (13 per cent), service holders (10 per cent), housewives (7 per cent) and others (3 per cent) (Table 4). The whole sample consists of customers in the age group 35-60 years (Table 6), and 89% of them are male (Table 7). The education level is dominated by the graduate degree (68%) followed by the postgraduate degree (17%) and the undergraduates (15%) (Table 8). It seems that the qualities of the respondent customers are unique in the perspective of generally understood social fabrics of Dhaka City.

However, the majority of bankers are officers (72%). Only 5% of the sample is senior executives (Table 5) most likely because they are busier than the officers. It is observed that the age, sex and education levels of the bankers are close to that of the customers under study.

Regarding the essence of the profit and loss sharing system of Islamic finance, Table 9 shows that the bankers are more aware than the customers. Fifty-five per cent of them believe that Islamic finances aim at both profit and losses. However, only 32% of the customers agree with them although

most customers (62%) believe that Islam permits profit and forbids *ribā*. The opinions vary due to the fact that the Islamic bankers get formal training on Islamic Economics and Banking and the conventional bankers are aware due to their professional consciousness. However, both the bankers and customers are conscious about the relation of profit, in lieu of interest, to Islamic finance. It is the outcome of launching Islamic banking in the country in 1983. The basis of such observation is that 11% of the bankers and customers believe that Islamic finance always mean for investment in real assets, while 9% of them have mentioned that Islamic finance cannot earn *ribā* in anyway.

A majority (69%) of the bankers and customers (Table 10) view that *zakat* has been mobilized through the Islamic banking system. Twelve per cent of the respondents have mentioned that welfare activities are organized through the Islamic banking system, while 10% believe that Islamic banking system has introduced new products. Again, 7% of respondents view the concept of *halāl* and *harām* is introduced in the case of investment, buying and selling, while least of them (2%) mention that mobilization of financial resources to the real sector of the economy is well introduced. This indicates that the life and society of Bangladesh have benefited from Islamic banking, which further justifies a separate role of the Islamic Banking system in the economy of Bangladesh.

The next question is: what is the basis of the development of Islamic banking system in Bangladesh? 55% of bankers and 69% of customers (Table 11) think that this is due to 'mere faith in Islam' of the overwhelming Muslims (88%) of the country. In contrast, 15% and 23% of them, respectively, believe that the 'intention to earn profit' is the basis of development of Islamic banking system. However, 18% of the bankers have the opinion that the 'tendency to avoid interest' is the basis, while only 2% of the customers believe it as a basis. Such discrepancy is again observed: when 9% of the bankers said that 'to do welfare of the economy' is the basis, it is supported by only 3% of the customers. 3% of both bankers and customers agree that the basis is 'to ensure justice in the financial transactions'.

It follows that the item 'to avoid interest' as a basis of development of Islamic banking system has not drawn the attention of the majority of the respondents. Why does it happen so? Do they believe that Islamic banks have opened the back door for continuation of transactions like interest-based banks?

In fact, all respondents believe so (Table 12). They have mentioned several causes for opening such a back door. The major cause, according to

the 73% of the customers and 60% of the bankers, is that the trading and the rental modes of investments of Islamic banks do not differ much from the transactions of interest-based banks. The agreement of payment of installment in due time and the extra payment for excess time of repayment of an investment under the trading and rental mode create the same financial burden to an investment customer. Besides, other arrangements (mortgage, security, registration etc.) for getting an investment loan from Islamic banks are the same as those of conventional banks.

On the other hand, 14% of the respondents view that the degree of risk in the present system of Islamic banking is not enough to justify this sort of banking. It is followed by 11% of the respondents, who views that Islamic banks are working along with the interest-based banks. The least of them (8%) believes that the products of present Islamic banks serve the purpose of interest-based banks.

In response to the question: what are the causes of crept of interest into the Islamic banking system, 45% of respondents replied that exploitation is going on through Islamic banking (Table 13). Alternatively, 19% mentioned two other causes: (i) the products of Islamic banks have failed to remove the curse of interest-based banking; and (ii) the bankers lead the Islamic-banking system to the garb of interest. Sixteen per cent believe that Islamic banking is introduced in a society, which is not reorganized on Islam. It seems that the bankers and customers are concerned about the interest factor, which tends to make both Islamic and conventional banks similar.

The next question is what are the reasons for which the Islamic banks do not operate in true spirit of Islamic Shari'ah? In response, the majority (35%) of the respondents have mentioned that only the level of profit earning cannot be the success criterion for an Islamic bank, when Islamic banks are registered as a schedule commercial bank with a view to earning profit. While 32% think that the status of the Shari'ah Council/Department is advisory, not supervisory in the system of Islamic banking, 20% has the opinion that Islamic banks do not ensure justice and welfare in financial transactions. A minority of respondents (12%) believes that exploitation still remains in the Islamic banking system. As a result, many Muslim businessmen and industrialists do not really patronize the Islamic banks. About 73% believe that the potential patrons do not find any business difference between Islamic and conventional banks (Table 15). The other two causes identified (20%) are: (i) lack of consciousness of the patrons, and (ii) confusion about Islamic banking. Minorities of respondents (8%) believe that people are not properly motivated to Islamic Banking.

Next, the risk factor of business came into consideration. This factor is always considered for generating profit in any business.

However, it is observed (Table 16) that the respondents opine that most of the Islamic modes of investment practiced by Islamic banks do not practically share risk for many reasons. While a majority of them (66%) believe that the insurance company covers risks, 21% said that Islamic banks do not buy practically for a sale. Ten per cent observe that buying and selling arrangements of Islamic banks are almost risk-free. Only 3% of the respondents believe that Islamic banks do business with depositors' money. Therefore, if there is any risk, it is borne by the depositors. It seems that the respondents are conscious about the relation of risk factor with Islamic banking.

Further, the respondents confirm that many customers are not interested in dealing with Islamic banks because they feel that only the title name of the banks has been changed and interest in a real sense has not been eliminated. Table 17 shows some causes behind these feelings. For example, many respondents (73%) feel that mark-up profit has created a financial burden like the interest burden of conventional banks. Other reasons are: (i) repayment of the bank's money by installment (10%), and (ii) a failure of payment of installment creates additional liability (7%). A few of them (6%) opine that Islamic banks, in most of the cases, do not consider business losses of the entrepreneur for adjusting repayments.

Possibility of reduction in the value of deposits through losses suffered by bank is a feature of Islamic banking system, but it may be harmful for deposit mobilization. With this view in mind, the respondents were asked: do they believe that the condition of deposit loss is not harmful for deposit mobilization? We received the response that possibility of loss is not detrimental to deposit mobilization. The respondents believe that the profit and loss sharing system of banking cannot ultimately make a loss of deposit. This opinion is expressed (Table 18) by 43% of respondents, while others (23%) view that the condition of deposit loss does not mean total loss of deposit. However, 20% of respondents believe that it is an actual element of investment, which makes the profit on the Islamic bank's deposit *halāl* (legitimate) therefore acceptable. Fourteen per cent of respondents think that the condition of a deposit loss is insignificant to a true Muslim, who expects a garden in the heaven in the life hereafter. This implies that the respondents have expressed their strong feelings in favor of Islamic banking.

Regarding the present modes of investment practiced by Islamic banks both bankers and customers believe that it is compromised with the interest

factor of conventional banks. For example, according to the respondents, *bay' murābahah* and *bay' mu'ajjal* modes of investment are compromised with the Pledge and Hypothecation techniques of interest-bearing banking. It is observed that 67% believe that finance under both systems of banking gave the same effect on business results. The remaining 33% view that both banks are (i) justice (*'adl*) and welfare (*ihsān*)-free, (ii) working side by side, and (iii) working in the same value loaded society (Table 19).

Finally, a last question was asked about how to get rid of that situation. They quest for governmental reformation measures for moral building and eradication of false values of life, which would pave the way for Islamic banking. They have also mentioned several causes to support their opinions (Table 20). A majority of them (59%) feel that Islamic banks cannot work well in an immoral society. While 17% have mentioned that governmental power can change social values, 13% believe that governmental reformation measures are powerful to build a moral society. About 10% of them have expressed that false values of life give a detrimental environment to Islamic banking. This indicates that the bankers and customers hold a very strong opinion in favor of governmental measures for reformation.

The above analysis of the misleading similarities between Islamic and conventional banks, along with the understandings, values and attitudes of the bankers and customers about the Islamic banking system, indicates the degree of commitments to Islamic banks in Bangladesh.

## 6. Summary and Conclusion

The prohibition of *ribā* (interest) makes Islamic banking different from conventional banking. Of course, the investments of an Islamic bank must be channeled to the Islamic Shari'ah approved sectors. The phenomenal growth of Islamic banks has attracted the attention of bankers, business community and bank customers. It is also contended that Islamic banks are not very different from conventional banks. This debate raises a natural question that if Islamic banks are no different from conventional banks, why they are growing so fast? A survey analysis of the deposit and investment mechanisms and the opinions of the bankers and the customers of both Islamic and conventional banks help our understanding and identification of this debate. Our theoretical analysis shows that Islamic bank practices are indeed different from those of conventional banks.

The central theme of this study is to examine some apparent similarities between Islamic and conventional banks, which frequently tend to equate the

two systems of banking. The degree of relationships of the apparent similarities was found through a process of scientific investigation. Data of this study was collected from both primary and secondary sources. Two sets of questionnaire were used in the interview survey, among the customers and bankers of selected Islamic and conventional banks in Dhaka City. A purposive random sampling was used in the survey. Two hundred (200) bankers and two hundred (200) customers were interviewed to record their opinions about some apparent similarities between Islamic and conventional banks.

Islamic banking maintains *Al-Wadī'ah* Current, *Mudārabah* Savings and Term Deposit accounts, and conventional banks maintain Current Deposit, Savings Deposit, and Term Deposit accounts. An analysis of these deposit mechanisms shows a misleading similarity that both Islamic and conventional banks pay money for the deposits of the customers, which is termed as profit in Islamic banking or interest in conventional banking respectively. While payment of return on deposit in Islamic banking contains element of risk, payment of interest in conventional banking does not contain the element of risk. Only payment on deposit apparently generates misunderstanding in the minds of bank customers whether Islamic banking is indeed different from conventional banks.

In terms of financing techniques, the prevalence of short-term financing in Islamic banks raises the questions of efficiency, equity and justness of Islamic banks. In addition, this also raises questions such as, whether Islamic banks pay profit? Or interest in the name of profit? We showed that the Islamic banking financing mechanisms are different from those of conventional banks. The misleading similarities between Islamic and conventional banking products are the result of the following observations:

First, fixed charges in percentage, which increases with time as compensation for violation of an agreement for repayment schedule of investment taken by the entrepreneur from the bank.

Second, dated payment obligations may not synchronize with the firm's cash flow.

Third, payment obligations are mandatory whether or not the business is making a profit. Fourth, a security or mortgage is essential for investment.

Finally, returns are practically based on the benchmark of an interest-based bank.

The survey analysis shows that both the bankers and bank customers have confusing notions about Islamic banking practices. We argue that this

misconception is partly due to incomplete knowledge in the fundamentals of Islamic finance and due to the over-reliance on short-term trade financing. The investment portfolio of Islamic banks has generally favored trade-related activities over production-related activities, short-term profitability over long-term profitability and private profitability over social profitability. Almost 80 to 90 per cent of investment has been made to short-term trade-related activities. Heavy reliance on a short-term asset portfolio makes Islamic banks vulnerable, increases its risk and threatens its stability. On the other hand, the borrowers prefer short-term trade loans to profit-loss sharing instruments, which have weakened the bank's portfolio. The real rates of return of the Islamic bank's asset portfolio are lower than those of conventional banks.

Islamic banks have become, to an extent, successful in the field of deposit mobilization, but socially beneficial and development oriented utilization of these deposits did not happen. Employment generation and a flow of resources towards the lower and middle classes, particularly in the rural areas, have not taken place. Still, Islamic banks are involved in the heroic role of eliminating *ribā* from financial dealings in Muslim countries against a backdrop of regulation in the area of taxation, legal framework, and weak moral fabric of society. In order to remove misconception from the minds of bankers and customers, there is no alternative to publicity, research and training of Islamic banking practices. Research should focus on the development of financial products that conform to Islamic Shari'ah, and training should be given to bankers, potential researchers and bank customers.

## Appendix

**Table 1: A Comparison of Deposit Mechanism between Islamic and Conventional Banks**

Deposit Mechanism of Islamic Banks	Deposit Mechanism of Conventional Banks
<p>Islamic banks accept <i>Al-Wadī'ah (Trust) Current, Muḍārabah Savings and Term deposits</i>. It has been observed that the common practices of Islamic banks, in the sources of funds, are as follows:</p> <ul style="list-style-type: none"> <li>• <i>Al-Wadī'ah</i> Current Deposit: All Islamic banks operate <i>Al-Wadī'ah</i> current accounts, commonly known as call deposits or demand deposits. The bank guarantees the full return of these deposits and the depositors are not paid any share of the profit or any other return in any form. <i>Al-Wadī'ah</i> demand deposits are treated as <i>Amānah</i> (where deposits are handed over by the depositors to the bank as a trust and the bank does not have the authority to use them without obtaining the specific permission of the owner of the funds), or as <i>qarḍ ḥasan</i> (money deposited in these accounts is interest free loan from the depositors to the bank and the bank is free to utilize these funds at its own risk without any return to the depositors and without needing any authorization)</li> <li>• <i>Muḍārabah</i> Savings Deposit The bank accepts deposits in a current account on the principle of <i>Al-Wadī'ah</i> requesting depositors to give permission to the bank to use these funds at its own risk, but guarantees full return of deposits and shares any profits voluntarily. The bank accepts savings deposits with an authorization to invest and share profits in an agreed manner for the period in which a required balance is maintained. The bank treats savings deposits as <i>qarḍ ḥasan</i> from depositors to the bank and guarantees pecuniary or non-pecuniary benefits to the depositors. The bank accepts savings deposits as part of an investment pool and treats them as investment deposits.</li> <li>• <i>Muḍārabah</i> Term Deposit</li> </ul>	<p>Conventional banks accept <i>Current, Savings, and Fixed Deposits</i>. The main characteristics of these deposits are given below:</p> <ul style="list-style-type: none"> <li>• Current Deposit: Its characteristics are as good as those of <i>Al-Wadī'ah</i> current deposits of Islamic banks.</li> <li>• Savings Deposit <ul style="list-style-type: none"> <li>❑ The bank accepts deposits from customers as a safe custodian of the customer's money.</li> <li>❑ The bank accepts deposits from customers on a declared rate of interest to be paid for such deposited money.</li> <li>❑ The bank uses these deposits at a higher rate of interest.</li> <li>❑ The depositors can withdraw the balance at any time.</li> </ul> </li> <li>• Fixed or Term Deposit</li> </ul>

<ul style="list-style-type: none"> <li>❑ <i>Mudārabah</i> Term deposits are called Profit Loss Sharing (PLS) Accounts or Participatory Accounts.</li> <li>❑ Individuals or companies can open <i>Mudārabah</i> Term deposit accounts either in domestic or foreign currency, provided that the bank is allowed to operate in foreign exchange.</li> <li>❑ Deposit holders do not receive any interest. Instead, they participate in the share of the profit or loss of the bank.</li> <li>❑ The return on <i>Mudārabah</i> Term deposit accounts is determined according to the actual profits earned from the investment operations of the bank and share of the profit in an agreed proportion by depositors according to the amount of their deposits and the period they are held by the bank.</li> <li>❑ Generally speaking, depositors do not have the right to withdraw from these accounts as is customary in time deposits in conventional banks. However, withdrawals can be made under special circumstances if the depositor forfeited his share of the profit for the amount withdrawn.</li> <li>❑ Usually, banks insist on a specified minimum amount to open and maintain the <i>Mudārabah</i> Term deposit account.</li> <li>❑ Most banks issue an investment certificate to depositors stating the terms and conditions of the deposit.</li> </ul>	<ul style="list-style-type: none"> <li>❑ Usually these accounts are opened for a specific period, e.g. three months, six months, one year or more.</li> <li>❑ Deposit-holders receive interest at different rates of interest for different terms of fixed deposits.</li> <li>❑ Generally the depositors cannot withdraw the money from these accounts. But however, withdrawals can be made under special arrangement forfeiting the interest to be added for the amount withdrawn.</li> </ul>
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**Table 2: A Comparison of Investment Mechanism between Islamic and Conventional Banks**

Investment Mechanism of Islamic Banks	Investment Mechanism of Conventional Banks
<p>There are seven Islamic financing modes practiced by the most of the Islamic banks of the world:</p> <ul style="list-style-type: none"> <li>• <b><i>Bay' Murābahah</i></b></li> <li>❑ The client approaches the Islamic bank with the request to finance his specific requirement like purchase of capital goods, raw materials, machinery equipment or consumer durable with specification and price information. The bank, after being convinced of the viability of the proposal, informs the client about the margin of profit, which the bank would like to make on the</li> </ul>	<p>Conventional banks provide finance by using the following techniques:</p> <ul style="list-style-type: none"> <li>• <b>Loans</b></li> <li>❑ A loan is an advance sanctioned in lump sum.</li> <li>❑ The borrower can draw it at a time or by pre-agreed instalment.</li> <li>❑ The bank debits the money to the loan account opened</li> </ul>

Investment Mechanism of Islamic Banks	Investment Mechanism of Conventional Banks
<p>original price.</p> <ul style="list-style-type: none"> <li><input type="checkbox"/> The final price of the commodity, which includes the price of the commodity paid by the bank to the original seller and the bank's profit with other incidental costs, is deferred to a payment on an installment basis.</li> <li><input type="checkbox"/> The sale item is in the possession of the bank before sale to the client.</li> </ul>	<p>in the name of the borrower.</p> <ul style="list-style-type: none"> <li><input type="checkbox"/> Interest is usually calculated and charged quarterly.</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Bay-Mu'ajjal</b></li> <li><input type="checkbox"/> It is a sale contract in which provision is made for an immediate delivery of goods, while the payment of the price is postponed to a later date. The client approaches the bank for financing the purchase of goods. The bank purchases the required goods and resells them to the customer at an agreed price to be paid later.</li> <li><input type="checkbox"/> The agreed price includes the cost of goods to the bank plus the bank's margin of profit with other incidental costs.</li> <li><input type="checkbox"/> The customer is required to pay the agreed price on due date.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Cash Credits</b></li> <li><input type="checkbox"/> It is made through a separate cash credit account.</li> <li><input type="checkbox"/> The bank allows the borrower to draw cash up to the limit of the credit by issuing check.</li> <li><input type="checkbox"/> Interest is charged on the daily balance of the account.</li> <li><input type="checkbox"/> It is a revolving credit facility.</li> </ul>
<ul style="list-style-type: none"> <li>• <b>Ijārah</b></li> <li><input type="checkbox"/> Bank maintains a number of various assets (with high degree of marketability) to respond to the needs of different customers.</li> <li><input type="checkbox"/> Banks lease these assets to any party to utilize for a term to be agreed upon.</li> <li><input type="checkbox"/> After the termination of the lease period, the assets are returned to the bank and the bank looks for a new lessee.</li> <li>• <b>Bay-Salam</b></li> <li><input type="checkbox"/> Salam is a sale of commodity, the delivery of which would be in a future date for cash price.</li> <li><input type="checkbox"/> Price is advanced in cash to the seller, who makes</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Overdrafts</b></li> <li><input type="checkbox"/> The bank allows the borrower, under this arrangement, to overdraw the current account, i.e., to draw money in excess of his credit balance, up to a certain limit.</li> <li><input type="checkbox"/> A check book is issued to the Borrower and he can draw check up to the limit of the agreed amount.</li> <li><input type="checkbox"/> Overdraft facility is allowed against the securities like share certificates and government promissory notes.</li> <li>• <b>Purchase or Discount of Bills</b></li> <li>A customer at the time of opening a Letter of Credit signs</li> </ul>

Investment Mechanism of Islamic Banks	Investment Mechanism of Conventional Banks
<p>the delivery of commodity of determined specification on a definite due date.</p> <ul style="list-style-type: none"> <li>❑ Generally, agricultural products are purchased in advance under this mode of investment to infuse finance so that production is not hindered for want of money.</li> </ul>	<p>an agreement with the bank assuring that the latter will pay the bill received on the former on a certain date onward in exchange for a specific rate of interest determined at the time of agreement. If the bill happens to reach well ahead of the date mentioned, the bank might purchase the bill, if requested, with a discount. In this case, the bank has made the return twice: firstly, by charging interest and then by discounting the bill.</p>
<ul style="list-style-type: none"> <li>• <b>Qarḍ Ḥasanah</b> It is loan without interest that plays a socially useful role engaging in income generating activities. It has a significant role to remove the financial distress caused by the absence of sufficient money in the face of dire need.</li> <li>• <b>Mudārabah</b> It is a contract between two parties, in which one party supplies capital to other party carrying on some trade on the condition that the resulting profits be distributed in a mutually agreed proportion, while all losses be borne by the provider of the capital.</li> <li>• <b>Mushārahah</b> <ul style="list-style-type: none"> <li>❑ Under this mode of finance, one or more entrepreneurs approach an Islamic bank for the finance required for a project. The bank provides total finance, and has the right to participate in the project.</li> <li>❑ The profits are distributed according to an agreed ratio or as per the capital proportion. Losses are shared in exactly the same proportion in which the different partners have provided the finance for the project.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• <b>Advances for Hire-purchase</b> <ul style="list-style-type: none"> <li>❑ Advances are made to the client under the condition that repayment of principal would be made in installments along with interest charged.</li> <li>• The immovable properties might be kept as security.</li> </ul> </li> </ul>

**Table 3: Distribution of the Questionnaire in the Final Survey**

Name of Bank	No. of Distributed Questionnaire		Total
	Bankers	Customers	
Islami Bank Bangladesh Limited	25	25	50
Al-Arafah Islami Bank Limited	25	25	50
Social Investment Bank Limited	25	25	50
Al-Baraka Bank Bangladesh Limited	25	25	50
National Bank Limited	25	25	50
IFIC Bank Limited	25	25	50
AB Bank Limited	25	25	50
The City Bank Limited	25	25	50
<b>Total : 8 Banks</b>	<b>200</b>	<b>200</b>	<b>400</b>

**Table 4: Composition of the Customers by Profession**

Type	Total	% of Total
Service holder	20	(10)
Businessman	114	(57)
Self Employed	26	(13)
Housewife	14	(7)
Others	6	(3)
Total	200	(100)

Source: *Field survey data, 1998*

**Table 5: Composition of the Bankers by Profession**

Type	Total	% of Total
Officer	144	(72)
Junior Executive	28	(14)
Mid Level Executive	18	(14)
Senior Executive	10	(5)
Total	200	(100)

Source: *Field survey data, 1998*

**Table 6: Composition of the Age of the Bankers and the Customers**

Type	Age	Total	% of Total
Banker	35-60 years	200	(50)
Customer	35-60 years	200	(50)
Total		400	(100)

Source: *Field survey data, 1998*

**Table 7: Composition of the Sex of the Bankers and the Customers**

	Male	Female	Total
Banker	160 (80)	40 (20)	200 (50)
Customer	178 (89)	22 (11)	200 (50)
Total	338	62	400 (100)

Source: *Field survey data, 1998*. Note: *Figure in the parenthesis indicates the percentage of total.*

**Table 8: Composition of Education Level of the Bankers and the Customers**

Education Level	Banker	Customer	Total
Under Graduate	26 (13)	30 (15)	56 (14)
Graduate	126 (63)	136 (68)	262 (65)
Post Graduate	48 (24)	34 (17)	82 (21)
Total	200 (100)	200 (100)	400 (100)

Source: *Field survey data, 1998*. Note: *Figure in the parenthesis indicates the percentage of total.*

**Table 9: Profit and Loss Sharing System is the Essence of Islamic Finance**

Causes	Bankers	Customers	Total
a) Islamic finance aims at both profit and losses.	55%	16%	36%
b) Islam permits profit and forbids <i>riba</i> .	26	62	44
c) Islamic finance cannot earn <i>riba</i> in any way.	10	8	9
d) Islamic finance is always meant for investment.	9	14	11

Source: *Field survey data, 1998*.

Note: *Figure indicates the percentage of total.*

**Table 10: Benefits Accrued to the Society from Islamic Banking**

<b>Benefits</b>	<b>Bankers</b>	<b>Customers</b>	<b>Total</b>
a) Zakat Fund has been mobilized through banking system.	72%	68%	69%
b) Welfare activities are organized through banking system	8	13	12
c) The concept of <i>Halal</i> and <i>Harām</i> in case of investment/buying and selling has been introduced.	5	9	7
d) Mobilization of Financial resources to the real sector of the economy has been introduced	3	2	2
e) New products of banking have been introduced.	12	8	10

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 11: Basis of Development of Islamic Banking**

<b>Basis</b>	<b>Bankers</b>	<b>Customers</b>	<b>Total</b>
a) Mere faith in Islam;	55%	69%	62%
b) Intention to earn profit;	15	23	19
c) To avoid interest;	18	2	10
d) To ensure justice in the financial transactions;	3	3	3
e) To contribute to the welfare of the economy	9	3	6

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 12: Causes of Continuation of Interest-based Transaction through Back Door by Islamic Banking System**

<b>Causes</b>	<b>Bankers</b>	<b>Customers</b>	<b>Total</b>
a) Trading and Rental based modes of investment do not differ much from the interest-based transactions.	60%	73%	67%
b) Products of present Islamic Banking are similar to those of interest-based banking system.	7	9	8
c) Risk-sharing in current practices of Islamic Banking is not proportional to its profiteering.	12	16	14
d) Islamic banks are working along with the interest-based banks.	21	2	11

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 13: Causes of Interest Creeping into the Islamic Banking System**

Causes	Bankers	Customers	Total
a) Exploitation is going on through Islamic system of banking	38%	53%	45%
b) Products of Islamic Banking have failed to remove the curse of interest from financial transactions.	28	11	19
c) Banking professionals have led Islamic system of Banking to the garb of interest based banking	16	23	19
d) Islamic system of Banking was introduced in a society, which was not re-organized on Islamic ideology.	18	13	16

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 14: Present Success of Islamic Banks is Not in Conformity with Shari'ah**

Causes	Bankers	Customers	Total
a) The status of Shari'ah Council/ Department is advisory, not supervisory in the system Islamic Banking	28%	37%	32%
b) Earning of profit cannot be the success criterion	42	28	35
c) Justice and welfare in financial transactions are not ensured by Islamic Banks	18	22	20
d) Exploitation still remains in Islamic banking system	12	13	12

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 15: Causes of Not Patronizing the Islamic Banks by Rich and Prominent Muslim Businessmen and Industrialists**

Causes	Bankers	Customers	Total
a) They do not find any real business differences between Islamic and conventional banking	69%	78%	73%
b) Not conscious about Islamic banking.	12	7	10
c) Confused about Islamic Banking	9	10	10
d) They are not motivated to I-Banking	10	5	8

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 16: Most of Investment Financing Techniques by Islamic Banks do Not Share Risk Proportionally**

<b>Causes</b>	<b>Bankers</b>	<b>Customers</b>	<b>Total</b>
a) The Insurance Company covers risks of Islamic banks' loans.	73%	58%	66%
b) Islamic Banks do not always buy for sale.	15	28	21
c) Buying and Selling arrangements by Islamic banks are almost risk-free.	9	11	10
d) Islamic banks do business with depositors money and share risk	3	3	3

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 17: Many Customers are not interested in Dealing with Islamic Banks as they feel that only the Name has been Changed and Interest in Real Sense has not been eliminated**

<b>Causes</b>	<b>Bankers</b>	<b>Customers</b>	<b>Total</b>
a) Mark-up profit makes customers liable for additional payment, which is same as that of conventional bank's fixed interest-based loan.	62%	83%	73%
b) Customers are required to repay banks money on installment basis	14	7	10
c) Failure of installment payment creates additional liability	16	6	11
d) The Islamic Banks in most cases do not consider business loss.	8	4	6

Source: *Field survey data, 1998.*

Note: *Figure indicates the percentage of total.*

**Table 18: Possibility of Loss of Deposit is not Detrimental to Deposit Mobilization**

Causes	Bankers	Customers	Total
a) PLS system of banking does not lead to loss of value of deposit ultimately.	49%	36%	43%
b) It is realized profit of investment which makes return on bank deposit <i>Halal</i> .	17	23	20
c) A true Muslim is not concerned about deposit loss, because he expects Haven in the life hereafter.	13	15	14
d) It does not mean total loss of deposit.	21	26	23

Source: Field survey data, 1998.

Note: Figure indicates the percentage of total.

**Table 19: Present Modes of investment of Islamic Banks are Compromised Modes of Financing with Interest**

Causes	Bankers	Customers	Total
a) Both gives same effect on business results	78%	56%	67%
b) Both are justice ( <i>'adl</i> ) and Welfare ( <i>ihsan</i> ) free.	9	13	11
c) Both are working side by side.	7	14	11
d) Both are working in the same value loaded society.	6	17	11

Source: Field survey data, 1998.

Note: Figure indicates the percentage of total.

**Table 20: Moral Uplifting of the Society Will Pave the Way for Islamic Banking**

Causes	Bankers	Customers	Total
a) Islamic banks cannot work well in an immoral society.	62%	56%	59%
b) False values of life give detrimental environment to Islamic Banking.	8	13	10
c) Governmental power can change the social values.	18	17	17
d) Governmental reformation measures are powerful to build a moral society.	12	14	13

Source: Field Survey Data, 1998.

Note: Figure Indicates the percentage of total.

## Notes

- <sup>1</sup> This definition was made by the Organization of Islamic Conference (OIC). See Islami Bank Bangladesh (1995), p.7.
- <sup>2</sup> This definition was made in the Islamic Banking Act 1983 of Malaysia. See *ibid*.
- <sup>3</sup> Nidaul Islam Magazine, November-December, 1995.
- <sup>4</sup> Ahmad (1997).
- <sup>5</sup> The questionnaires were submitted to Islamic Economics Research Bureau (IERB), the sponsor organization of the research project. Those were examined and approved by the appropriate authority of the IERB. The General Secretary of the IERB wrote a forwarding Letter to the Respondents. The questionnaire can be obtained from the author. All the questions appear in the form of tabulated responses in the Appendix of this paper.
- <sup>6</sup> See Khan (1986) for the stability of Islamic banking.
- <sup>7</sup> Akkas (1996), pp.101-103.
- <sup>8</sup> S. A. Maududi (1987).
- <sup>9</sup> al-Masri (????).
- <sup>10</sup> Khan (1987).
- <sup>11</sup> Ridha Saadallah, "Concept of Time in Islamic Economics", Mimeo. Mentioned in *ibid*.
- <sup>12</sup> See Institute of Islamic Banking and Insurance, London, *Islamic Banking Diploma Module-1*, Lesson 3, p.3.

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## Equity Fund's Islamic Screening: Effects on its Financial Performance

*Abul Hassan\* and Antonios Antoniou\*\**

### 1. Introduction

Integrating religious principles with modern markets, Islamic investing is the popular term for the modern-day practice of buying and selling securities in accordance with the principles of Islam. The basic tenet of Islamic investing is that a Muslim should invest his/her assets to reflect the Islamic principles that govern his/her daily life. For example, just as drinking alcohol and eating pork products are prohibited in Islam, so too is investing in wine or pork processing companies. Islamic investing also prohibits stock positions in companies whose 'primary business' involves are banking, alcohol, gaming, pornography, tobacco and weaponry industries (Usmani, 1999). The seemingly constricting process of Islamic investing has not hindered its growth and prominence in the financial services industry. Often hailed by conventional financial observers as the pre-eminent international emerging market, Islamic investing has grown from a regional, small market to an industry encompassing mutual fund complexes, investment banks, and retail brokerage, etc. As the popularity of equity markets increases, Muslim scholars and business people have moved towards defining and implementing the principles underlying Islamic investing (DeLorenzo, 2001). Of particular note was the establishment in 1996 of the Dow Jones Islamic Market Index (hereafter, the DJIM), and later in the year the 1999 FTSE Global Islamic

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Index. Between these two index families, over fifteen style<sup>1</sup> and regional indexes have been created to track stocks conforming to Islamic principles. The industry continues to draw assets under management in spite of the recent lull in conventional financial markets, as both the religious and secular communities develop more complex and liquid investment products.

Shari'ah scholars have accepted the common stock guidelines, and as a result interest has been generated among the fund managers of the equity funds. It has been agreed that buying and selling corporate stocks does not violate Islamic norms because stocks and shares represent real assets. Dividends comply with Shari'ah, whereas payments or receipt interest (*riba*) in transactions are not allowed. Therefore, unlike fixed income assets such as government bonds and term bank deposits, equities are more compatible with the Islamic doctrine of profit and risk sharing principles. Islamic equity funds experienced excellent growth during the late 1990s as they rode on the technology boom. In 1996, for example, there were twenty-nine Islamic equity funds on the market with US\$800 million in assets. By early 2000 the number of funds had grown to ninety-eight with approximately US\$5 billion in assets. According to the study on Islamic equity funds conducted by Failaka for the year ending 2001, the high growth rate, about 50%, enjoyed by the industry during the 1990s has dropped, although, today there are over one hundred Islamic equity funds, their total assets estimated at roughly US\$5.3 billion (Failaka, 2001).

The DJIMs were created and marketed by Dow Jones and Company, which provides Islamic investors with an acceptable universe of stocks to invest in and a benchmark against which performance can be measured (Iqbal, 2000). Being an index, the DJIM provides a unique opportunity to assess the impact of the constraints on performance free of other considerations such as investment style, fund objectives and timing, and is needed the analysis of the performance of both Islamic and ethical mutual funds.

Currently included in the Islamic Market family of indexes are the broad Dow Jones Islamic Market Index, the Dow Jones Islamic Market US Index, the Dow Jones Islamic Market Technology Index, the Dow Jones Islamic Market Extra Liquid Index, the Dow Jones Islamic Market Canadian Index,

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<sup>1</sup> If the current style of a fund, either estimated from a fund's returns or identified from a fund's holdings, is a reliable indicator of the future style of the fund, the fund sponsor can do a better job in the future risk control of the portfolio. Therefore, the predictability of the style is a much more valuable piece of information for fund sponsors and individual investors.

the Dow Jones Islamic Market UK Index, the Dow Jones Islamic Market Europe Index, and the Dow Jones Islamic Market Asia/Pacific Index. The DJIM addresses demand by creating a standard for applicable Islamic equity investing. It was designed to track the performance of leading, publicly traded companies whose activities are consistent with Islamic Shari'ah principles. Shari'ah principles, following guidelines provided by its *fatmā* and Shari'ah Supervisory Committee on the DJIM, rule out those companies whose business activities are incompatible with Islamic law. After removing companies with unacceptable core business activities, the remaining list is tested by a financial-ratio 'filter', the purpose of which is to remove companies with an unacceptable debt ratio.

Screening criteria are general rules followed by Islamic funds, and are also known as "Qualitative Screening". Their basic target is to deal with industry screening and business practices. Funds need to investigate whether the industry they plan to invest in is permissible in Islam.

By way of guidance, stocks whose core activities come under, or are related to the following headings, are excluded:

- a) banking or any other interest related activity,
- b) alcohol,
- c) tobacco,
- d) gaming,
- e) insurance,
- f) pork production, packaging and processing or any other activity related to pork,
- g) activities deemed offensive to the principles of Islam,
- h) sectors/companies significantly affected by the above.

Companies with incompatible lines of business are removed from the 'universe' of stocks included in the Dow Jones Global Index (DJGJI). Companies classified in other industry groups may also be excluded if deemed to have a material ownership in, or revenues from, prohibited business activities.

Besides qualitative screening, "Quantitative Screening" is required, as Islamic law reaches beyond the simple exclusion of business conducted by non-permissible companies to analysing financial data and ratios. Debt and asset ratio is considered, as to how much of the company's capital is financed by debt in relation to assets. Although Islamic Shari'ah law does not allow the interest-based loans, however, based on the Islamic legal principle and subsequent *fiqh* opinions, a company is not a permissible investment if debt

financing is more than 33% of its capital. Quantitative screening is also concerned with interest-related income, which includes companies which place their surplus funds in investments which yield interest income. Companies which pass these screens are generally eligible for inclusion in the DJIM's investable universe.

Islamic screening criteria provide a complete framework that fund managers follow in performing their investment practices. The exclusion of some sectors and preference for others may have an effect on the direction Islamic equity funds follow. This can have a positive or negative effect depending on the balance of sectors in the portfolio. For instance, Islamic equity funds, which are over-loaded with technology, achieved their best performance during the technology boom period dominant in the second half of the 1990s and which lasted until April 2000.

Despite the increasing attention of practitioners to ethically screened investments, there is relatively little academic research on Islamic ethical equity funds, if any. Therefore, this research sought to address the following objectives:

- a) To examine the potential impact of Islamic screening restrictions on investment performance by comparing the performance characteristics of a diversified portfolio of Islamic screened stock indexes (DJIM) with conventional benchmark (DGI).
- b) To assess the degree of correlation in price movement and volatility among the Islamic stocks (DJIM), Islamic technology related stocks (DJIM-Tech) and UK Islamic stocks (DJIM-UK).

The layout of the paper is as follows:

In section 2 we review the performance evaluation literatures on ethical funds. Section 3 discusses the models and methodology used in the performance analysis. Section 4 focuses the data and sample period. Section 5 presents the empirical results. Finally section 6 contains conclusions.

## **2. Review of the Empirical Evidence**

Islamic investing has much in common with modern forms of investing known as 'ethical investing', 'socially responsible investing', 'faith investing' and 'green investing'. Each of these investment funds has much of value to contribute and each has something in common with the teaching of Islam (DeLorenzo, 2001). It is, therefore, important to keep abreast of what is happening in the ethical funds sector. Most studies which have examined the

performance of managed funds or mutual funds have found that they do not outperform the market, and in some cases significantly under perform the market. This conclusion seems also to have been reached worldwide. In the UK, Samuels (1968), Guy (1978), Moles (1981) and Fletcher, (2000) found that managed funds or mutual funds did not outperform the market. These studies are, therefore, all supportive of the early studies in the US by Treynor (1965), Sharpe (1966) and Jensen (1968 and 1969).

There is no significant evidence on the performance of ethical mutual fund or unit trusts outside UK and USA markets. Studies done by Sauer (1997) and then Statman (2000) compared the returns of ethical and non-ethical USA mutual funds to each other, and to both the S & P 500 and the Dominic Social Index (DSI). Both studies used Jensen's Alpha and concluded that no significant differences between risk-adjusted returns for ethical and non-ethical funds exist.

Luther, Matatko and Corner (1992) and Luther and Matatko (1994) studies were based on UK data, comparing ethical funds to market-wide indices like the FT All Share Price Index. Luther, Matatko and Corner (1992) investigate the returns of 15 ethical mutual funds. Their results provide some weak evidence that ethical mutual fund tend to out perform general market indices. Besides, a bias towards smaller companies for ethical mutual fund is documented. Luther and Matatko (1994) also find this small cap bias and show that comparing ethical funds to a small cap benchmark significantly improved their relative performance. Later Mallin, Saadouni and Briston (1995) made efforts to solve the benchmark problem by using a matched pair analysis. Using a sample matched on the basis of fund size and formation date, they provide evidence of ethical mutual funds out performance, based on Jensen's Alpha. Then Gregory, Matatko and Luther (1997) argue that matching based on fund size does not control for a small cap bias in the ethical portfolios. Based on the two-factor Jensen approach, firstly they confirm their prior observation of the small cap bias. Secondly, no significant difference between the financial performance of ethical and non-ethical mutual fund is found.

### **3. Research Methodology**

The Performance of Dow Jones Islamic Market Index (DJIMI) and Datastream Global Index (DGI) is assessed using the traditional performance measure e.g. Sharpe, Treynor and Jensen measures. A correlation model is also applied to detect the degree of correlation between price movements in

Islamic investments and technology related stocks and United Kingdom (UK) stocks, resembled by the DJIM-Technology Index (DJIM-Tech) and DJIM-UK Index (DJIM-UK) respectively. Volatility of all used indexes is measured for a further insight into the risk associated with investing in each of them.

### **3.1 Jensen's Alpha**

Jensen's Alpha (1968) represents the average risk premium per unit of systematic risk and shows how to determine whether the difference in risk adjusted performance is statistically significant, measuring the ability of active management to increase returns above those which result purely from taking the risk which lies in the fund. Jensen's Alpha is based on the Capital Asset Pricing Model (CAPM) which calculates the expected return on a security or a portfolio over a specific period of time by the following equation:

$$E(R_p) = R_{rf} + \beta[E(R_m) - R_{rf}] \quad (1)$$

where:

$E(R_p)$  = expected average return of the portfolio,

$E(R_m)$  = expected average excess return of the market,

$R_{rf}$  = average risk free rate,

$\beta$  = the systematic risk measure of the portfolio.

However, after allowing an intercept to measure for any abnormal performance, the following regression will be run:

$$ER_p = \alpha + \beta ER_b \quad (2)$$

where:

$ER_p = E(R_p) - R_{rf}$  is the average excess return of the portfolio,

$ER_b = E(R_b) - R_{rf}$  is the average excess return of the benchmark,

$\alpha$  = the Alpha measure for out/under performance.

### **3.2 Sharpe Measure**

The Sharpe measure (1966) deals with return and risk in terms of the Capital Market Line (CML). It measures the return of a portfolio, in excess of the risk-free rate, relative to its total risk.

$$\text{Sharpe measure} = \frac{R_p - R_{rf}}{\sigma_p} \quad (3)$$

$R_p$  = average portfolio's return for a given period of time,

$R_{rf}$  = average risk free rate for the same period,

$\sigma_p$  = standard deviation of the rate of return of a portfolio for the same period.

### 3.3 Treynor Measure

The Treynor Measure (1965) is based on a widely employed criterion for assessing portfolio performance, which is the Security Market Line (SML). The Treynor ratio gives the excess return per unit of systematic risk (non-diversifiable).

$$\text{Treynor Measure} = \frac{R_p - R_{rf}}{\beta_p} \quad (4)$$

where:

$R_p$  = average portfolio's return for a specific period of time,

$R_{rf}$  = average risk free rate for the same period,

$\beta$  = portfolio's beta for the same period.

### 3.4 The Correlation Model

To detect the degree of co-movement between the performance of the DJIM and the DGI, the log of the prices of the two indexes will be individually regressed against the log of the prices of the Dow Jones Islamic Market-Technology Stocks (DJIM-Tech) and the beta coefficient will be compared. The following regressions will be run:

$$\ln P_{\text{DJIM}} = \alpha + \beta_1 \ln P_{\text{DJIM-Tech}} + \beta_2 \ln P_{\text{DJIM-UK}} \quad (5)$$

$$\ln P_{\text{DGI}} = \alpha + \beta_1 \ln P_{\text{DJIM-Tech}} + \beta_2 \ln P_{\text{DJIM-UK}} \quad (6)$$

where:

$\ln P_{\text{DGI}}$  = log of the price of Datastream Global Index at time t,

$\ln P_{\text{DJIM-Tech}}$  = log of the price of DJIM-Technology Index at the time t,

$\ln P_{\text{DJIM}}$  = log of the price of Dow Jones Islamic Market Index (DJIM) at time t,

$\ln P_{\text{DJIM-UK}}$  = log of the price of DJIM- United Kingdom Stock Index at time t.

In the above models, the beta measures the elasticity of the Dow Jones Islamic Market Index (DJIM) with respect to the DJIM-Technology Index and the DJIM-United Kingdom Stock Index, i.e. the percentage change in DJIM for a percentage change in the DJIM-Tech and the DJIM-UK. However, due to non-stationarity problems associated with the previous regression, the first difference (returns) will be checked instead and new beta coefficients will be assessed. The new regressions will be:

$$R_{DJIM} = \alpha + \beta_1 R_{DJIM-Tech} + \beta_2 R_{DJIM-UK} \quad (7)$$

$$R_{DGI} = \alpha + \beta_1 R_{DJIM-Tech} + \beta_2 R_{DJIM-UK} \quad (8)$$

where:

$$\Delta \ln P_{DJIM} = R_{DJIM} = \ln P_{DJIM}^{t+1} - \ln P_{DJIM}^t =$$

return on DJIM (9)

$$\Delta \ln P_{DJIMTech} = R_{DJIMTech} = \ln P_{DJIMtech}^{t+1} - \ln P_{DJIMtech}^t =$$

returns on DJIM-Technology Index (10)

$$\Delta \ln P_{DGI} = R_{DGI} = \ln P_{DGI}^{t+1} - \ln P_{DGI}^t =$$

returns of Datastream Global Index (11)

$$\Delta \ln P_{DJIMUK} = R_{DJIMUK} = \ln P_{DJIMUK}^{t+1} - \ln P_{DJIMUK}^t =$$

return of DJIM UK Index (12)

The degree of correlation between returns on the Dow Jones Islamic Market Index (DJIM) and Datastream Global Index (DGI) is examined by checking whether the betas of the independent variables (DJIM-Tech and DJIM-UK) in both regressions are statistically significant, while, comparing the values of betas will indicate which of the two indexes is more influenced by the performance of DJIM-Tech stocks and DJIM-UK market stocks. It is expected that the performance of the DJIM to be more affected by the performance of technology stocks because it is over-weighted with technology stocks if compared to Datastream Global Index, over 26% versus 24% respectively. Therefore, this would partly explain the slip in the DJIM performance over the past three years, tracking the drop in technology and UK Stocks prices.

### 3.5 Volatility

Volatility shows the dispersion of the percentage changes in prices or rate of return. The most commonly used measure of stock return volatility is

standard deviation. Financial economists find this statistic useful because it summarises the probability of seeing extreme values of return. When the standard deviation is large the chance of a large positive or negative return is large (Schwert, 1990).

#### **4. Data and Sample Period**

This study examines the returns of the global Dow Jones Islamic Index (DJIM) against the Datastream Global Index (DGI) over the period January 1996 to March 2003. The DJIM is a subset of the Dow Jones Global Index (DJGI). Made up of over eight hundred stocks, it is an Islamic equity benchmark index that excludes stocks from the DJGI whose company and primary business is non-permissible, based on Shari'ah principles. The prohibited industries are banking, alcohol, tobacco, gaming, insurance and pork. Companies are excluded if their debt ratio is equal or greater than 33.33%. According to Shari'ah screening, the index completely excludes banks and all other financial institutions because their main business involves interest. It is also noted that the index's heavy load of technology stocks, with a total exposure of over 26% in the index out of the total Islamic stocks. The DJIM is a capitalisation weighted price index computed on the basis of the last prices. It does not include reinvested dividends and is based on December 31, 1995 with the base value set at 1000. The DJIM obtained the data directly from Dow Jones & Company. Our data consists of the weekly price of the DJIM, DJIM-Tech, DJIM-UK (Wednesday to Wednesday to limit the day of the week effect). The choice of the weekly data interval is largely a practical decision given the short sample period available. The use of monthly data, though common in empirical stock market studies (Jensen, 1968, Fama & MacBeth, 1973, Guy, 1978), Since our present study uses the short sample period which would reduce the number of observations to a level where the robustness of the results would be compromised, we, therefore, use the weekly data interval.

The Datastream Global Total Market Index (DGI) for the period from January 1996 to March 2003 obtained from Datastream is used as the proxy for the market portfolio. The three-month US Treasury bill return obtained from Datastream is used as a proxy for the risk-free rate. This rate is subtracted from the DJIM and benchmark index returns to compute weekly excess returns.

In order to evaluate the performance, the data will consist of three periods consisting of weekly excess returns. The first is the period from

January 1996 to March 2000 (250 observations), during which international stock markets were going up. The second period goes from April 2000 to March 2003 (156 observations), during which markets were mainly going down, while, the third period consists of the first and second periods combined, that is from January 1996 to March 2003 (406 observations), which provides the general market fluctuations of ups and downs during that period. The division of the data samples is based on market performance over each period, helping provide a better picture of how our indexes have reacted to the general health of stock markets depending on their sectoral selection.

The following formula is used to calculate the returns on indexes from prices:

$$\Delta \ln P_{DJIMTech} = R_{DJIMTech} = \ln P_{DJIMtech}^{t+1} - \ln P_{DJIMtech}^t$$

where :

$\ln P_{DGI} = \log$  of portfolios priced at time t+1,

$\ln P_{DGI} = \log$  of the portfolios priced at time t .

To obtain the weekly excess returns, the risk free rate is subtracted from the weekly returns of each index, as the used measures are based on relative performance. The formula used is:

$$ER_p = R_p - R_{rf}$$

where:  $R_p$  = index weekly return,

$R_{rf}$  = risk free rate.

## **5. Empirical Results**

The Sharpe and Treynor measures and the Jensen Alpha are calculated and explained. The validity and results of the correlation models are also checked and interpreted in order to prove the strong relationship between the DJIM and DJIM Technology and DJIM-UK stocks. The volatility of the indexes is presented and results also analysed.

**Table 1: Summary of Weekly Excess Returns**

<i>Jan 1996- March'00</i>	<i>Mean</i>	<i>Std. Error</i>	<i>Min.</i>	<i>Max.</i>	<i>Normality Test<sup>1</sup></i>	<i>ADF<sup>2</sup></i>
ER <sub>DJIM</sub>	0.0034	0.0208	-0.0396	0.0531	0.2911 [0.8744]	-11.114**
ER <sub>DGI</sub>	0.0031	0.0216	-0.0515	0.0613	0.0038 [0.9891]	-11.412**

<i>April'00- March'03</i>	<i>Mean</i>	<i>Std. Error</i>	<i>Min.</i>	<i>Max.</i>	<i>Normality Test</i>	<i>ADF</i>
ER <sub>DJIM</sub>	-0.0049	0.0291	-0.0911	0.0861	2.2155 [0.3511]	-14.22**
ER <sub>DGI</sub>	-0.0053	0.0282	-0.0956	0.0897	9.1032 [0.0168]*	-14.44**

<i>Jan.1996- March'03</i>	<i>Mean</i>	<i>Std. Error</i>	<i>Min.</i>	<i>Max.</i>	<i>Normality Test</i>	<i>ADF</i>
ER <sub>DJIM</sub>	-0.0026	0.0254	-9.2101	0.07661	1.8832 [0.4211]	-15.97**
ER <sub>DGI</sub>	-0.0025	0.0252	-9.8543	0.07992	11.7652 [0.0056]*	-15.99**

1. Normality Test following Chi<sup>2</sup>(2) distribution.

2. Augmented Dickey-Fuller Test for stationarity.

\* 5% level of significance

\*\* 1% level of significance

Normality test results on indexes excess returns are mixed with ER<sub>DGI</sub> statistically significant for two out of the three examined periods, while, ER<sub>DJIM</sub> are not normally distributed. ADF tests show statistically significant figures at 1% level of significance, indicating the stationarity of the data examined. Excess returns show that DJIM was only able to outperform DGI in the first period, which can be attributed to rising stock markets, especially technology related during that period. In his study Guerard (1997) found that higher excess returns for portfolio using ethical screens than those from an unscreened portfolio for the period 1987-1996. Although standard deviations of DJIM proved to be higher than that of DGI throughout our sample periods, concluding that DJIM is risky than its benchmark.

### 5.1 The Sharpe and Treynor Measures

Sharpe and Treynor measures have been reported as under for the three periods under study.

**Table 2: Sharpe and Treynor Measures for the January 1996 to March 2000**

	<i>Datastream Global Index (DGI)</i>	<i>Dow Jones Islamic Market Index (DJIM)</i>
Sharpe	0.1148	0.1711
Treynor	0.0022	0.0036

As per result, for the period from January 1996 to March 2000, both ratios indicate that the DJIM provided an average excess weekly return of 0.17 versus 0.11 for DGI as per Sharpe measure. According to Treynor measure, per unit of Beta, DJIM provided an average excess weekly return of 0.0036 versus 0.0022 for the DGI. These results are supported by the fact that during the sample period, global stock markets surged to new record highs. The out performance of DJIM may be explained by its overweighing in technology as technology related stocks did better than other sectors up late March 2000, reaching their all times highs, with NASDAQ reached its highest level at 4704.73, gaining 93%.

In view of the above results, it may be pointed out that during rising stock market cycles, Islamic investments seem to outperform unscreened investments, stating a positive Islamic screening sectoral bias.

**Table 3: Shape and Treynor Measures for the April 2000 – March 2003**

	<i>DGI</i>	<i>DJIM</i>
Sharpe	-0.1521	-0.1743
Treynor	-0.0051	-0.0066

As per result for the period from April 2000 to March 2003, the Sharpe and Treynor ratios indicate that the Dow Jones Islamic Market Index (DJIM) under-performed Datastream Global Index (DGI). According to Sharpe measure, per unit of total risk, DJIM provided a negative average excess weekly return of 0.1743 versus 0.1521 for Datastream Global Index. According to Treynor measure, per unit of Beta, DJIM provided a negative average excess weekly return of 0.0066 versus 0.0051 for the Datastream Global Index. These results are consistent with the fact that stock prices were mainly down throughout the sample period. Hence, the under-performance of DJIM may also be attributed to declining technology related stocks during the examined period, reaching their lowest prices. NASDAQ lost 140% of its value during the period going down to 1046.72 points, while DJIM UK index dropped by 49% reaching 519.55 points.

In view of the above results, it may be pointed out that during falling stock markets periods, Islamic investments seem to under perform unscreened investments due to its sectoral and country biases.

**Table 4: Sharpe and Treynor Measures for the period January 1996 to March 2003**

	<i>DGI</i>	<i>DGIM</i>
Sharpe	-0.1621	-0.1742
Treynor	-0.0049	-0.0059

As per result for the period from January 1996 to March 2003, the Sharpe and Treynor ratios indicate that the DJIM under-performed DGI. As per Sharpe measure, per unit of total risk, DJIM provide a negative average excess weekly return of 0.1742 versus 0.1621 for DGI. Whilst per unit of Beta, DJIM provided a negative average excess weekly return of 0.0059 versus 0.0049 for DGI, as per Treynor measure.

Above results are supported by the fact that during the sample period, global stock prices had gone through high as well as low stages, which explains the negative excess average weekly returns reported for all indexes.

## 5.2 Jensen's Alpha

The following are the results of Jensen's Alpha's statistical tests.

**Table 5: Statistical Tests**

	$R^2$	<i>RESET</i>	$DW^1$
Jan. 1996-March 2000	0.8801	0.8702	1.79**
April 2000-March 2003	0.8033	3.3339	2.91**
		[0.3011]	
Jan. 1996-March 2003	0.9001	3.8411	2.81**
		[0.0661]	

1. Durbin-Watson test for correlation.

\*\* 1% significant level.

The null hypothesis of the Ramsey's RESET test is rejected as all test's values are statistically insignificant. The coefficients of determination for all periods are above 80%, suggesting that much of the variations in the returns on DJIM are due to worldwide markets' movements, while results obtained from DW test are statistically significant at 1% level of significance supporting the acceptance of the hypothesis that there is no autocorrelation.

$$ER_{DJIM} = 0.0013 + 1.0075_{DGI}$$

$$\text{Std Error} \quad 0006 \quad 0.0271$$

$$\text{T-Value} \quad 2.2601^{**} \quad 37.9011$$

During the period from January 1996 to March 2000, the above results show a positive Alpha against the benchmark, indicating positive abnormal returns for the DJIM.

T-values show that the Alpha is statistically significant at 1% level. This proves that the DJIM return is greater than was expected for that level of risk, indicating superior performance over DGI, which is consistent with the results obtained using the Sharpe and Treynor measures.

$$\begin{array}{l} ER_{DJIM} = \quad -0.0012 + 0.8785 ER_{DGI} \\ \text{Std. Error} \quad 0.0001 \quad 0.3612 \\ \text{T-value} \quad -1.15 \quad 25.21 \end{array}$$

During the period from April 2000 to March 2003, results show a negative Alpha against the benchmark, indicating negative abnormal returns for the DJIM. It means the DJIM return is lower than expected for that level of risk, indicating inferior performance over DGI. However, T-values show that the Alpha is statistically insignificant.

$$\begin{array}{l} ER_{DJIM} = \quad -0.00004 + 0.8921 ER_{DGI} \\ \text{Std. Error} \quad 0.0008 \quad 0.0324 \\ \text{T-value} \quad -0.4455 \quad 34.0001 \end{array}$$

During the whole sample period from January 1996 to March 2003, results show a negative Alpha against the benchmark, indicating negative abnormal returns. The DJIM return is lower than expected for that level of risk, indicating inferior performance over DGI. However, T-values show that the Alpha inferior performance is statistically insignificant for Islamic investments when stock prices are dropping.

### **5.3 The Correlation Model and Volatility**

The summary statistics of the DJIM, DGI, DJIM Technology Index, and DJIM UK Index for the period from January 1996 to March 2003 are given in Table 6 below.

Normality tests for the above mentioned indexes suggest that only  $R_{DGI}$  and  $R_{DJIM-UK}$  are normally distributed. Results also show that absolute ADF values of all indexes are statistically significant at 1% significant level, indicating that  $R_{DJIM}$ ,  $R_{DGI}$ ,  $R_{DJIM-Tech}$  and  $R_{DJIM-UK}$  are stationary.

**Table 6: Summary of the Weekly Returns**

	<i>Mean</i>	<i>Std. Error</i>	<i>Min.</i>	<i>Max.</i>	<i>Normality</i>	<i>ADF</i>
R <sub>DJIM</sub>	-0.0021	0.0257	-0.0886	0.8101	1.6901 [0.4401]	-15.123**
R <sub>DGI</sub>	-0.0025	0.0259	-0.0832	0.7921	11.0124 [0.0039]*	-15.982**
R <sub>DJIM-Tech</sub>	-0.0019	0.0487	-0.1722	0.1624	0.8967 [0.6712]	-16.341**
R <sub>DJIM-UK</sub>	-0.0015	0.0299	-0.0766	0.1101	7.6525 [0.0243]*	-15.552**

\*5% significant level

\*\* 1% significant level

$$\begin{array}{l}
 R_{DJIM} = -0.000512 + 0.037961 R_{DJIM-Tech} + 0.2411 R_{DJIM-UK} \\
 \text{Std. Error} \quad 0.0006713 \quad 0.01452 \quad 0.02771 \\
 \text{T-Value} \quad -0.711 \quad 24.94511 \quad 7.9932
 \end{array}$$

The RESET test suggests that the model is not mis-specified. As the result of the test is statistically insignificant, it allows us to reject the hypothesis of mis-specification. The fact that  $d=2.41$  (DW) supports acceptance of the hypothesis that there is no autocorrelation as  $d > d_u$  ( $2.41 > 1.77$ ). The F value (570.8) statistically significant at 1% level of significance, showing that the dependent variable  $R_{DJIM}$  is linearly related to the explanatory variables  $R_{DJIM}$  and  $R_{DJIM-UK}$ . The coefficient of determination  $R^2 = 0.84$  means that around 84% of the total variations in  $R_{DJIM}$  is explained by the model. This is not surprising, as the DJIM index includes a large number of global technology and UK stocks.

$$\begin{array}{l}
 R_{DJIM} = -0.000512 + 0.288215 R_{DJIM-Tech} + 0.254311 R_{DJIM-UK} \\
 \text{Std. Error} \quad 0.001189 \quad 0.226512 \quad 0.05311 \\
 \text{T-values} \quad -0.39 \quad 11.89 \quad 7.22
 \end{array}$$

The statistically insignificant result of the RESET test rejects the hypothesis that the model is mis-specified. The DW test ( $d=2.54$ ) supports the acceptance of the hypothesis that there is no autocorrelation as  $d > d_u$  ( $2.54 > 1.77$ ). The F value (190.9) is statistically significant at 1% level of significance, showing that the dependent variable  $R_{DGI}$  is linearly related to the explanatory variables  $R_{DJIM-Tech}$  and  $R_{DJIM-UK}$ . The coefficient of determination  $R^2 = 0.625$ , suggests that almost 62% of the total variation in  $R_{DGI}$  is explained by price movements of sectors other than technology related.

The Beta coefficients shown in the regressions explain the relationship between returns on the DJIM-Tech index and returns on the Dow Jones Islamic Market Index (DJIM) the Datastream Global Index (DGI). T-values indicate that the coefficients are statistically significant. But the values of  $R_{DJIM-Tech}$  coefficients show relatively larger correlation between returns on the DJIM and returns on the DGIM-Tech in comparison to that between returns on the DGI and DJIM-Tech. This result is consistent with the fact that the GJIM is overweighted with technology stocks (above 26%) in comparison to the DGI (around 24%). But the values of  $R_{DJIMUK}$  coefficients show a greater influence for price movements of UK stocks on the Datastream Global Index than on the Dow Jones Islamic Index.

**Table 7: Average Weekly Returns and Volatility**

<i>Jan.'96- 03</i>	<i>Mar'03</i>	<i>DJIM</i>	<i>DGI</i>	<i>DJIM-Tech</i>
Average		-0.0054	-0.0057	-0.0085
Weekly Return				
Standard		0.0272	0.02741	0.0457
Deviation				

The above standard deviations for the average weekly returns of three indexes indicate that the standard deviation of the DJIM Technology index is the largest, proving that the DJIM-Tech is the most volatile index. However, the DGI has the lowest volatility level and hence the least volatile index, which may be due to its balanced sectoral diversification. The foregoing discussion shows that the DJIM seems to be more volatile than the DGI, which indicates that the Islamic index may be riskier than the conventional index. However, this result is closely related to the current composition of the Islamic index, characterised by high exposures to technology and UK stocks and its exclusion of banking stocks that are far less volatile than technology related stocks.

## 6. Conclusions

In our study, we show that the impact of Islamic screens is closely related to the performance of stock markets worldwide. However, the bias of Islamic equity towards technology stocks has proved beneficial during rising stock market periods (as per our sample January 1996 to March 2000), but it hit the performance of Islamic equity investments during falling stock markets (April 2000 to March 2003 sample period) badly. In a comparative study done by

Luther and Matatko (1994) in respect of UK ethical mutual funds, compared to the whole UK stock market and taking as a sample period 1985-1992, the result indicated that ethical mutual funds are heavily concentrated in the smaller company sector and had performed poorly over the study period. It is clear; therefore, that Islamic or ethical screening is a major determinant in portfolio selection, hence international and sectoral diversification. Our results show that any argument that Islamic equity investments are less profitable than conventional types of investments is questionable. This is supported by relatively major differences between Sharpe and Treynor measures and significant positive Alpha over the positive returns period when the Dow Jones Islamic Market Index outperformed the Datastream Global Index. It is not out of place here to mention that Islamic equity investments face a greater number of difficulties than conventional equity investments, with screening criteria regarding stock selection imposing either a positive or negative influence, mainly depending on the health of the market. Hence the growth and development of the Islamic equity funds market will depend largely on the nature of innovations, including different investment strategies and risk assessing tools, to be used in compliance with Shari'ah rules.

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## Legal Aspects of Islamic Banking: Malaysian Experience

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### Introduction

Malaysia is the forerunner in Islamic banking. The world is looking to this country and trying to learn from its experience in developing modern and sophisticated instruments which are said to be Shari'ah compliant. This is the first country in the world to introduce and promote an Islamic inter-bank money market to link all the market players and promote short-term liquidity. The main contributing factor leading to its success is the undeniable support of the Government. To further spur its growth, Bank Negara Malaysia (BNM) in 2001 introduced the Financial Sector Master Plan (FSMP), which includes the aim of a 20 percent market share for Islamic Banking and Takaful vis-à-vis conventional by 2010.

In Malaysia currently there are two Islamic banks, Bank Islam Malaysia Berhad (BIMB), which commenced operation in July 1983 and Bank Muamalat Malaysia Berhad (BMMB) in 1999, a relatively new bank as the result of a merger and takeover exercise.<sup>1</sup> They were established by virtue of an act of Parliament; the Islamic Banking Act 1983 (IBA), which is considered as the beginning of the effort to assimilate Islam into the Malaysian economic system. Thereafter, more statutes were enacted to

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govern and regulate the financial sector in Malaysia. For instance, the Government Investment Act 1983 (GIA),<sup>2</sup> and the Takaful Act 1984 (TA).<sup>3</sup>

The full monopoly of BIMB in Islamic Banking lasted for ten years until 1993, when three commercial banks, i.e., Maybank, Bank Bumiputera and United Malayan Banking Corporation were given the opportunity to participate in the pilot project of the Interest-free Banking System (IBS),<sup>4</sup> probably to test the market as to the profitability and viability of Islamic banking offered by conventional banks. Certainly, the project has been shown to be a remarkable success with many commercial banks getting on the bandwagon of IBS. Now almost every commercial bank offers Islamic banking which attracts both Muslim and non-Muslim customers.

The Islamic banking system without the law is futile and meaningless. The legal system is supposed to regulate and license the Islamic banking business, besides imposing control and supervision of the affairs of the Islamic banks. With the rapid development of the Islamic banking system in Malaysia, the law must also be able to keep up with the speed of that development. As such, the study on the development of the legal regime becomes an important area to be understood. Realizing that purpose, the article intends to delve into the various legal issues relating to Islamic banking in Malaysia.

## **2. Statutory Provisions**

In Malaysia, there are two laws governing Islamic banking. One is the IBA 1983 which exclusively governs BIMB and BMMB and the other is the Banking and Financial Institutions Act 1989 (BAFIA) which regulates conventional banks and Islamic Banking Divisions (IBDs) or SPI banks.<sup>5</sup> The nature of these laws is somewhat different as the IBA was enacted with the intention of Islamic banking in mind while BAFIA was enacted to govern conventional banking.<sup>6</sup> Section 124(6) of BAFIA specifically provides that “The Act shall not apply to Islamic banks.” As such, one can loosely say that the IBA, as the name implies, is an Islamic statute while BAFIA is a conventional or civil statute to govern their respective banks. The nature of the dual banking system; a full-fledged Islamic banking system operating in parallel with a sophisticated conventional banking system is unique. So far, Malaysia is the only Muslim country to implement such a model with both types of banking working hand-in-hand or side-by-side utilising essentially the same banking infrastructure.

## **2.1 IBA 1983 Versus BAFIA 1989**

IBA 1983 was the first law in Malaysia covering Islamic matters that deals with economic activity and is a good attempt to enhance the role of Islamic law by not being only restricted to family and matrimonial matters per se. Nevertheless, this Act is substantially modelled on the Banking Act 1973 (repealed and replaced by BAFIA). Having a first look at the said Act, one could feel that there is nothing Islamic about it except where it states “...aims and operation not contrary to the religion of Islam.” It could be said that the IBA is merely a piece of legislation to permit the establishment and operation of an Islamic bank in Malaysia. This is probably why the Act is relatively brief and simple compared to BAFIA, its civil law counterpart.<sup>7</sup> The Act, for example, only defines ‘Islamic banking business’ to mean “banking business whose aims and operation do not involve any element which is not approved by the religion of Islam.”

This blanket definition seems to be very ambiguous and may carry far-reaching implications. This definition surely poses the question: What is Islamic banking business? Shari‘ah contracts used by Islamic banks and SPI banks, such as *muḍārabah*, *mushārahah*, *ijārah*, *murābahah* and *wakālah*, are not mentioned in the Act. The definition seems to be very simple and open-ended, literally “everything under the sky and above the soil of Islam” is a permissible (*ḥalāl*) type of Islamic banking. In other words, legally an Islamic bank is allowed to engage in all types of business which are lawful in the eyes of Shari‘ah. In fact, the generality of the definition of Islamic banking business<sup>8</sup> could benefit the Islamic banks in Malaysia as they can practise ‘Universal banking.’ ‘Universal Banking’ can be defined as the conduct of a range of financial instrument services comprising deposit taking and lending, trading of financial instruments and foreign exchange, underwriting of new debt and equity issues, brokerage, investment management and insurance. In brief, Universal Banking is similar to the concept of the ‘financial supermarket’ which offers every financial need under one roof.<sup>9</sup> On the negative side, in the absence of a statutory definition of ‘banking business’ in the Act, it is the practice, and the law (by virtue of Sections 3 and 5 of the Civil Law Act 1956), to have regard to the English law to determine its meaning. In the case of interpreting what would be “Islamic banking business”, the Civil Court and the practitioners could define it in similar terms as conventional banks in the Common law jurisdictions. The only exception is that the aims and operations of such banking business should not involve any element that is not approved by the religion of Islam. Probably due to this, Islamic banks have emulated the ‘Anglo-Saxon’ style of

banking by having co-companies to undertake various financial functions, even though the IBA 1983 allows an Islamic bank to run Universal Banking.

It is acceptable fact that the conventional banks have no choice but to have subsidiaries to undertake various financial businesses because they are legally constrained under BAFIA. Section 2 of BAFIA states:

“ ‘Banking business’ means:

- a) the business of –
  - i) receiving deposits on current account, deposit account, savings account or other similar account;
  - ii) paying or collecting cheques drawn by or paid in by customers; and
  - iii) provisions of finance; or
- b) such other business as the Bank (Central Bank of Malaysia (CBM)) with the approval of the Minister, may prescribe.”

From the above, BAFIA has restricted conventional banks to 3 main businesses; viz. (i) receiving deposits (ii) paying and collecting cheques and (iii) giving loans. Furthermore, Section 32 restricts conventional banks from engaging in trade, either retail or wholesale, except in connection with the realisation of security given to or held by it for the purpose of carrying on its licensed business. Section 66 prohibits conventional banks from being involved in investment.<sup>10</sup> Both these sections are absent in IBA on purpose so as to give effect to the operation of Islamic banking business which is centrally based on trade and investment, albeit as mentioned above. IBA is basically a carbon copy of the conventional Banking Act 1973, a predecessor of BAFIA. This is the example where the exceptions were done in order to comply with “the aims and operations must not involve any elements which are not approved by the Religion of Islam”. This would easily distinguish Islamic banking from that of conventional, as while the latter earns most of its profits against a fixed interest rate for the granting of loans, the former earns the profit from trading and investment activities.

Besides being brief and general, the IBA has limited licensing to companies under the Companies Act 1965. Section 3 of the IBA states:

“Islamic banking business shall not be transacted in Malaysia except by a company which is in possession of a licence in writing from the Minister authorising it to do so.”

The above provision limits the licensing of an Islamic bank to a company only. According to the definition section of the IBA (Section 2), a ‘company’ means a company enacted under the Companies Act 1965 and therefore, only companies enacted under the Companies Act can operate Islamic banking. As a result, statutory bodies or companies enacted under different laws, cannot operate an Islamic bank. Mainly due to this legal constraint, Bank Kerjasama Rakyat Malaysia (Bank Rakyat) was unsuccessful in its attempt to be the second full-fledged Islamic bank, although its operations have been Islamised. Bank Rakyat is actually *de facto* an Islamic bank but *de jure* it is not as it was enacted under the Co-operative Societies Act 1948. As one expert observed:

“The establishment of Bank Muamalat Malaysia (sic) as the country’s second Islamic bank caught many by surprise since Bank Kerjasama Rakyat Malaysia had been tipped to be the second of such banks after Bank Islam Malaysia Bhd. It is surprising as Bank Rakyat was always having the idea that it would be the (country’s) second Islamic bank...but most probably the plan was somewhat delayed as Bank Rakyat was still under the Co-Operative Act.”<sup>11</sup>

This limitation should be removed and the rule applicable in BAFIA adopted. This is of wider application as BAFIA extends to “any individual, corporation, statutory body, local authority, society, trade union, co-operative society, partnership and any other body, organisation, association or group of persons, whether corporate or unincorporated.”

IBA has also posed legal uncertainties when it comes to the conflict of laws. Section 55 of the IBA reads:

“An Islamic bank which is incorporated under the Companies Act 1965 shall be subject to the provisions of the Act as well as the provisions of this Act, save where there is any conflict or inconsistency between the provisions of that Act and the provisions of this Act, the provisions of this Act shall prevail.”

The above section is quite clear that when there is a conflict between the IBA and the Companies Act, the IBA shall prevail, but the effect could be far-reaching. What about other laws that an Islamic bank is subject to, such as the Contracts Act, National Land Code, Hire Purchase Act and Sale of Goods Act? If there is a conflict between any of these other Acts, which law shall prevail? Would the court apply the legal maxim of *expressio unius est exclusio alterius* (the express mention of one thing implies the exclusion of another). Since the legislature’s intention is to limit the scope only to cover the Companies Act, as such, in other situations where there are conflicts

between Islamic law and other statutes, the former will not necessarily prevail.

This oversight should be rectified. Perhaps a lesson could be taken from Pakistan where the Islamic banking law has been constructed as follows:

“The provisions of this ordinance shall have effect notwithstanding anything contained in the Companies Act 1913 (VII of 1913), or any other law for the time being in force.”<sup>12</sup>

The above provision overrides all other laws so that if there is a conflict between the Islamic banking law and any other law currently in force in Pakistan, the provision of the former shall prevail.

One interesting statutory requirement for an Islamic bank in Malaysia which is not present in BAFIA is the establishment of an in-house Sharī‘ah Advisory Body (SAB) to advise the bank management as to Sharī‘ah compliance. Section 3(5)(b) provides:

“That there is, in the articles of association of the bank concerned, provision for the establishment of a Syariah advisory body to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam.”

The details of the SAB is not elaborated in the Act. It is to be detailed by the bank’s Articles of Association. The IBA only provides that the statutory duty of the SAB is to “advise the bank on its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam”. The Islamic Banking (Amendment) Act 2003 has been recently passed.<sup>13</sup> It incorporates a new section 13A on the “Advice of Sharī‘ah Advisory Council” which provides:

“An Islamic bank may seek the advice of the Syariah Advisory Council on Syariah matters relating to its banking business and the Islamic bank shall comply with the advice of the Syariah Advisory Council.

In this section, “Syariah Advisory Council” means the Syariah Advisory Council established under subsection 16B (1) of the Central Bank of Malaysia Act 1958.”

However, there still exist some legal uncertainties as to the legal position of the SAB which needs to be resolved urgently, such as:

- 1) Are the SAB decisions binding on the bank's management? IBA only provides for the statutory duty of the SAB to give advice but nothing is mentioned about their decision must be acceptable and binding on the bank. It is argued that SAB is not a creation of statute but of its Article of Association. As such, SAB cannot have any legitimacy or power beyond that it has under IBA i.e., merely an advisory role. On the other hand, it could also be submitted that if the decision or the opinion of SAB is ignored by the bank management, it will run the risk of its product or service be challenged in the court as to its Sharī'ah validity;
- 2) Are their decisions subject to judicial review? Can the Court quash or review their decisions on Islamic banking matters?<sup>14</sup>

## **2.2 BAFIA and SPI Banks**

SPI (or IBS) banks, formerly known as Interest-free or SPTF banks, are a peculiar and unique creature of the system. SPI banks offer both Islamic and conventional products. However, the whole structure is conventional as they are licensed and regulated by BAFIA 1989.<sup>15</sup> There is no new law enacted to govern them and they can operate within the existing law. Prior to 1989, they were operating Islamic banking business using the second limb of Section 2 of BAFIA which is concerned with "such other business as the Bank (Central Bank of Malaysia (CBM)), with the approval of the Minister, may prescribe." Islamic banking business such as involvement in trade (*bay' bithaman ajil, murābahah*) or investment (*muḍārahah* and *mushārahah*), were therefore not covered under the first limb of the said Section.

In 1999, there was an amendment to Section 124 of BAFIA by virtue of the BAFIA (Amendment) Act 1996<sup>16</sup> which legalised and formalised the carrying on of Islamic banking and financial business by licensed institutions. With this amendment, 6 new provisions were incorporated to govern and regulate the SPI banks. They are as below with commentary connected therewith:

- 1) SPI banks are allowed to carry on Islamic banking business (IBB) or Islamic financial business (IFB) in addition to their existing traditional banking business provided that they consult the Central Bank (CBM);
- 2) SPI banks in carrying out IBB or IFB are subject to other provisions of BAFIA. As such, if there is a conflict between this section and other sections of BAFIA, which one will prevail? For instance, on

the one hand, Section 124(1) of BAFIA allows SPI banks to carry on Islamic banking business and Islamic financial business in addition to their existing business but on the other hand, Section 32 prohibits licensed institutions from carrying on trade, either retail or wholesale, including import and export, except in connection with the realisation of a security given to or held by it for the purpose of carrying on its licensed business. Likewise, Section 66 restricts licensed institutions from involvement in investment activities. Thus, the two provisions seem to be in direct contradiction with the operation and business of Islamic banking and finance, as to be involved in trade and investment is the essential thrust as an alternative to *ribā*. This is to comply with the divine revelation which has legalised trade and prohibited *ribā*.<sup>17</sup> From the foregoing, one can submit that the granting of a BBA facility by SPI banks is tantamount to engaging in trade, and thus in breach of Section 32. Likewise, *muḍārabah* and *mushārahah* dealings between SPI banks and their customers are in fact violating Section 66 of BAFIA. That brings up the issue of capacity to enter into a contract which is an important legal issue to be resolved, particularly in the absence of any judicial precedents on the matter. However, on closer scrutiny of BAFIA, such “conflicting provisions” can be mitigated by referring to the BAFIA (Trading by Licensed Banks, Finance Companies and Merchant Banks) Order 1994, which came into force on 1 March 1993. The provision is self-explanatory. It provides that “All licensed banks, finance companies and merchant banks may engage in either or both of the following forms of trade: the sale of property at a price which includes a profit margin and the sale of property on a deferred payment basis at a price which includes a profit margin, so long as such trade is not conducted on the basis of interest.”

- 3) As such, the said Order has actually provided an exemption to SPI banks to engage in sale so as to materialize the operation of Islamic banking business. Likewise, the restriction on investment is mitigated by virtue of the BAFIA (Acquisition and Holding of Shares and Interests in Shares) (Licensed Banks, Licensed Finance Companies and Licensed Merchant Banks) Regulations 1991 which came into force on 1 October 1989;
- 4) In carrying out IBB or IFB, the SPI may seek the advice of the SAC established under subsection (7) of BAFIA on the operations of the business to ensure that it does not involve any element which is not approved by the Religion of Islam;

- 5) SPI banks shall comply with any written directions relating to the IFB or IFB issued by the Central Bank in consultation with the SAC. Subsections (3) and (4) seem to be connected to each other. They provide that the SPI may seek the advice of the SAC to ensure the Sharī‘ah compliance of IBB or IFB. The word used is ‘may’ which in law means optional and not mandatory. It means that SPI banks may seek the advice of the SAC but it is not mandatory as they can consult their own Sharī‘ah consultants as required under the BNM Guidelines. But Subsection (4) uses the word “shall” which means that if an SPI bank refers the Sharī‘ah issue to BNM’s SAC for a ruling, thereby the written directives issued by the CBM in consultation with the SAC has to be complied with;
- 6) An SPI bank is still legally regarded as a conventional bank and shall be deemed to be not an Islamic bank. Although it offers Islamic banking products (along with conventional ones) and abiding strictly by the Sharī‘ah requirements, it is still a conventional bank as its main structure is still conventional-based. This is, in fact, the old provision which remains in the section;
- 7) BAFIA shall be inapplicable to Islamic banks. Pursuant to this, it is a clear intention of the legislature to have two sets of statutes to govern Islamic and conventional/SPI banks;
- 8) Section 124 (7) deals with 2 crucial points:-
  - i) it requires the establishment of the SAC at the CBM to advise the CBM on the Sharī‘ah aspects of IBB or IFB. Pursuant to this, the CBM has created a special department for Islamic Banking and *Takāful* and its Sharī‘ah officer becomes the secretariat to this SAC. As such, in Malaysia, there exists two groups of Sharī‘ah Advisors (a) in-house advisors belonging an Islamic bank by virtue of the IBA 1983 called a Sharī‘ah Advisory Body (SAB) and (b) the national SAC attached to the CBM acting as the central body to advise the CBM on all Islamic matters relating to banking and finance (IBB and IFB), by virtue of BAFIA 1989.

The question remains is what if the decision/opinion of an SAB and the SAC conflicted. Which one would prevail? There was uncertainty over this issue, but with the recent amendment, one can presume that an SAC decision will prevail over that of a SAB as Section 16B of the CBMA (Amendment) 2003 regards the SAC as the authority for the ascertainment of Islamic law for the

purpose of Islamic banking business, *takāful* business, Islamic financial business, Islamic development financial business, or any other business which is based on Sharī‘ah principles and it is supervised and regulated by the CBM.

- ii) Besides “Islamic banking business” which has been defined as in the IBA, Section 124 has introduced a new term, “Islamic financial business” which means “financial business, the aims and operations of which, do not involve any element which is not approved by the Religion of Islam”. The rationale of differentiating them is unknown as in Islam there should be no difference, because an Islamic bank can be involved in banking and financial activities as submitted earlier under the concept of “Universal Banking.” It is the concept of the Anglo-Saxon banking system which differentiates banking institutions from financial institutions which is evident from the celebrated Common law precedent of *United Dominion Trust (UDT) v Kirkwood*.<sup>18</sup>

### 3. Jurisdiction of the Court

Islamic law in Malaysia is only applicable in a very limited sphere; family law and religious offences. Islamic law is provided for under the State list and therefore is under the administration of each state.<sup>19</sup> There was an amendment to Article 121 of the Federal Constitution 1957 in 1988 which restrains Civil Courts from having jurisdiction to hear cases where Islamic law is applicable and is now vested in the Sharī‘ah courts. Previously, the Sharī‘ah Courts and Civil Courts exercised concurrent jurisdiction on certain matters involving Islamic law. With the inclusion of Clause (1A) in Article 121, it was thought that the jurisdiction of the Civil Courts on matters involving Islamic law had been taken away.

Nevertheless, in cases involving a banking transaction based on Islamic principles, the High Court has ruled that the said clause has not taken away the Civil Courts’ jurisdiction and that it does have jurisdiction to hear such a case. Thus, the law relating to commerce and business (*mu‘āmalāt*) is still either the statute law or the English law. Sharī‘ah Courts only have jurisdiction over matters falling under the State list. The Civil Court has jurisdiction to hear all cases falling under the Federal list. Thus, banking and its related matters fall within the ambit of the Federal list, i.e., the Civil Court. Besides, the State List expressly states that Sharī‘ah courts shall have jurisdiction only over persons professing the religion of Islam.

Two leading Islamic banking cases relating to *Bay' Bithaman Ajil* (BBA) were decided by the Civil Court (High Court). Commentary on these cases can be found elsewhere.<sup>20</sup> In the case of *Bank Islam Malaysia Berhad (BIMB) v Adnan bin Omar*,<sup>21</sup> there was a preliminary objection raised by Adnan (Defendant) which was not reported and no written judgement is supplied. The issue was about the courts' jurisdiction.<sup>22</sup> The Defendant argued that since BIMB (Plaintiff) is an Islamic bank, the Civil Court has no jurisdiction to hear the case in view of Article 121 (1A) of the Federal Constitution 1957. The judge overruled that objection and submitted that the matter was rightly brought before the Civil Court. It was submitted that List 1 of the Ninth Schedule enumerates the various matters in which Parliament can enact laws. The scope is very comprehensive, including banking. List 11 in the State list provides for the constitution, organisation and procedure of Shari'ah Courts, which shall have jurisdiction only over persons professing the religion of Islam and in respect only of any of the matters included which exclude banking. It was further argued that since BIMB is a corporate body, it does not have a religion and therefore is not within the jurisdiction of the Shari'ah Court.

Perhaps the time has come to set up an Islamic Division under the High Court structure whereby all Islamic banking cases, and any other Islamic related case, can be dealt with. Besides, it could encourage the specialisation of judges and lawyers in this area of law as has been done with the other divisions (commercial, civil, criminal, appeals and special powers). This effort will not lead to duplication of the Shari'ah Court's jurisdiction as it has limited jurisdiction. This Islamic Division would be a good solution to this problem and should be regarded as complying with the intention of the framers of the Federal Constitution that upholds Islam as the religion of the Federation (Article 3). It is also consistent with the official declaration that Malaysia is an Islamic state and intends to be the global centre for Islamic banking and finance.

Recently, there has been a move by the Kuala Lumpur High Court to form a separate court within the Commercial Division to handle Mu'amalat cases, which have been assigned their own registration numbers to differentiate them from conventional cases.<sup>23</sup> For this, the Court in deciding the case will have to refer to the Shari'ah Supervisory Council at CBM,<sup>24</sup> and their opinion will have to be taken into consideration, as the Court is not competent to decide the case by itself. Recently, there was an amendment to the Central Bank of Malaysia Act 1958 (CBMA) which has incorporated the following:

“Where in any proceedings relating to Islamic banking business...or any business which is based on Shari‘ah principles and is supervised by the Bank (Central Bank of Malaysia) before any court or arbitrator any question arises concerning a Syariah matter, the court or the arbitrator, as the case may be, may-

- a) take into consideration any written directives issued by the Bank pursuant to subsection (7); or
- b) refer such question to the Syariah Advisory Council for its ruling.”

### 3.1 Civil Court and its Common Law Principles

In the Civil Court, the judge will decide the case based on the submission made by the counsels and the law as he finds it. Normally, if he is unclear about any part of the law, for instance if it involves foreign law, he will call an expert witness to assist the Court. Since the case of *Ramah v Laton*,<sup>25</sup> Islamic law has been regarded as part of *lex loci* (law of the land) of which the Court must take judicial notice. It means that the judge must propound the law and it would not be justified for the judge to call for expert evidence related to any issue pertaining to Islamic law in the court proceedings. The judge is deemed to know the law, as Islamic law is regarded as local law, or at any rate must be able to find it - in statute, case law reports or academic writings. Whenever necessary, the judge will interpret the law and apply it before he/she comes to a decision. Being trained in secular and Common law institutions, one can easily assume that the law that the judge might find and apply is English Common law.

The legal risk of Islamic banking and financial matters falling under the Civil Court and triable by Civil-trained judges is that it may lead to the application of laws and concepts that contradict Shari‘ah principles, spirit and even terminologies. There are cases where this has occurred. For instance, *Bay‘ Bithaman Ajil* (BBA) has been referred to as a term loan, whereas it should be termed an Islamic financing facility because BBA is not a loan but a deferred payment sale<sup>26</sup>. In another case, the learned judge posed controversy about the concept of sale in Islam in his judgement in *Dato’ Haji Nik Mahmud bin Daud v Bank Islam Malaysia Berhad*,<sup>27</sup> which was concerned with a deferred payment sale under the contract of BBA. As a matter of fact, the main purpose of sale as far as Islamic law is concerned is to effect the passing of ownership from one party (seller) to another (buyer) against a consideration (price). This is actually the main ‘illah (effective cause) of the sale contract. Nevertheless, the judge ruled that in a BBA contract,

particularly in a re-financing arrangement (where the customer has sold the property to a bank on cash and bought it back on deferred payment), there was no real intention of the parties (customer and bank) to effect the transfer of the property, but is merely a device to facilitate the BBA transaction. Perhaps this judgement, with due respect, should be reviewed in view of its legitimacy as far as Shari'ah is concerned as the main intention of a sale contract (*al-bay'*) is to effect the transfer of ownership from the seller to the buyer.

#### **4. Applicable Law**

As far as Islamic banking transactions and legal documentation is concerned, it is submitted that the following laws are relevant and applicable:-

- i) Valid according to Islamic law;
- ii) Compliance with Civil/Federal laws as well as procedural laws;
- iii) State law; and
- iv) English Common law

##### **4.1 Valid according to Islamic Law**

IBA and BAFIA have categorically stipulated that Islamic banking business must be able to ensure that their aims and operation do not involve any element which is not approved by the Religion of Islam.<sup>28</sup> Furthermore, the Central Bank shall revoke the license if an Islamic bank is carrying out its banking business not in accordance with Religion of Islam.<sup>29</sup> It is submitted that Islamic banking documentation must satisfy all the requirements of Islamic law relating to contracts, agreements or arrangements otherwise it would be rendered null and void. This is presumed, as the IBA has not categorically provided the same as in BAFIA. Section 125 of BAFIA states that:

“Except as otherwise provided in this Act, or in pursuance of any provision of this Act, no contract, agreement or arrangement, entered into in contravention of any provision of this Act shall be void solely by reason of such contravention”

Therefore, contravention of the provisions of BAFIA does not render the contract, agreement or arrangement null and void, and it is argued that the same is not applicable to IBA. As such, Islamic banking documentation must ensure the compliance to the aims and operation of banking business in

accordance with Islamic religion and its law (Shari'ah) as this is the main requirement of the law. Although to date there is not a single case which has questioned the validity of the Islamic transaction and the application of Islamic law, it is difficult to believe that Islamic law has no relevance in cases involving *mu'āmalāt*. For instance, what is the purpose of having BBA or *ijārah* financing, if upon dispute, Shari'ah is not to be applied or becomes irrelevant?

#### 4.2 Comply with Civil/Federal and Procedural Laws

Thus far, Islamic commercial documentation must satisfy the requirement of existing laws. For instance, if it is financing for land, the legal documentation must satisfy all the requirements as laid down by the National Land Code (NLC) 1965. If it is a share or bond issue, attention is to be given to the relevant securities law and other rules and regulations as set by the Securities Commission (SC). In the recent case of *Bank Kerjasama Rakyat Malaysia Bhd v Emcee Corporation Sdn Bhd*,<sup>30</sup> The learned judge ruled that the fact that it is an Islamic banking facility (*Bay' Bithaman Ajil* (BBA)) is immaterial as the applicable law and principles are as same as if the case involved conventional banking:

“As was mentioned at the beginning of this judgment the facility is an Islamic banking facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under conventional banking. The charge is a charge under the National Land Code. The remedy available and sought is a remedy provided by the National Land Code. The procedure is provided by the Code and the same law that is applicable, the same order that would be, if made, and the same principles that should be applied in deciding the application.”

In fact, all reported cases on Islamic banking are concerned with the Civil law and its procedure.<sup>31</sup> None of the cases challenged or questioned the validity of Islamic contracts and principles. All the reported cases related to Islamic banking so far revolve around procedural issues such as related to the NLC, to obtain interlocutory injunction under Specific Relief Act and compliance with Rules of High Court (RHC). Therefore, as the Court in the *Bank Rakyat case* (supra) decided, the remedy sought after is a remedy provided under the NLC, as such the law applicable should be the NLC itself. The fact is, although the case involved an Islamic banking facility, this was immaterial and irrelevant.

The potential legal risk is that what if the Civil law and procedure such as the Rules of High Court (RHC) is in conflict with Shari'ah and its principles? In other words, what if compliance to the law and rules of procedure are impossible, as they do not facilitate the operation and practice of Islamic banking? If this happens, the risk is that the case will be discharged or the decision made against Islamic transactions as a prima facie case has already been established by the other party who opposes it. This presumption is exactly what happened in the case of *BIMB v Adnan* (supra). The customer had challenged the bank's right to obtain a foreclosure proceeding for the following reasons:

- i) the amount of RM583,000.00 which was stated as a loan in the charge document was never received by him as a loan; it was just a facility amount and he only received RM265,000.00. Thus, there is no compliance with O. 83.r.3(3)(a);
- ii) The plaintiff (bank) did not comply with Order 83 Rule 3(3)(c) as the plaintiff's claim did not include a claim for interest. That was in breach of Order 83 Rule 3(3)(a). In this respect, the plaintiff also did not comply with O.83 r.3(7);
- iii) There was no compliance with O.83 r.3(3)(d) because the amount which remained unpaid under the charge was not RM543,995.89 or any definite amount as it was subject to rebate as stated by the plaintiff in its affidavit.

O.83 r.3(3)(a) provides *inter alia* that the plaintiff in its affidavit must show the state of the account between the chargor and the chargee, with particulars of the amount of the advance.

O.83 r.3(3)(c) requires the chargee/financier to state, *inter alia* the amount of any interest or instalments in arrears at the date of issue of the originating summons and at the date of the affidavit.

O.83 r.3(7) provides that where the plaintiff's claim includes a claim for interest to judgement, the affidavit must state the amount of a day's interest.

From the foregoing, it is submitted that O.83 with its rules do not accommodate the operation of BBA, especially for foreclosure proceedings. The rules which require a bank to state the amount of interest is very much contrary to the operation of Islamic banking which is interest free.

At first instance, this is a straight-forward case of non-compliance with the procedural law and a prima facie case that has been established by the bank's customer (Defendant). However, the Court was invited by the Bank's

counsel (Plaintiff) to make necessary modifications as well as to be flexible with the rules in view of the impossibility of imposing and charging interest in the Islamic banking practice and operation by an Islamic bank. The learned Judicial Commissioner (JC) supported this argument and was of the view that the words “except where the Court in any case or class otherwise directs” in the preamble to Rule 3(3) indicated that the Court was able to “exercise a discretion to allow a certain flexibility in the requirements of that provision in particular cases.” This was a case, added by the learned JC “where such discretion should be exercised.”<sup>32</sup>

This case is one example whereby the Court has exercised discretion from complying with the strict requirements of the procedural law. The case would be different if the judge wanted to comply strictly with the requirement and letter of the law and wished not to exercise an exception to Islamic banking and finance simply for uniformity or any other grounds as the Court may deem fit.

#### 4.3 Compliance to State Law

Not only the document or transaction must be able to comply with the requirement of Islamic law, relevant statutory laws prevalent as well as procedural law, it has to also comply with the provisions of the state law. In Malaysia, Malay Reservation Enactments are enacted by each state and the provision slightly varies from one another, especially for the definition of a Malay and other natives. In the celebrated case of *Dato' Hj. Nik Mahmud bin Daud v BIMB* (supra),<sup>33</sup> the Plaintiff, Nik Mahmud contended that the Property Purchase Agreement (PPA) was null and void as it was in contravention with the provisions of the Kelantan Malay Reservation Enactment 1930 (KMRE), as such the charge agreement is equally ineffective. The brief facts of the case are that the Plaintiff entered into an *Al-Bay' Bithaman Ajil* (BBA) agreement with BIMB. He sold the land to BIMB at RM520,000 payable on cash as manifested by the Property Purchase Agreement (PPA) and BIMB immediately sold it back to him on deferred payment amounting to RM629,000 (cost price plus bank's profit margin) as evident from the Property Sale Agreement (PSA). Thereafter, the land was secured as documented in a charge agreement for the same amount as in the PSA. The land was held under KMRE and Section 7(i) expressly states that:

“No right or interest of any Malay in reservation land and no right or interest in such land acquired by virtue of section 13A by any person not being a Malay shall be transferred to or transmitted to or vest in any person not being a Malay provided that leases of

reservation land shall be valid to the extent specified in subsection (ii) to (v) below, save as provided in this Enactment.”

From the above, it is obvious that the Enactment prohibits any transfer or transmission or vetting of any right or interest of a Malay in reservation land to any person not being a Malay. So, the issue is whether the execution of the PPA, whereby the Plaintiff sold the land to the Defendant, constituted a transfer of right or interest? The plaintiff argued that BIMB is neither gazetted as a Malay or native of Kelantan and therefore the sale of land to BIMB is invalid as it contravened sections 7 and 12 respectively.<sup>34</sup> As a matter of fact, the Plaintiff is a Malay under Schedule 2 of KMRE as well as a native of Kelantan. However, the Bank is not.

The Plaintiff actually managed to make a prima facie case about the contravention of the state law (KMRE). However, the learned judge in delivering the judgment in favour of the defendant took an interesting principle, i.e., intention of the contracting parties which is rarely exercised by a Civil trained judge. The judge ruled that:<sup>35</sup>

“(I)t was never the intention of the parties in as much as it can ever be said to be within their contemplation, to involve any transfer of proprietorship. It so happened that the execution of the property purchase agreement and the property sale agreement constituted part of the process required by the Islamic banking procedure before a party can avail itself of the financial provided by the defendant. ...Accordingly, it is my judgment that the execution of property purchase agreement had not transgressed the provisions of ss 7 and 12 of the Malay Reservation Enactment since there was no dealing or attempt to deal in the said lands contrary to the provisions thereof”.

From the above, the learned judge took intention of the contracting parties as an essential element in construing ‘dealing’ or ‘attempt to deal.’ It was held that there was actually no intention to pass the ownership of the land. All the time, the registered proprietorship of the land was still vested with the bank’s customer (plaintiff) and as such, no intention to infringe the provisions of KMRE. The execution of PPA and PSA were actually the process required by the Islamic banking procedure before a party could avail itself to the BBA facility provided by the Bank. This is considered as an exception to the concept of sanctity of contract which is usually adopted by the Civil Court judge. In a way, on the one hand, the judgment could be applauded, if it had been otherwise, the bank’s customer after obtaining the financial facility (cash) could easily default on his periodical instalments or

could run away without having to pay for the financing amount given by the bank. This will obviously cause adverse loss to the bank and will dampen the smooth operation and activity of Islamic banking in Malaysia. But, on the other hand, the judgment poses a controversial issue about the validity and principles of BBA itself. BBA is a deferred payment sale and it is regulated under a sale contract. As far as Islamic law is concerned, the purpose of a sale contract is to transfer the ownership or proprietorship of the property from a seller to a buyer for a consideration. Nevertheless, with this judgement, the Court concluded that in a BBA contract (particularly in this case where it is better known as “buy-back sale” (*bay' al-ṭnah*)), there was no real intention to transfer the property from one party to another. The sale and purchase agreements were only a device used to be able to effect the BBA transaction. As such, to adopt Imam Malik’s view, “it is simply a device or legal stratagem (*hīlah*) whose function is to attain an illegal end through legal means.”<sup>36</sup>

#### 4.4 English Common Law

The application of English law in Malaysia is based on the provisions of Sections 3 and 5 of the Civil Law Act (CLA) 1956. Section 5 expressly states that:

“In all questions or issues which arise or which have to be decided in the States of West Malaysia other than Malacca and Penang with respect to partnership, corporations, banks and banking, principles and agents...and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in like case at the date of the coming into force...”

From the foregoing, in matters relating to commerce, English law is to be applied. As such, the jurisdiction is certainly vested to the Civil Court. In addition, Section 3 of the CLA 1956 provides for the application of English Common law and rules of equity when there is a lacuna in the provision of any written law. From the foregoing, it is submitted that the IBA 1983 is not exhaustive and comprehensive. As such, any ambiguity, clarification and interpretation will be referred to the Civil Court. Civil judges who are Common-law trained are likely to use the law which they are familiar with, after listening to the well researched submission of the counsels who have quoted and referred to the Common law precedents.

## **5. Concluding Remarks**

In Malaysia, in spite of the rapid development of Islamic banking and finance in Malaysia, the legal regulatory regime is lagging behind. Legal reforms are urgently needed in order to facilitate the smooth running and operation of the Islamic banking system. The IBA, which is intended to license and regulate Islamic banking, needs to be more elaborated to rectify the loopholes mentioned in this paper. The area of conflict between the IBA and other laws which influence Islamic banks, such as National Land Code, Hire Purchase Act and Companies Act, needs to be resolved. The lesson from Pakistan in its banking law ought to serve as a lesson to our drafters, so as to bring certainty to the law and be a guidance to the Civil Court as to which law should be applied in the event of conflict of laws.

Further, the role of lawyers and legal practitioners in applying the principles of Islamic law in Islamic banking should be given important consideration. As Islamic transactions (*mu'āmalāt*) are not merely a worldly matter but a kind of worship (*ʿibādāt*), the case should not be made equal to a conventional one. Reference to Islamic law principles should be made, whenever necessary, in order to realize the interest and needs of the contracting parties (especially so if the parties are Muslim). They have chosen the Islamic facility over the conventional for a purpose, i.e. its validity, and surely they would want the case to be regulated by Islamic principles in the event of dispute. Having said that, it is a necessity for the members of the legal profession and judiciary to be conversant and competent in this area. They have to equip themselves with knowledge of Islamic laws on banking and finance as well as existing laws and procedures.

In addition, the learned judges of the Civil Court need to be more flexible, creative and make more exceptions in the application of the existing substantive laws and procedures as these laws were enacted before the establishment of Islamic banking in Malaysia. There are laws and procedures that run counter to the principles of Islamic banks which if applied to them, could cause undue unfairness to the Islamic and SPI banks which would defeat the whole purpose of the law itself, i.e. to promote justice and fairness.

In the absence of a fully comprehensive legal framework for Islamic banking in Malaysia, there is a great dependence on precedents. Thus far, there are very few cases which could be used for reference. Therefore, reference could be made to the practice of other Muslim countries, such as Pakistan. It follows that continuous research on the legal aspects of Islamic banking becomes very necessary.

## Notes

<sup>1</sup> At the end of 1999, Bank Muamalat was established following the merger of Bank Bumiputera Malaysia Berhad (BBMB) and Bank of Commerce (M) Berhad (BOCB). Under the arrangement, all conventional banking assets and liabilities of BBMB were transferred to BOCB while the Islamic banking assets and liabilities of BOCB and BBMB Kewangan Berhad were moved to Bank Muamalat Malaysia Berhad. See The Star 9 February 1999, New Straits Times 13 August 1999.

<sup>2</sup> GIA 1983 is an Act which confers on the Minister power to receive investments for a fixed period and to pay dividends thereon. The Act was enacted simply to enable the Government to receive moneys from an Islamic bank for a fixed period. The Act empowers the Government to issue Malaysian Government Investment Certificates (MGIC) with no fixed return (to replace interest) but in the form of a gift (Hibah). The Islamic bank is acting as creditor to the Government (Bank Negara) based on the principle of *al-qard al-hasan* (interest-free loan).

<sup>3</sup> TA 1984 provides for the regulation of Islamic insurance (Takaful) business. It allowed for the establishment of the first Takaful company, Syarikat Takaful Malaysia Berhad (STMB), better known as Takaful Malaysia, which operates along Shari'ah principles. Only in 1993 was a second Takaful company incorporated with the name of MNI Takaful, later renamed as Takaful Nasional. To date (January 2004), there are another 2 Takaful operators, namely Mayban Takaful and Takaful Ikhlas.

<sup>4</sup> It was formerly known as Interest-free banking or Skim Perbankan Tanpa Faedah (SPTF) which was also known as Islamic Windows or Islamic Counters. It means that interest-free products are offered to the customers along with conventional products under the same roof.

<sup>5</sup> Later, SPTF banks were renamed SPI (Skim Perbankan Islam) banks.

<sup>6</sup> BAFIA is actually a combination of the former Banking Act 1973 and Finance Act 1969 and is meant to provide a new law for the licensing and regulation of banking institutions, finance companies, discount houses, money-broking business and other institutions carrying on certain other financial business and matters connected to business (Preamble of the Act).

<sup>7</sup> Both IBA and BAFIA have 8 parts but the former only has 60 sections whereas the latter has 131 sections.

<sup>8</sup> See for instance, Yasin (1996) and (1999). Also see Shariff (1998).

<sup>9</sup> For details of this, see Yasin (1999).

<sup>10</sup> By virtue of the BAFIA (Acquisition, Holding of Shares and Interests in Shares (Licensed banks, Licensed Finance Companies and Licensed Merchant Banks) Regulations 1991 provides for exceptions to that prohibition. Subject to the approval of the Central Bank, shares that are approved under s4 and 5 of the Trustee Act 1949 may be held by a bank as long as the total price paid for the shares does not exceed 25 percent of the bank's paid-up capital. The shares held in a single company may not exceed 10 percent of the bank's paid-up capital.

<sup>11</sup> Statement by Wan Abdul Rahim Kamil, Managing Director of Abrar Discounts Berhad when commenting about the establishment of Bank Muamalat as the country's second Islamic Bank (New Straits Times, 13 February 1999).

<sup>12</sup> Section 42 of the *muḍārabah* Companies and *muḍārabah* (Flotation and Control) Ordinance, 1980.

<sup>13</sup> It is now enforced from 1<sup>st</sup> January 2004.

<sup>14</sup> The IBA has been amended along with other statutes related to Islamic banking such as BAFIA, the CBMA and the Takaful Act. However, the IBA has not amended any provisions relating to SAB. As such, the legal position remains uncertain.

<sup>15</sup> Section 124(5) states that "(Any licensed institution carrying on Islamic banking business or Islamic financial business shall be deemed to be not an Islamic bank)."

<sup>16</sup> Act A954.

<sup>17</sup> Al-Baqarah: 182.

<sup>18</sup> 2 *Quarterly Bulletin* (1966), Vol.2, p.431.

<sup>19</sup> Look at Schedule 9, list 2, Federal Constitution 1957.

<sup>20</sup> See Yasin (1997), see also Yasin (2003).

<sup>21</sup> *Central Law Journal* (1994), Vol.3, p.735.

<sup>22</sup> *BIMB v Adnan bin Omar & Others* (KL High Court Civil Suit No S3-22-101-9) also reported by the late Prof. Ibrahim (1996), "Legal Solution", p.1. "Toward a Smoother Implementation of Islamic Banking and Finance", paper presented at the National Congress on Islamic Banking and Finance, KL, December 1996.

<sup>23</sup> See Amalan, Arahan (Practice Note) No. 1/2003 (6 February 2003) issued by Chief Judge of Malaya.

<sup>24</sup> Much of this has been dealt with under the sub-heading of "BAFIA and SPI Banks."

<sup>25</sup> *Ramah v Laton* (1927) 6 FMSLR 128 (CA).

<sup>26</sup> See the case of Adnan Omar, where the learned JC ruled that "(I)n any event, there was no question of early repayments as the loan was not a term loan and the defendant's failure to pay the instalments....(p.737). See also the case of *Bank Kerjasama Rakyat Malaysia v Nesaretnam a/l Samyveloo* [unreported] whereby it was stated that "the plaintiff approved a loan facility under the concept of Al-Bay' Bithaman Ajil in favour of the defendant...."

<sup>27</sup> *Central Law Journal*, (1996), 1, p. 737. The case went on appeal and the Supreme Court on 25 February agreed with the findings of the trial judge, see *Malaysian Law Journal*, (1998), 3, p.393-403. More on this case will be discussed later in this paper.

<sup>28</sup> Section 2 of IBA.

<sup>29</sup> Section 11 of IBA.

<sup>30</sup> [2003] *Central Law Journal*, Vol.1, p. 635.

<sup>31</sup> See the cases of *BIMB v Adnan Omar* and *Dato' Haji Nik Mahmud v BIMB*. These two cases have been commented on elsewhere, see Yasin (1997) and (2003). See also cases of *Bank Kerjasama Rakyat Malaysia v Nesaretnam a/l Samyveloo* [unreported] and *BIMB v Ainin Abdullah & Anor* (1998).

<sup>32</sup> *Central Law Journal*, (1994), Vol.3, p. 737, also quoted by Marican (1994), p.9.

<sup>33</sup> *Central Law Journal*, (1996), Vol.1, p. 576 (HC).

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<sup>34</sup> Section 12 states “(A)ll dealings or disposals whatsoever and all attempts to deal in or dispose of reservation land contrary to the provisions of the Enactment shall be null and void”.

<sup>35</sup> *Central Law Journal*, (1996), Vol.1. pp.585-586. The case went on appeal and the Supreme Court upheld the judgment of the High Court, see Supreme Court judgment reported in *Malaysian Law Journal*, (1998), Vol.3, pp. 393-403.

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## Legal Aspects of Islamic Project Finance and Asset Securitization in Indonesia: A Vehicle for the Development of Islamic Banking

*Reza Adirahman Djojosingito\**

### 1. Introduction

Project Finance and Asset Securitization are becoming the main vehicles for the development of modern banking sector. The importance of such vehicles cannot be undermined for Islamic banking. The combination of Project Finance and Assets Securitization will serve as a powerful tool for Islamic banking to mobilize funds from the market and to extend financing which is based on the principles of risk mitigation and allocation where return is justified by risk taking. It is without doubt that the creation of conducive environment for Islamic Banking necessitates the development of such vehicles, especially the legal aspects of them as sufficient and sound legal system pertaining to Islamic Project Finance and Asset Securitization will certainly strengthen the operation of Islamic banking.

Having adopted a dual banking system through the promulgation of Law No. 10 year 1998 concerning banking law, Indonesia has a sufficient legal basis for such development in Islamic banking field. However, due to their complex nature, Indonesia still needs a strong legal framework which can deal with the Islamic Project Finance and Asset Securitization. In this context, the paper will assess the legal aspects of Project Finance and Asset Securitization and propose such framework in the light of Indonesian legal system and the principles of Shari'ah.

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\* At the time of writing the author was an employee of the Legal Department, Islamic Development Bank, Jeddah, Saudi Arabia. However, the views and opinions expressed herein are personal and do not represent those of the Legal Department or the Islamic Development Bank.

The paper will review the existing laws, as well as the one in draft form, related to Islamic banking, Project Finance and Asset Securitization. Moreover, special emphasis will be made on leasing mode of financing as it is necessary for creation of Shari'ah compatible securitization. The Paper will also assess the ramification of the existing unresolved *fiqh* issues related to leasing and asset securitization, and describe how the Islamic Project Finance and Assets Securitization will form a bridge between the traditional banking and Islamic banking.

The development of Islamic Project Finance and Asset Securitization will not only promote the development of Islamic banking but also galvanize the establishment of an Islamic economic and financial system in Indonesia.

## **2. The Importance of Project Finance and Asset Securitization**

### **2.1 The Ideal Islamic Banking System**

Islamic banking is part of the broader concept of Islamic economics which aims at the introduction of value system and ethics of Islam into the economic sphere. Because of this ethical foundation, the concept of Islamic Banking for the follower of Islamic faith is more than merely a concept on how to do banking. It is the embodiment of the submission to Allah since following the Islamic precepts is a religious obligation. Based on this tenet, the Islamic banking can be elaborated as a system of banking which provides just financing, is free from factors unlawful to Islam and offers benefits not only to the shareholder of the bank but also to the stakeholder of the bank.

Therefore, some basic characteristics can be drawn to identify an Islamic banking. It is the element of justice which makes it prohibited for Islamic banking to charge exorbitant profit. The distribution of profit depends on the magnitude of risk assumed, while the distribution of loss is based on the ability of one to bear such losses. Moreover, Islamic banking is participatory in nature. An Islamic bank is supposed to assume all normal risk of business that an entrepreneur/a businessperson will assume. Profit or loss irrespective of its quantum should be shared between the bank and the customer. Return on the bank's investment is not normally the function of time and when the return is pre-determined, it is pre-determined in absolute terms and not affected by any delay or pre-payment.

Consequently, it is sufficient to say that, in economic sense, the Islamic banking should avoid the potential huge divergence between real assets and real liabilities which may be translated into a Profit and Loss Sharing Banking

with some elements of morality and justice.<sup>1</sup> It is true that in practice the Islamic banking consists of Profit and Loss Sharing (PLS) and Non-PLS mode of Financing in assets side. However, the heavy reliance on the Non-PLS mode often attracts sarcastic criticisms that most Islamic Finance techniques used at present bear no difference in substance to the conventional finance and that the superficial distinction of the Islamic and conventional finance is mainly centred in the use of Arabic names and in the disguised trade transactions for conventional transaction which are substantially similar to those of conventional finance. Even though this notion can be refuted by the development of myriad Shari'ah justifications for a restricted scope of application of some conventional techniques, it is sufficient to say that efforts should be directed toward the revival of the early concept of double tier *muḍārabah* in Islamic banking in order to minimize the effects of the above-mentioned sarcastic criticisms.

In this context, the Project Finance and Assets Securitization become very important. The nature of Project Finance in terms of assumption of risk and the flexibility of the assets securitization arrangements enable the creation of ideal Islamic banking system. The explanation of the role of the two will be given in the subsequent sub-section.

## **2.2 The Role of Project Finance and Assets Securitization**

Project finance which involves assuming risk beyond credit risk and entails allocating risk to the parties who can handle the risk best is so far the closest conventional mode of financing to those of Islamic finance. The inherent assumption of risk has caused the lender in any project finance transaction to become more responsible as the success of the venture depends on the project being able to generate enough cash flows to repay the financing. This attitude is relevant to the core principles of Islamic finance. Therefore, transforming the form of the conventional project finance to employ acceptable Islamic modes of financing may lead to the creation an Islamic compatible mode of financing which is acceptable not only to Islamic banks but also traditional banks.

Moreover, the other major obstacle for Islamic banking is the difficulties of raising the resources<sup>2</sup> through international money markets, something that the conventional banks take for granted. Since, the fundamental basis for such a market is interest, unless a similar infrastructure which is compatible to Shari'ah is created, mobilization of resources through ordinary means as the one employed by conventional banks is virtually impossible. It is true that steps toward the creation of Islamic money market have been started. However, it is not viable in the near future. Therefore, the only option

available for Islamic banks is to utilize the existing conventional infrastructure of the money market. The capital market is the most appropriate solution to these problems. As long as the means of mobilizing the capital is Sharī'ah compatible, the structure is acceptable. The instruments which are most compatible with Islamic Sharī'ah are the equity instruments. However, for financing institutions, giving up their equity position is not desirable as it can dilute their interest or it is simply too expensive. Therefore, the viable alternative to this is through securitizing the assets of the financial institution or any subsidiary thereof.

The combination of asset securitization and project finance will also provide Islamic bank with the means for connecting the mobilized deposits and the investment in performing the intermediary function. This connection will enable the creation of true double tier *muḍārabah* which was, so far, difficult to be implemented.

Another facet of this combination is that the securitization of the non-recourse projects will not only provide a means for the mobilization of capital but also create an internal system which will allow the matching of different maturities of the first tier *muḍārabah* (the deposit) with the second tier *muḍārabah* (the investment).<sup>3</sup>

Below is the simplified diagram of the structure of the Islamic Banking (Figure 1) which is based on the double-tier *muḍārabah* model. (It is to be noted that the diagram is a very simplified one. The structure can be very complicated, it can also consist of some hybrid structures or some enhancements.

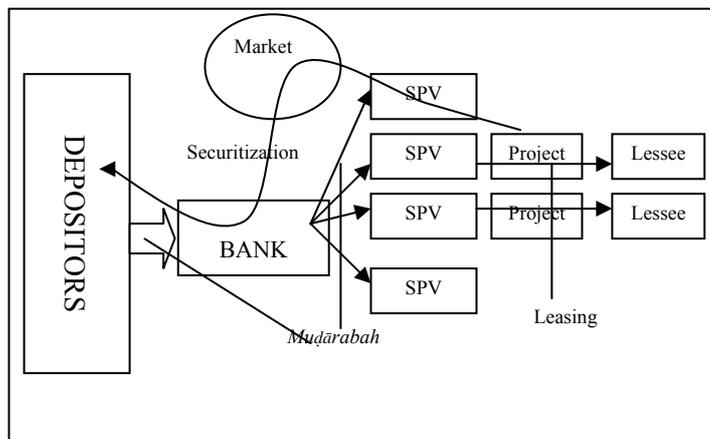


Figure 1: The Double-Tier *Muḍārabah* Islamic Banking Structure.

The structure is based on two tier *muḍārabah* model, where the Depositors will place their fund as a *muḍārabah* deposit in the Bank which in turn invest the fund through *muḍārabah* in several project. Such *muḍārabah* is structured as a non-recourse project finance transaction using leasing as a main vehicle where the repayment of the financing was convened only to actual revenue generated by the project. Then, each individual project is securitized and sold back to the bank. Because all projects are converted into marketable quasi equity security, the risk of maturity mismatch between the first tier *muḍārabah* and the second tier *muḍārabah* can be avoided.

### **3. The Indonesian Present Legal Environment**

Indonesian laws have adopted a dual banking system through the promulgation of Law No. 10 year 1998, concerning amendments to banking law<sup>4</sup> which forms a legal basis for the development of Islamic Banking in Indonesia. And through the law No. 23 year 1999,<sup>5</sup> concerning Bank Indonesia which paved the way for the creation of the Shari'ah based regulatory and supervisory framework. Bank Indonesia (The Indonesian Central Bank) has been very active in this regard. Soon after the promulgation of the Law No 10 year 1998 which gives Bank Indonesia the power to supervise and regulate the banking sector in Indonesia,<sup>6</sup> it promulgated several Bank Indonesia Regulations (*Peraturan Bank Indonesia*) which were intended to regulate the Islamic banking. These regulations are quite comprehensive. They cover almost every facet of administrative aspect of Islamic banking. However, the same is not the case for the operational aspects of Islamic banking. The present legal and regulatory regimes are insufficient in this regard. A significant problem is the lack of legal bases for Islamic Banking.

#### **3.1 Laws related to Project Finance**

One of the milestones of Indonesian banking law development is the promulgation of the Law No. 7 year 1992, concerning banking. It simplifies the banking system in Indonesia and creates a unified law dealing with the banking system.<sup>7</sup> The 1992 Banking law also introduce the banking system based on the principles of profit sharing.<sup>8</sup> The law also relaxes the security requirements on the banking activities. While under the Law No. 14 year 1967 the banks had to provide security for each and every credit it extend.<sup>9</sup> The Law of 1992 requires only to have confidence in the debtors that they can repay the financing according to the financing agreement.<sup>10</sup> So long as the banks can satisfy itself with the creditworthiness of the debtor, the security

might cover only the things which are financed by the financing.<sup>11</sup> The 1992 law was later amended by the Law No 10 year 1998. The most important feature of it is the introduction of dual banking system in Indonesia.<sup>12</sup> Through the promulgation of 1998 banking laws, a bank is at liberty to choose whether to operate as a conventional bank or as an Islamic bank.<sup>13</sup> As the Islamic banking perspectives toward risk is rather different than those of conventional banking, the introduction of Islamic banking gives another opportunity to banks to conduct financing which has different risk profile than conventional banks.

The relaxation of the requirements for security since 1992 and the gradual recognition of Islamic banking<sup>14</sup> opened the possibility of Indonesian banks to engage into project finance activities. As banks are not required to take additional security in financing a project, the notion of reliance only to the ability of the financed project to generate repayment is a possibility under Indonesian banking laws. However the law stops at recognition, so far there is no adequate supporting institutions for successful project finance. Example for this is the law related to secured transactions. The absence of Floating Charges make it difficult to mitigate the risk associated with Project Finance.

### **3.2 Laws related to Assets Securitization**

Despite the fact that the Asset Securitization is one of the most important mechanisms for finance, Indonesia has not yet had any law governing such institution. There is however, an attempt by the Government of Indonesia to create such a law.<sup>15</sup> Unfortunately, the draft law is not compatible with Islamic principles. The draft law clearly states that the securitization can only be conducted over debts.<sup>16</sup>

### **3.3 Laws related to Leasing**

The laws related to leasing are centred around the Presidential Decree No. 61 year 1988 which stipulates the activities allowed to be carried out by a financial institution.<sup>17</sup> At the outset, this decree does not pose any legal hurdle for application of leasing according to Shari'ah principles. However, the implementing regulation on leasing activities contains a requirement which may contradict the Shari'ah principles. The Decree of the Minister of Finance, No. Kep.Men.Keu.RI.No1169/KMK.01/1991, puts an obligation on the parties to a leasing agreement to put a clause which determines the liability<sup>18</sup> of a lessee in the event of non-functionality of the object of the lease agreement.<sup>19</sup> The point of the above example is that while the decree neither permit nor forbid that those activities carried out through Islamic means, this decree cannot be considered as the legal basis for Islamic leasing.

Moreover, the fact that this Presidential Decree was based on the laws which do not recognize the principles of Shari'ah<sup>20</sup> can further support the above argument.

#### **4. Analysis on Laws related to Islamic Banking, Project Finance and Assets Securitization**

##### **4.1 Inadequacy of Indonesian Legal System**

###### *4.1.1 The Inadequacies Related to Basic Norms of the Legal Sources and Legislative Order under Indonesian Laws*

As a country following a civil law system, Indonesia places a heavy emphasis on the codification of laws and requires that all laws be transformed into written laws. This emphasis necessitates a basis on which the laws should be created. Consequently, the basis which determines the Legal Source and Legislative Order becomes the most important part of the Indonesian Legal System. This basis was laid out by the highest political body in Indonesia,<sup>21</sup> the People's Consultative Assembly. Through its Decree No. III/MPR/2000, it lays out the Legal Source and Legislative Order of the Indonesian Legal System which should be the basis in creating the Indonesian Legal System. It is mentioned that the Source of Indonesian law is the state ideology, Pancasila<sup>22</sup> and that the Legislative Order which shall be the followings:

- i) The 1945 Constitution;
- ii) Decrees of the People's Consultative Assembly of the Republic of Indonesia;
- iii) Statutes/Laws
- iv) Government Regulations in lieu of Statutes
- v) Government Regulations;
- vi) Presidential Decrees;
- vii) Regional Regulation.

The important aspect of this decree is that the principle which dictates that lower level laws/regulations cannot contradict higher level laws/regulations.<sup>23</sup> In regard to the Islamic principles, this decree presents difficulties as most of the laws (in the level of Government Regulation and above) rarely recognize directly the Islamic principles or mention any

reference to Islamic legal principles. Even though the Decree refers to the unwritten laws as another source of laws, it cannot be argued that the unwritten laws mentioned in this decree encompasses Islamic principles as most treatises construe these unwritten laws as the *conventions*<sup>24</sup> in state governance practices and not as a general principles of laws or a custom where the Islamic principles are likely to be part of.<sup>25</sup>

#### *4.1.2 The Absence of Basic Laws for Islamic Banking*

Even though the existence of Islamic banking is recognized in Indonesia through the promulgation of the Law No. 10 Year 1998 and Law No. 23 year 1999, the part which deals with the Islamic banking is minimal.<sup>26</sup> The laws cover only the very basic tenets of Islamic banking. The Laws for instance fail to address the issue of double taxation in Islamic financial transactions or the specific supervisory needs of Islamic bank and contain general requirements for banking industries which impede the development of Islamic banking.

#### *4.1.3 The Inexistence of Laws Related to the Islamic Mode of Financing*

It is unfortunate that as a largest Muslim country in the World, Indonesia does not yet have the laws related to Islamic Mode of Financing. Even the compilation of Islamic laws in Indonesia<sup>27</sup> does not even mention any Islamic Mode of Financing. The only legal or regulatory instrument which deals with Islamic Mode of Financing is the Regulation of Bank Indonesia. Some Regulations of Bank Indonesia defines some Islamic modes of financing and for limited extent the mechanism thereof.

#### *4.1.4 The Laws Related to Asset Securitization Compatible to Islam*

In conventional financing, success of securitization as an alternative source of financing is premised upon creation of secured transactions regimes that allow for the effective creation, perfection and enforcement of security interests in receivables. It is also the requirement for Islamic financing, however, such requirement is more stringent for Islamic asset securitization as the securitized assets cannot be in the form of debt. This necessitates the use of trust. For Indonesia, as a country following civil law system, the arrangement will be complicated as the institution of trust is not known in civil law system. Moreover, in regard to draft law on asset securitization, the Islamic banks will likely face difficulties when attempting to employ the asset securitization in its operation since the draft law clearly states that the securitization can only be conducted over debts.<sup>28</sup>

#### **4.2 The Need for Specialized Legal and Regulatory Regimes for Islamic Banking**

Due to the uniqueness of Islamic banking, it is necessary to develop a specialized law (*lex specialis*) which lays down a sound foundation for the operation of Islamic banking to complement existing legal and regulatory infrastructure. The current laws in Indonesia unfortunately overlook some unique facets of Islamic banking which may result in unfair treatment of Islamic banks. Some examples may be cited in this regard. Under the current legal environment, a bank is not supposed to conduct any business transaction unrelated to conventional banking business—whereas permissibility of such transactions is essential for Islamic banking.<sup>29</sup> Similarly, the prohibition for banks of making capital participation (in the form of owning shares) in certain businesses work against the nature of Islamic banking.

Moreover, the absence of any law related to Islamic mode of financing will also create operational difficulties for Islamic banking. Two examples may be cited to highlight this point. The first example is related to *muḍārabah* mode of financing. Indonesian laws cannot protect adequately the parties to the *muḍārabah* transaction as the nature of the transaction is not within the ambit of the Indonesian legal system. The *muḍārabah* transaction entails transfer of ownership which resembles the common law trust.<sup>30</sup> As a country following civil law system,<sup>31</sup> Indonesian laws do not recognize dual ownership<sup>32</sup> in equity and at law which is the essential facet of *muḍārabah* transaction. While the profit sharing aspects of *muḍārabah* transaction may be covered by the freedom of contract principle,<sup>33</sup> other aspects of it cannot be governed by Indonesian law.<sup>34</sup> The second example is related to the leasing mode of financing. Indonesian law governs the leasing transaction through the Presidential Decree No. 61 year 1988 which stipulates the transactions which may be carried out by a financial institution.<sup>35</sup> While this decree does not pose any legal hurdle for application of leasing according to Shari‘ah principles, the subsequent implementing regulation on leasing contains a requirement which may contradict the Shari‘ah principles.<sup>36</sup>

As for the regulatory regimes, the main impediment is the lack of legal bases for operational aspect of Islamic banking. The present legal regimes do not provide sufficient room for Bank Indonesia as the regulator and supervisory authority under the Law No. 10 year 1998. As the regulation of Bank Indonesia is not within the ambit of the People’s Consultative Assembly’s Decree No. III/MPR/2000, it is safe to say that the regulation can only serve as an administrative rule within the domain of Bank Indonesia<sup>37</sup> and does not have the authority of a law. Therefore, the main

problem does not lie with the regulatory regimes but with the legal basis underlying the regulatory regime.

### **4.3 The Need for Supporting Legal Institutions**

There is also a need for development of supporting legal institutions closely related to the operation of Islamic banking which are not exclusively for Islamic banking. Such legal institutions are non-recourse project finance, leasing and asset securitization. Non-recourse project finance<sup>38</sup> will serve as the tool for developing Islamic financing which is based on allocation and mitigation of risk between parties in a banking transaction where the return will be justified by the involvement of risk taking. Leasing will be the basis of mode of financing which will enable the creation of Shari'ah compatible asset securitization. However, merely securitizing the assets is not solving the problems as the assets to be securitized should be in the form of equity or any form that represent ownership over real assets. This necessitates the creation of an arrangement enabling the financier to hold the assets of the venture while securitizing some sort of right of ownership over the assets to the investor. Trust arrangement can easily achieve this through separating the legal ownership from the beneficial ownership.

It is, therefore, sufficient to say that the principles of equity (as opposed to common law) are crucial to the success of the implementation of the Islamic banking. However, what can be easily implemented in a common law country encounter a major legal impediment when it is to be applied in a civil law country. Some sort of legal reform should be undertaken before the arrangement can be done. Indonesia, being a civil law country, faces this very problem. Since, it upholds the principles of unity of ownership, an attempt to introduce the principles of equity will face some legal hurdles. However, taking into account Indonesia's past experience in dealing with issues related to the implementation of the principles of equity,<sup>39</sup> it is not impossible to introduce a reform based on experiences of other civil law countries in implementing the principles of equity into its legal system.<sup>40</sup>

### **4.4 The Issue of International Standard**

The New Capital Adequacy Framework of the Basel Committee on Banking Supervision does not take into consideration the different nature of Islamic banking operations. This can result in unfair treatment of these banks as the risk of the Islamic banking would be perceived higher than the conventional banking institutions.

The *mudārabah* structure, where the assets of the Islamic banking institutions comprise of non-recourse projects, which are securitized and linked to the depositors and the market, provide solution to this problem. The Project Finance structure offers a relatively more certain revenue and provides easier corporate governance which will decrease the undue risk taking and moral hazard. Thus it will enable the assessment of Islamic banks on the conventional standards of soundness and stability without jeopardizing their interests.

#### **4.5 The Unresolved *Fiqh* Issues**

The idea of Project Finance is to create an off balance sheet portfolio consisting of the self sufficient projects which can generate enough revenue for repayment of the financing. In this context, the structure can overcome some unresolved *fiqh* issues, especially in relation to the issue of operating lease and sale of debt. By creating a special purpose vehicle (SPV) which is financed through *mudārabah*, the responsibility of the lessor can be transferred to the SPV. Therefore, the SPV can structure the lease arrangement as an operating lease instead of financial lease without affecting the balance sheet of the Bank. Consequently, avoiding *fiqh* objection on financial lease.<sup>41</sup>

The structure can also solve the *fiqh* issue related to the sale of debt. As all investment will be conducted in the *mudārabah* mode of financing which can be considered as a quasi equity, the assets to be securitized will not be in the form of debts over which the securitization cannot be done.<sup>42</sup>

### **5. A Note for Further Development**

It is sufficient to say that for emerging volatile economy such as that of Indonesia, the Islamic banking system should be the fundamental basis for its economic development or at least, effort should be directed toward the creation of conducive environment to Islamic banking which might enable the transformation of conventional banking to Islamic banking. In this respect, two aspects will be dealt with in this section. The first is related to the necessary legal framework and the second subchapter will be dealing with the possibility of transforming conventional banking.

#### **5.1 The Need for Comprehensive Legal Framework**

While some Islamic scholars proposed some models based on profit and loss sharing, most Islamic banking in Indonesia still operates in substance just

as their conventional counterpart.<sup>43</sup> Therefore, effort should be taken to rectify such situation.

Indonesia regulatory framework related to Islamic banking was unfortunately not yet directed to the creation of Islamic banking based on the double-tier *muḍārabah* model.<sup>44</sup> There is a need for regulatory framework conducive to creation of such Islamic banking. However, the regulatory framework for banking is not enough. Because the regulatory framework is just a manifestation of a legal framework, the creation of conducive legal framework is inevitable, especially for operational aspects of Islamic banking. Hence, a sufficient level of infrastructure is needed to allow Islamic banking to grow. In the case of Indonesia, the necessary legal framework is the establishment of the basic laws for Islamic banking, the laws related to the Islamic mode of financing, the laws related to Islamic leasing and the laws related to asset securitization.

#### 5.1.1 *The Implementation of the Framework*

Since the Indonesian Laws in principle do not recognize the principle of *stare decisis* or the binding force of precedence,<sup>45</sup> it is imperative that the framework be implemented in legal products which are not open to interpretation.<sup>46</sup> To achieve this, the legal basis should be one of the law/regulation listed in the People's Consultative Assembly Decree No. III/MPR/2000. In this respect, the issue of the recognition of Islamic principles is more substantial than merely providing facilities to the players in this industry. It will create a legal foundation for Islamic financial activities; it is important that the legal basis be in the form of statute. The reason for establishing the legal basis through statute is that the statute is the only legal products apart from the Constitution and the Decree of the People's Consultative Agency promulgated through the involvement of the legislative authority of the country.<sup>47</sup>

Other important part of the framework is that the statute to be established should embody the Islamic principles and not only lay down the administrative procedures for carrying out such activities. The importance of establishing the statute incorporating Islamic principles through Parliament cannot be more highlighted, as the Parliament is the embodiment of the peoples of Indonesia. From legal point of views, they are the only institution that carries a mandate and has the obligation to dig the values living in the society and to reflect them in the laws. By establishing such a legal basis, not only the existing practices can be accommodated, but also the future development of such activities can be legalized.

*5.1.2 Applicability of the Framework in Indonesia*

Although not widely practiced and representing only a tiny portion of Indonesian financial market share, Islamic banking activities have been carried out in practice without any significant legal problem. Moreover, the attitude of the government of Indonesia toward Islamic finance is quite positive. Both facts actually prove that the proposed framework can be applied in Indonesia. However, relying on the two facts alone is not enough, as there are two preconditions that must be taken into account to assess the applicability of any legal framework. Those preconditions are that the legal framework must be acceptable legally and sociologically.

Apart from being a country with a large Muslim population, Indonesia has experienced a period where the Islamic values were the norm of Indonesian society; and to some extent it also formed the legal system of the country in the form of *Adat* law. This was the case until the declaration of independence in 1945. Therefore, it is fair to conclude that there will be no social resistance in reintroduction of the Islamic principles through the proposed framework into the Indonesian Legal System. The second precondition is that the framework should be within the ambit of the Indonesian basic legal structure. The fact that the framework will be created in accordance with the MPR Decree No. III/MPR/2000 will make it acceptable from legal point of view.

Moreover, there are three factors which must exist, namely the certainty of law, the utilitarian factor of the law and the element of justice. The framework will certainly fulfil all three factors. The framework will ensure the certainty of the law as it will fill the gaps which are the result of the inexistence of law pertaining to Islamic banking institutions. The utilitarian factor will also be fulfilled as the framework will cater the need of the Muslim majority. The fulfilment of the need of the majority will certainly create the greatest total of individual happiness. Finally, this framework will restore the neglected rights of the Muslim majority which are to be ruled by the principles of *Shari'ah*. The restoration of rights will certainly serve as the manifestation of justice for Indonesian society.

However, the fact that the proposed framework can be applied in Indonesia is not enough for the development of Islamic banking in Indonesia. The proposed framework will not have an impact unless the law derived from such framework can function as a tool for social engineering. The framework must be able to drive Indonesian society towards the establishment of Islamic economic system. This objective can only be

attained through creation of a framework which accommodates the practice of Islamic banking, coupled with few reforms in Indonesian legal system.

Reforms are necessary in the banking sector, especially in relation with the introduction of the principle of equity and the imposition of the doctrine of the binding force of precedent (the principle of *stare decisis*). By introducing the principle of equity, it will be possible to create a legal institution close to the classical *muḍārabah* and *mushārahah* which will pave the way for the establishment of a double-tier *muḍārabah* Islamic bank or other financial activities which are based on mutual interest and shared responsibilities. Moreover, the recognition of the principle of *stare decisis* will open the possibility to build gradually the legal foundation for activities which are based on the living value in the society such as Islamic values. Furthermore, the creation of sound legal bases for Islamic banking operations will result in the comprehensive legal and regulatory framework for Islamic banking.

## 5.2 The Possibility for Transforming Conventional Banking

At the outset, Islamic principles and modern commercial practices are diametrically opposite. Modern commercial practices which base their activities on the concept of “time value of money” create a heavy bias towards the interest based system. Islamic principles, on the other hand, condemn such reliance, though it does accept the notion that the capital is not free. However, a common understanding can be reached, especially in relation to risk concerning one particular transaction if both the Islamic bankers and the conventional bankers are willing to assume risk beyond merely the credit risk. In the case of project finance, it is the nature of the arrangement that the banker should assume risks beyond credit risk of the recipient of the financing. Thus, in practice, there is no significant difference between conventional and Islamic banking where project finance arrangement is exploited. While the assumption of risk in conventional commercial practice was valued based on the interest rate imposed to the borrower, the Islamic banking takes the assumption of risk as a pre-requisite to the financing.

This fact opens the possibility for the convergence between the conventional and Islamic project finance. Everything being equal, the only differing view is on the consequences of the assumption of risk. In fact, the valuation of the interest rate can be easily converted into provision of profit sharing as it is possible in project finance to calculate exactly the return of a physical transaction involving real assets as opposed to financial assets.<sup>48</sup>

Taking into account the possible convergence of Islamic and conventional banking in the Project Finance, the fact that the business of Islamic banking market has crossed the USD 100 million threshold and the fact that Muslims in the world constitute 20% of the World population with 10% of the Global GDP,<sup>49</sup> it is fair to expect enormous desire of the conventional banker to attempt to share this cake, if the environment is conducive for employing project finance. Thus, it is sufficient to say that provided the legal and regulatory regimes in Indonesia are conducive to such convergence, the transformation of conventional banking into Islamic banking will be inevitable.

## **6. Conclusion**

It is sufficient to say that the combination of Islamic Project Finance and Assets Securitization will serve as a powerful tool for the development of Islamic banking to mobilize funds from the market and to extend financing which is based on the principles of risk mitigation and allocation where return is justified by risk taking. The development of sufficient and sound legal framework pertaining to Islamic Project Finance and Asset Securitization will certainly create conducive environment for Islamic banking, strengthen the operation of Islamic banking and lay down a firm legal basis for Islamic banking activities. However, as the framework must be able to drive Indonesian society towards the establishment of Islamic economic system, it is necessary that such a framework is coupled with few reforms in Indonesian legal system. In this respect, the necessary reforms are the introduction of the principle of equity and the imposition of the doctrine of the binding force of precedent.

Finally, the development of a comprehensive legal framework related to Project Finance and Asset Securitization will not only promote the development of Islamic banking and its regulatory regimes but also encourage the transformation of traditional banking into Islamic banking which in turn will galvanize the establishment of an Islamic economic system in Indonesia. The creation of conducive environment for Islamic banking will reduce the huge divergence of real assets and real liabilities in banking sectors which in time will create a robust financial environment more resistant to financial shocks and banking crises.

## Notes

<sup>1</sup> Equality and Justice are the core principles of Islamic Economic System. These principles are manifested mainly in the form of prohibition of interest. However, the Islamic ban on interest does not mean that the capital is “free of charge” in an Islamic system. Islam recognizes capital as a factor of production but it does not allow this factor to make a prior or predetermined claim on the productive surplus in the form of interest. The permissible viable alternative is the profit-sharing system. The reason behind rendering profit-sharing admissible in Islam as opposed to interest is that in the case of the former it is only the profit-sharing ratio not the rate of return itself predetermined. Another rationale for Islamic finance is that wealth should be put into productive use in order that others may share in its benefits. It is therefore unjustified to charge an interest for the mere use of money. The owner of wealth should invest it in a productive and real transaction. However, profit-sharing is only one side of a coin. The other side is that losses should also be shared between the parties which can bear such losses, however, the inability to bear a loss will exonerate such obligation.

<sup>2</sup> To illustrate the difficulties, we may cite an example of the Interbank *Muḍārabah* Investment Certificate. While the innovative initiative has to be applauded, there is no clarity on the relationship between the fund transferred on *muḍārabah* basis to the investment made by the recipient bank except to the overall revenue or profit generated by the recipient bank in one particular period. This lack of clarity may lead to criticisms on some quarters having different interpretations on the *muḍārabah* mechanism. Another example is in relation to *Wadī‘ah* Certificate. While the *wadī‘ah* mechanism envisaged resembles the mechanism of bailment without administrative charge, the *wadī‘ah* mechanism entails the giving out of bonuses by Bank Indonesia which are determined according to the indicated remuneration of the Shari‘ah Interbank *muḍārabah* Investment Money Market or the average indicated remuneration of the Shari‘ah Interbank *Muḍārabah* Investment certificates which are recorded in the Shari‘ah Interbank *Muḍārabah* Investment Money Market. Even though, there is no obligation in the part of the Bank Indonesia to pay the bonuses, it is implied in the Peraturan Bank Indonesia No. 2/9/PBI/2000 concerning the Bank Indonesia *Wadī‘ah* Certificate that the bonuses will be paid. Moreover, the lack of legal bases also resulted in different treatment between the conventional and Islamic banking. The clear example of this is the prohibition of conventional banking in issuing the Shari‘ah Interbank *Muḍārabah* Investment Market certificate.

<sup>3</sup> One factor that creates difficulty in matching the deposit *muḍārabah* and the investment *muḍārabah* is the illiquid nature of the *muḍārabah* investment. By using asset securitization, the *muḍārabah* investment is in fact, becomes liquid which make the redemption of the deposit *muḍārabah* much easier even in the case of the maturity mismatch between the deposit and investment *muḍārabah*.

<sup>4</sup> State Gazette No. 182 year 1998.

<sup>5</sup> State Gazette No. 66 year 1999.

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<sup>6</sup> See Article 24-35 of Law No. 23 year 1999. It is to be noted that under the previous banking regime in Indonesia, despite the fact that BI sets and administers the operative rules and regulations related to banking operations, it was the Ministry of Finance that had the ability to enforce the rules, through its authority to issue and revoke banking licenses. See Nasution (June 1994), p.78.

<sup>7</sup> Even though the Law No. 14 year 1967 was intended to be the only law dealing with banking system, the Indonesian legislative still promulgated special laws dealing with banking system, especially related to state owned banks. Such laws are Government Regulation in Lieu of Law No. 21 year 1960 tentang

Bank Pembangunan Indonesia (Indonesian State Gazette year 1960 No. 65, Supplement No. 1996); Law No. 13 year 1962 tentang Ketentuan- ketentuan Pokok Bank Pembangunan Daerah (Indonesian State Gazette year 1962 No. 59, Supplement No 2490); Law No. 17 year 1968 tentang Bank Negara Indonesia 1946 (Indonesian State Gazette year 1968 No. 70, Supplement No 2870); Law No. 18 year 1968 tentang Bank Dagang Negara (Indonesian State Gazette year 1968 No. 71, Supplement No. 2871); Law No. 19 year 1968 tentang Bank Bumi Daya (Indonesian State Gazette year 1968 No. 72, Supplement No. 2872); Law No. 20 year 1968 tentang Bank Tabungan Negara (Indonesian State Gazette year 1968 No. 73, Supplement No. 2873); Law No. 21 year 1968 tentang Bank Rakyat Indonesia (Indonesian State Gazette year 1968 No. 74, Supplement No 2874); and Law No. 22 year 1968 tentang Bank Ekspor Impor Indonesia (Indonesian State Gazette year 1968 No. 75, Supplement No. 2875).

<sup>8</sup> Article 6 para m of Law No. 7 year 1992.

<sup>9</sup> See Article 24 of Law No. 14 year 1967.

<sup>10</sup> Article 8 of Law No. 7 year 1992.

<sup>11</sup> Elucidation of Article 8 of Law No. 7 year 1992 which states "*Kredit yang diberikan oleh bank mengandung risiko, sehingga dalam pelaksanaannya bank harus memperhatikan asas-asas perkereditan yang sehat. Untuk mengurangi risiko tersebut, jaminan pembelian kredit dalam arti keyakinan atas kemampuan dan kesanggupan debitur untuk melunasi hutangnya sesuai dengan yang diperjanjikan merupakan faktor penting yang harus diperhatikan oleh bank. Untuk memperoleh keyakinan tersebut, sebelum memberikan kredit, bank harus melakukan penilaian yang seksama terhadap watak, kemampuan, modal, agunan, dan prospek usaha dari debitur. Mengingat bahwa agunan menjadi salah satu unsur jaminan pemberian kredit, maka apabila berdasarkan unsur-unsur lain telah dapat diperoleh keyakinan atas kemampuan debitur mengembalikan hutangnya, agunan dapat hanya berupa barang, proyek, atau hak tagih yang dibiayai dengan kredit yang bersangkutan. Tanah yang kepemilikannya didasarkan pada hukum adat, yaitu tanah yang bukti kepemilikannya berupa girik, petuk, dan lain-lain yang sejenis dapat digunakan sebagai agunan. Bank tidak wajib meminta agunan berupa barang yang tidak berkaitan langsung dengan obyek yang dibiayai, yang lazim dikenal dengan "agunan tambahan"*".

<sup>12</sup> Conventional and Islamic banking

<sup>13</sup> Article 1 para 3 of Law No. 10 year 1998.

<sup>14</sup> The recognition of the Islamic banking is not directly related to the development of Project Financing. However, it indicates the changing attitude toward banks assuming risk beyond credit risk.

<sup>15</sup> At present, Draft Law concerning Asset Securitization is being considered in the Ministry of Law and Human Rights of the Republic of Indonesia.

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<sup>16</sup> See Article 3 of the Draft Law on Assets Securitization.

<sup>17</sup> Article 2 stipulates the activities which are Leasing, Venture Capital, Trading in Commercial Papers, Factoring, Credit Card and Consumer Finance.

<sup>18</sup> It is true that the contract can determine that the liability being 0%. However it is clear that this regulation is not intended to be the basis of Islamic Leasing.

<sup>19</sup> According to Shari'ah, the lessee to an *ijarah* contract cannot be held responsible for the damage or any loss due to the non functionality of the object of the lease.

<sup>20</sup> This Presidential decree was based on the Constitution, the Commercial Code, Civil Code, Law No. 12 year 1967 concerning Cooperatives and Law No. 14 year 1967 concerning Banking. See the Recital of the Presidential Decree No. 61 year 1988. It is to be noted that the Commercial Code and the Civil Code were initially intended for the European and were the codification of living values of Netherlands/western society. Prior to Indonesian independence, the Islamic majority native Indonesians were subject to *adat* law which consists of among other Islamic law.

<sup>21</sup> Even though this statement is not absolutely accurate given the fact that the recent amendments to Indonesian Constitution have curtailed most of the power of this institution. However, it is still sufficient to regard this institution as the highest political body as its power still encompasses the legislative, judicative and executive branch of Indonesian state political apparatus. It is to be noted that Indonesian system is not purely based on the *trias politica* concept. Similar concept exists in the second echelon of Indonesian political institution, where the President, the Parliament (*Dewan Perwakilan Rakyat*) and the Supreme Court holds respectively the executive [and legislative to limited extent], legislative and judicative power.

<sup>22</sup> See Article 1 of the MPR Decree No. III/MPR/2000.

<sup>23</sup> Article 4 of the MPR Decree No. III/MPR/2000

<sup>24</sup> See for instance, Apeldoorn (2001), at p.321.

<sup>25</sup> There is a notion to regard Islamic Principles as a part of general principles of laws or a custom under Indonesian Laws, however this is a minority view. Islamic Principles are more inclined to be regarded as a living value in society. See subsequent section dealing with this.

<sup>26</sup> See Law Office of Remy and Darus (2002), p.91.

<sup>27</sup> Presidential Instruction no. 1 year 1991 concerning Islamic Laws Compilation.

<sup>28</sup> See Article 3 of the Draft Law on Assets Securitization.

<sup>29</sup> For more elaborated explanation See Law Office of Remy and Darus (2002), p.91.

<sup>30</sup> Some Islamic Financial Institution even used the terminology "trust financing" to denote the mechanism contemplated in classical *muḍārabah*.

<sup>31</sup> For concise and brief explanation about the difference between Common Law and Civil Law system, See Raoul-Duval (1997), p.181-182. Among the principal difference is that the treatment of statute provisions and legal principles by Judges in their decision making.

<sup>32</sup> It is true that the notion of ownership in *muḍārabah* transaction is not exactly the same as the notion of ownership in common law trust. However, it is safe to say that both are similar. Therefore, it is appropriate to take the example of the dual ownership of the common law system to highlight the problem associated with the implementation of *muḍārabah* under Indonesian legal system.

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<sup>33</sup> Article 1338 Burgelijk Wetboek.

<sup>34</sup> The consequences which may arise are related to the status of the *mudārabah* object in case of insolvency of the *mudārib*, the liability of the *mudārib* and the rights of the investor. As the explanation will make this paper unnecessarily long, the writer will not make elaboration on this issue.

<sup>35</sup> Article 2 stipulates the activities, which are Leasing, Venture Capital, Trading in Commercial Papers, Factoring, Credit Card and Consumer Finance.

<sup>36</sup> See previous subsection on the legal aspect of Leasing in Indonesia.

<sup>37</sup> Which basically means banks (and their organ) under Bank Indonesia supervision and cannot be extended to other stakeholder of banking system.

<sup>38</sup> See previous subsection on the laws related to Project Finance. It can be argued that even though the employing project finance is possible under the current law, there is still a need for some supporting legal institutions.

<sup>39</sup> Indonesian Law is mostly developed from the 19th Century Dutch Law. Similar to the Dutch Law, Indonesian Law recognizes forms of ownership which are less than absolute ownership such as usufruct or easement. In addition, Indonesian *adat* community also recognized a concept resembling dual ownership in the concept of *ulayat* land. Under this concept, one person can obtain ownership to land so long as he is looking after the land. If he neglects the land, ownership is transferred back to the community.

<sup>40</sup> Based on their method of accepting the principles of equity, there are three categories of civilian countries. The first is for countries which adopt and incorporate the principles of equity in their legal system. The second is for countries which neither adopt nor incorporate the principles of equity, but which create a new legal vehicle similar to the concept of trust. The third is for countries which in adopting the principles of equity, create such a concept within the civilian legal framework.

<sup>41</sup> For more elaborated explanation See Chapra and Khan (2000), p.74.

<sup>42</sup> For more elaboration See *id* at 77.

<sup>43</sup> 70% of the typical Islamic banks' portfolio is in the form of *murābahah*. While *murābahah* principles is acceptable to Shari'ah as long as the bank secure a real ownership of the commodity, most of the *murābahah* financing entails only a constructive ownership of the commodity.

<sup>44</sup> See previous section dealing with the reason why an ideal Islamic Bank should be based on double tier *mudārabah*.

<sup>45</sup> See Article 1917 of the *Burgelijke Wetboek voor Indonesië* Staatsblad 1847 No. 23.

<sup>46</sup> Not in absolute term as it is impossible to create a law with absolute clarity.

<sup>47</sup> Article 5 and 20 of the Indonesian 1945 Constitution. See Government of Indonesia (1945).

<sup>48</sup> Khan (1997), p.16.

<sup>49</sup> Khan (1997), p.13.

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## Islamic Bonds: Indonesian Experience

*Cecep Maskanul Hakim\**

### 1. Introduction

The launching of *muḍārabah* bond, issued by PT. Indonesian Satellite Corporation Tbk in October 2002 is a spectacular step in Islamic finance in Indonesia. Until the day of issuance, the discussion of Islamic finance goes on within the boundaries of Islamic banking, since most Islamic finance products are practiced by Islamic banks, and in more limited portion, by insurances. Moreover, pros and cons of Islamic bond still persist amongst the practitioners and experts as to whether Islamic bond concept can be put into practice.

To add more surprise, arrangement for issuing the bond takes only three months, a relatively short time compared to its conventional counterpart, Indosat Bond II. Few are informed that Indosat is the third company which offered to issue Islamic bond, after two other organizations who were interested but abandoned their plans in the last minute. It is not known why they rejected the proposal. However, such a refusal is a typical response resulting from strong doubt, whether an Islamic instrument can be sold in the market and generate profit. The scepticism increases when the instrument is first of its kind, even among Islamic financial institutions.

Amidst the controversy about its Shari'ah compliance, more of *muḍārabah* based Islamic bonds are being issued. Four similar bonds have already been launched until midst of 2003, while others are waiting to be

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launched. There is also a suggestion that the government should consider issuing such bonds to enhance its public image.

There have been many efforts around the Islamic world to introduce bonds based on profit sharing principle. These efforts are driven mainly by two reasons: First, to provide an investment alternative for Islamic banks that, in general, have liquidity surplus. This excess liquidity problem has been so persistent that it creates a '*less profitability syndrome*' for the bank, which in turn reduces its competitiveness against their conventional competitors (Ahmed (1995)). No doubt, that non-competitiveness problem affects Islamic banks' performance lowering the return to their customers. Second reason to introduce Islamic bonds is to develop Islamic capital market. This purpose has two aims, namely providing Islamic instruments for investors who want to avoid interest-based instruments, and to mobilize fund for longer-term projects such as infrastructure financing.

In 1990, the Parliament in Jordan passed a bill entitled '*Muqāraḍah Act*' in which a bond might be issued based on *muqāraḍah* principle, another name for *muḍārabah* contract. However, this act could not come into practice. Islamic Fiqh Academy, Makkah, also had objections on it since there was a clause in the Act that allowed guarantee in favour of *sabibul māl*. A similar bond was issued by Tehran Municipality Board which was not a popular bond either, since it guarantees the investor's principal return. In Malaysia, *Caḡamas Muḍārabah Bond* was introduced as early as 1985 by a government-owned company. Apart from its successful attempt in providing money market instrument for Islamic banks in Malaysia, many see this bond as not purely Islamic, since it invests the fund into the sale of debt with discount, which becomes source of intense and continuing debate among the Islamic bankers and scholars as well.

## **2. Muḍārabah Bond; An Effort of Redefinition**

The launching of Indosat Islamic Bond (the formal title being *Obligasi Syariah Muḍārabah Indosat 2002*) is followed by launching of similar Islamic bond in May 2003 by Berlian Laju Tanker, a shipping company; Bank Muamalat and Bank Syariah Mandiri, two Islamic full-fledged banks; Bank Bukopin, a conventional bank that has Islamic business unit in July 2003, and recently (August 2003) by Ciliandra Perkasa, a holding company for several palm-coconut-farming companies. All of these bonds are based on *muḍārabah* contract.

Indosat Islamic Bond put the investor as *sabib al-mal* and the issuer as *muḍārib*. The fund generated from this bond was intended to finance satellite

and multimedia business, under separate subsidiaries. It was changed later and allocated for working capital of the company after it was found that it is not legally possible to transfer revenue from subsidiaries to parent company other than earnings for the shares it owns. Profit for the bond hence is counted as proportional share of the holding company's revenue. In case of the shipping company, the fund is utilized for operating a ship leased by a government-owned oil company, from which the payment for bond profit is made.

Both Bank Muamalat and Bank Bukopin Islamic bonds mobilized fund for extending their *murabahah* financing. Profit paid to the bonds is derived from specified *murabahah* assets by each bank. In the case of palm oil company, fund is mobilized partly for the purpose of increasing ownership of parent company in its subsidiary and building palm-to-oil processing factory, while profit is paid with reference to the revenue from palm-(fruit and/or oil) sale contract of the subsidiary company to the parent company, or to other parties during a 5-year period ahead.

As suggested in Hakim (2002) the term '*muḍārabah* bond' indeed contains two words that have contradicting concepts to one another. *Muḍārabah* denotes a contract in which one party provides capital and the other provides expertise with profit pre-agreed between them and no guarantee -whether for profit or principal- is permitted as a condition.<sup>1</sup> On the other hand, bond -as commonly understood in financial terminology- refers to an interest-bearing certificate issued by a government or corporation, promising to pay interest and to repay a sum of money (the principal) at a specified date in the future.<sup>2</sup>

To our opinion, the contradicting concepts in '*muḍārabah* bond' are similar to what is now popularly accepted as 'Islamic bank'. In the beginning, most people felt odd with the term. Since the word 'bank' denotes practices that involve interest, something that is neither known nor accepted under Islamic law. However, as the time elapsed, and more people understood Islamic banking practices and products, such oddity gradually faded and is replaced by a discourse on details of the system, product, supervision, technology and others.

It is not certain whether the term '*muḍārabah* bond' will follow the case of the term 'Islamic bank' in acquiring recognition from the market. But it is certain that by issuing *muḍārabah* bond, the meaning of bond has now expanded. Some points are worth to note:

The word 'bond' now consists of, not only debt but also, investment relationship. It certainly breaks a long-held definition in the financial world. In fact the word 'bond' literally suggests any tie between/among parties who

are involved in a contract that defines right and duty to one another. And this tie does not always mean debt relationship. Similarly, the word 'bond' also means 'liability'. This meaning for the bond can be found in some occasions, like the one in a popular jargon among treasury dealers, "my word is my bond". The liability in this case refers to a responsibility to buy or sell a particular currency at pre-agreed rate, and does not mean paying a debt.

The word 'bond' now does not always involve interest practices as the main return for the fund. It may contain a profit from investment. On the other hand, the term investment in Islamic finance normally refers to a profit-loss sharing arrangement in which both parties share profit (also loss) based on prevailing condition in the project.

Attaching *muḍārabah* contract to bond causes the latter to lose other fundamental features. The 'bond' contract now does not necessarily have a guarantee for the fund put in the contract, since *muḍārabah* –according to majority of scholars- is non-guarantee contract.<sup>3</sup> However, in reality, the market has been familiar with such non-guaranteed bonds, or at least, less-guaranteed ones, such as what is called as "junk bond". The term is used because such bonds receive lower quality rating from different rating agencies. However, it is not fair to equalize *muḍārabah* bond with such bonds since the rating depends on many factors<sup>4</sup> and the nature of both contracts is different. It is sufficient to say that development in the market alone has already stretched the meaning of the bond in the context of providing guarantee.

To avoid this complication, there are those who suggest the use of "certificate" instead of "bond", such as those used in other countries like Bahrain and Sudan. The market in these countries is now accustomed with many Islamic instruments like *istiṣnā'* certificate, *salam certificate* and *mushārahah certificate*. For Indonesian case, there is a plausible reason why the term 'bond' is used, instead of 'certificate'. It has been known that the financial authority has abandoned the use of "certificate" since it has an ambiguous meaning. It used to denote certain investment paper issued by a certain company. However, as different instruments developed in the market, and investment in turn can be classified into shares and bonds, or even participation unit of a mutual fund, the specific denotation of 'certificate' cannot any longer be maintained.

There is another suggestion to use other term like '*ṣukūk*', the one recently issued in Malaysia for *ijārah* contract. However, the term will increase more complication in Indonesian market that has not yet even been familiar with existing basic Islamic banking products. It might be introduced in the future, if the market is well prepared and sufficiently educated.

## 2.1 Multi Impacts of *Muḍārabah* Bond

There are several distinct implications of recent issuance of *Muḍārabah* bond.

### 2.1.1 Risk Assessment

To apply *muḍārabah* contract into a bond raises an important and critical issue, namely risk. Since *muḍārabah* contract puts aside any possibility of guarantee -both for its profit and principal- from the issuer as *muḍārib*, *muḍārabah* bond is seen as more risky than its conventional counterpart. Even Malaysian investment bankers have warned of uncertainty in *muḍārabah* transaction on which this obligation is based. According to them, this will be a negative point in selling the instruments to the investor who will invest their fund. However, the positive sentiment that was displayed during the issuance, overcame such worries. The bond was oversubscribed and many parties bought it. Indeed it is the beginning of the story, not its end. The performance of the issuer, in term of its business and finance, along with national economic condition will be the prime factor for evaluating the risk.

### 2.1.2 The Method of Evaluation

A conventional bond might be easier to price by the investors. Normally a bond price will be calculated based on its rate of interest and periodical return. If a bond interest is paid annually along with its principal that has a certain-year maturity then the future value of the bond will be calculated using the formula

$$FV = A(1 + \alpha)^n$$

Where FV is Future Value of a bond, A is principal repayment,  $\alpha$  is rate of interest and n is time period.<sup>5</sup>

This formula cannot be applied in *muḍārabah* bond since it does not involve interest. Therefore, a new formula should be assigned to assess the future value of the bond.

$$FV = A + \sum_1^m \beta_m \quad m = 1, 2, 3, \dots$$

$$\text{and } \beta_m = \pi(P) \quad 0 < \pi < 1.$$

Where  $\beta_m$  is sum of total allocated profit ( $\pi$ ) generated for the bond from total profit of the project (P), and paid periodically. Theoretically the nominal result of  $\pi$  (P) can be a negative number if P is negative, which brings about a

negative impact on A. This situation might occur when the project incurs a loss.

Furthermore, since the end value of  $\pi$  depends on P, while P is generated from operation that depends on many factors, then FV is influenced by other factors such as cost, sales, and even economic and political situation. We may write in general

$$f(FV) = f(P, \beta, \lambda, \gamma, \eta \dots)$$

Alternatively, the ‘uncertain’ nature of the  $\pi$  then brings similarity of the bond evaluation to the evaluation of unit trust (mutual fund) with its Net Asset Value assessment method.

### 2.1.3 Accounting Implication

Since the bond is based on *muḍārabah* contract, it has certainly an accounting implication. If one refers to conventional accounting standard, any fund raised by a bond should be recognized as one of liability component. To be exact, it will be placed as a secondary capital that is known as “Tier II”. However, Islamic accounting treats *muḍārabah* fund differently. Since this fund is categorized as “unrestricted investment” fund, it should be treated as capital that is exposed to profit-loss sharing principle.<sup>6</sup>

The treatment however, brings another issue to resolve. If *muḍārabah* fund raised from a bond is recognized as capital, is it similar to the capital that is poured in by the shareholders and known as the “Tier I”? It seems that AAOIFI as international accounting standard organization for Islamic financial institution should create different categories of ‘capital’ as a result of different transactions. In Islamic classic business law, besides *muḍārabah* ‘capital’, there are also *mushārahah* ‘capital’, and *salam* ‘capital’. However, as far as fund from *muḍārabah* bond is concerned, it is sufficient to say that it is treated as ‘temporary capital’ that differs from ‘permanent capital’ owned by shareholders.

From the investors’ perspective, a profit generated from *muḍārabah* bond should also be accounted in different ways. Since it involves ‘uncertainty’, both in availability and the amount, they cannot book such a profit on accrual basis for certain periods in advance. They can do so only by *expectation*. The cumulative real value may be obtained at the end of an accounting period, and of course at maturity date. This might include many adjustments in their entries, for the real profit may differ to what is expected. However, in this case conventional accounting may also apply for the cases where unperformed business occurs.

### 2.1.4 Political Implication

Some analysts see the issuance of *muḍārabah* bond as the dawn of a domestic fund raising, and another milestone in building a more independent stance against foreign sources such as the International Monetary Fund (IMF) or World Bank. This idea might be too early to discuss. However, it may work if there is a clear political will from the authority to undertake the suggestion, especially in developing and exploring new Islamic instruments. These instruments have proven to be successful elsewhere to raise domestic funds in order to finance different projects, for short- and long-term. Two factors are identified behind this success: First, in a Muslim-majority country it is related closely with public tradition of sharing, a tenet that always stressed out in Islamic business ethics. This tradition nowadays also takes gradually a greater influence in ‘capitalistic’ society. On the other hand, the instruments are based on Islamic business transactions that are more or less familiar to their *‘ulamā* (Islamic scholars). Second, accountability and transparency performed by the management, both at state and private institutions, give confidence to the people in trusting the fund with them.

### 3. Shari‘ah Issues

The issuance of *muḍārabah* bonds is based on two *fatwās* issued by National Shari‘ah Board.<sup>7</sup> First *fatwā*, considered as “umbrella” for other *fatwās* to be issued later on, consist of possibility of bond issuance on the basis of different Islamic legal contracts, whether on profit-loss sharing basis such as *muḍārabah* and *mushārahah*, or on fixed income basis like sale (*murābahah*, *salām*, and *istiṣnā‘*) and lease (*ijārah* and *ijārah wa al-iqtinā‘/ijārah al-muntabiah bay‘ al-tamlīk*). Second *fatwā* refers in particular to the issuance of bond on the basis of *muḍārabah* contract and its detailed operations.

To apply a *muḍārabah* contract in a bond certainly raises many issues from shari‘ah perspective. Many aspects of existing *muḍārabah* become source of questions. There are three issues that have become source of prolonged discussions.

#### (i) Revenue versus Profit Sharing:

Existing *muḍārabah* bond utilize revenue sharing as income distribution method. This choice intensifies controversy as to which method is more suitable for Islamic financial institution. Although National Shari‘ah Board has issued a decree (*fatwā*) in favour of revenue sharing, there are many who see the decision is inappropriate.

It is a majority opinion that the income distributed to the parties in *mudārabah* contract is profit, which is defined as revenue that has been reduced by 'normal' costs. However, almost no one agrees what constitute 'normal cost' since there is a tendency that one party will exaggerate the cost, while the other does the opposite. Two popular schools of thought are known to have the opposite opinion on this matter. The Hanafite scholars argue in favour of allowing the *mudārib* using part of the capital as the cost, while Shafiite scholars go against the opinion.<sup>8</sup> Both schools of thought in fact discussed what is presently known as *gross* and *net profit*. Revenue is something else. From accounting point of view, its position is in the top of income statement, even higher than gross profit. However, Shafiite opinion, in the extreme case, infers also the meaning of revenue.

It is interesting to note the reason why the National Shari'ah Board choose revenue sharing as income distribution method. Before the decree is issued several empirical simulations were undertaken based on data of income distributed for customers' deposit in some Islamic banks. It was found that if profit-sharing method is used as income distribution, the profit rate in Islamic banks is far lower than the interest rate paid to conventional banks deposit. In other word, Islamic banks are still less competitive in term of profit. It was from the Islamic banks discretion the revenue sharing is then suggested to be the income distribution method. This method is chosen with reservation: If some time in the future, Islamic banks have been more competitive, there is no reason any longer to stick on revenue sharing method, and therefore they should switch into profit sharing. This temporary nature of the *fatwa* is not known to many, since it is not literally written on.<sup>9</sup>

**(ii) First Quarter Profit:**

According to one clause in existing *mudārabah* bond contract, investors are entitled to take profit in every quarter. This means that if it is issued in October 2002, or the 4<sup>th</sup> quarter of the year, then the investors will have their first profit in January 2003. Given the condition that a quarterly report can only be published at the end of January, (or in this case, in the second quarter) then the first quarter profit will only be paid at the end of second quarter, or at the end of March 2003.

The shari'ah issue comes up when the issuer insists on paying the profit at the beginning of January. This effort is apparently based on the desire of the management to keep goodwill of their bond in the market. The question is from where the issuer will pay the profit, while the fund has been used just only within three months? And at what rate will be the payment? The answer for this proposal is that the management may do so from its own fund as a

loan (*qard*) with a condition that the fund must come from a *halāl* source, and at the rate calculated from the real income in which the *muḍārabah* fund is utilized. The latter is conditioned as to avoid the issuer might take benchmark from money market which is known as interest-based institution.

**(iii) Guarantee:**

Although *muḍārabah* contract prescribes no guarantee in all forms, many who are unaware that there is an exception to this iron-like rule, namely when the *muḍārib* breaches any clause in the contract. This issue also comes up for the case of *muḍārabah* bond. After a long research of Islamic classical textbooks and comparing them with modern financial techniques, it was found that a guarantee may be asked from the *muḍārib* (the issuer in the case of *muḍārabah* bond) in the form of fund or property belong to him, if he is proved to breach the contract. However, in the case of the issuer of *Muḍārabah* bond, it is sufficient to issue letter of guarantee stating the above undertaking.

**(iv) Secondary Market:**

*Muḍārabah* is an investment contract. Once contract is concluded and business is undertaken, it causes the ownership of *muḍārabah* asset (*māl*) by *sahib al-mal*.<sup>10</sup> If this principle is applied in *muḍārabah* bond, the investor as *sahib al-mal* owns the *muḍārabah* asset represented in the form of bond. According to Islamic law, an asset (*māl*) can be utilized (*taṣarruḥ*) by its owner by his will. He may sell at a certain price that might differ with the nominal price (due to market perception on the asset), or he may keep it as his wealth.<sup>11</sup> This view is stated to answer the questions forwarded in many occasions whether *muḍārabah* bond can be traded in secondary market. These questions might arise as a result of old conception that bond is a debt instrument and hence its sale might fall into the law of controversial *bayʿ al-dayn*. To avoid such a misconception, it is necessary to switch into a redefinition of bond itself as already discussed in Part II of this paper.

#### 4. Suggested Islamic Bonds and its Constraints

*Muḍārabah* bond is one type of Islamic capital market instrument that has already been developed successfully. A chance to develop other instruments now has opened up. If similar method is applied in developing Islamic instruments, (i.e. putting Islamic transaction mode into bond-type instrument), there are some types of bond waiting to be explored by concerned parties.

**(i) *Mushārah* Bond**

The idea of *mushārah* bond is similar to what is applied in *muḍārahah* bond, except that the issuer participates in providing fund for investment. However, it should be explored more in details since there are certain regulations that might hinder an issuer to buy back the bond, or to combine his own capital with the one mobilized through public offering.

**(ii) *Ijārah* Bond**

In *ijārah* type bond, an issuer should have an asset that can be sold to the investors. The investors, whether directly or through an agent will lease him for a certain period. The lease contract may or may not consist of an option that the issuer can buy back the asset after the lease period ends. The investors can sell this asset-backed bond to the market.

The constraint for this type of instrument would be on the taxation side. It may be noted that Malaysia provides a tax privilege for its Islamic instruments as shown in the issuance of *ijārah sukūk*; there is no such provision at present in Indonesia. The clear consequence for this kind of instrument would be double tax problem that causes disincentive both for investor and issuer as well.

**(iii) Sales Bond**

This bond based on sale transaction approved by Islamic law, such as *murābahah*, *salam* and *istiṣnā'*. To avoid sale of debt that might occur when the bond is sold in secondary market, a third party (government or other institutions) must be authorized to undertake the contracts.

The possible form of this instrument, other than stocks/shares of a company, in Indonesian context would be in the form of what is known as asset-based securities. Similar to what would be met by *ijārah* bond, this kind of instrument will likely be unwelcome by the market since its liability of double taxation. This case prevails even for conventional asset based securities

**(iv) Rupiah versus Foreign Exchange**

*Muḍārahah* bonds recently issued are Rupiah-based bonds. Many expect that similar bond will be issued in terms of foreign exchange.<sup>12</sup> This might help boost foreign capital to flock in domestic market, and hence increase its performance. In the future this idea should be considered if international investors are welcome to share domestic development. One excellent example of this bond is “*ijārah sukūk*” issued by a Malaysian company. These ‘*sukūk*’ are issued both in ringgit and dollar, and are the first of its kind in

Malaysia. The prime purpose of the issuance is to tap fund from Middle East that is anticipated to flow out from western countries caused by 11 September tragedy. However, even nominated in foreign exchange, the Middle East investors' demand for it could not be fully met due to domestic high demand for such instrument.

## **5. Concluding Remarks**

*Muḍārabah* bond has put a breakthrough in Islamic capital market in Indonesia, amidst controversy over its applicability in conventional regulated market. For some, it is also test for its sustainability in the market, considering the experience of Islamic mutual funds that from 1997 have tried in vain to survive out of economic crisis. There are many who have great hopes from this bond, financially and ideologically.

A new way of fund mobilization has been introduced, and other ways are waiting to be explored. They are more familiar to and have more support from grassroots level, since the basis of these ways comes from their very tradition. It is only political will from the authority that may put these ways into actions, and benefits will follow. The others will come by themselves.

## Appendix

### List of Islamic Bonds Issued in Indonesia by September 2003

<b>1 Obligasi Syariah <i>Muḍārabah</i> Indosat, 2003</b>	
Year Issued	2002
Issuer	PT. Indosat Tbk
Underwriter	AAA Securities
Trustee	PT. Bank Rakyat Indonesia, Tbk
Contract	<i>Muḍārabah</i>
Period	5 years
Amount	Rp. 100 billion (approximately USD 11.76 million, with exchange rate 1USD = Rp.8,500. and additional Rp.25 billion or USD 2.94 million after public expose.
Purpose	Working Capital
Rating	Id AA (Stable Outlook)
Guarantee	No guarantee
<b>2 Obligasi Syariah <i>Muḍārabah</i> Berlian Laju Tanker 2003</b>	
Year Issued	2003
Issuer	PT. Berlian Laju Tanker, Tbk
Underwriter	AAA Securities
Trustee	PT. Bank Rakyat Indonesia, Tbk
Contract	<i>Muḍārabah</i>
Period	5 years
Amount	Rp.100 billion approximately equivalent to USD 11.76 million, with exchange rate 1USD = Rp.8,500)
Purpose	Operating Capital for shipping oil
Rating	Id BBB (Stable Outlook)
Guarantee	No guarantee
<b>3 Obligasi Syariah <i>Muḍārabah</i> Bank Muamalat 2003</b>	
Year Issued	2003
Issuer	PT. Bank Syariah Muamalat, Tbk
Underwriter	PT. Cipadana Sekuritas & PT. Mesana Investama
Trustee	PT. Bank Niaga Tbk.
Contract	<i>Muḍārabah</i>
Period	5 years
Amount	Rp.200 billion (approximately USD23.53 million, with exchange rate 1USD = Rp.8,500)
Purpose	<i>Murābahah</i> financing

Rating	Id BBB- (Stable outlook)
Guarantee	No guarantee
<b>4 Obligasi Syariah <i>Muḍārabah</i> Bank Bukopin 2003</b>	
Year Issued	2003
Issuer	PT. Bank Bukopin, Tbk
Underwriter	PT. AAA Securities
Trustee	PT. Bank Mandiri, Tbk
Contract	<i>Muḍārabah</i>
Period	5 years
Amount	Rp.50 billion equivalent to USD5.88 million, with exchange rate 1USD = Rp.8,500.
Purpose	<i>Murābahah</i> financing
Rating	Id BB (Stable outlook)
Guarantee	No guarantee
<b>5 Obligasi Syariah <i>Muḍārabah</i> Ciliandra Perkasa 2003</b>	
Year Issued	2003
Issuer	PT. Ciliandra Perkasa
Underwriter	PT. Indoprimer Securities
Trustee	PT. Bank Niaga, Tbk
Contract	<i>Muḍārabah</i>
Period	5 years
Amount	Rp.100 billion equivalent to USD11.76 million, with exchange rate 1USD = Rp.8,500.
Purpose	Increasing ownership in oil-processing company and building factory plant
Rating	Id BB (Stable Outlook)
Guarantee	Palm-oil farm, self provided

## Notes

<sup>1</sup> Zuhaily (1984), p.854.

<sup>2</sup> Samuelson and Nordhaus (1985), p. 898; Dornbusch and Fischer (1987), p. 125.

<sup>3</sup> Zuhaily (1984).

<sup>4</sup> Pefindo, the Indonesia Securities Rating Agency, gives 'IdAA (Stable Outlook)' rating for Indosat *Muḍārabah* bond, similar to its conventional counterpart.

<sup>5</sup> Schall, Lawrence D. and Haley, Charles W., *Introduction to Financial Management*, McGraw-Hill, New York, Fourth Edition, 1986.

<sup>6</sup> AAOIFI, *Accounting and Auditing Standard for Islamic Financial Institutions*, Bahrain, 2001.

<sup>7</sup> National Shari'ah Board is an autonomous body under Majelis Ulama Indonesia (Indonesian Council of Ulama). Formed in 1998 with two main functions: issuing

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*fatwās* on different products and operations of Islamic financial institutions, and supervising the institutions in order to comply with Islamic Shari‘ah by posting Shari‘ah supervisory boards within the institutions. Dewan Syariah Nasional, *Himpunan Fātawā Dewan Syariah Nasional*, Jakarta, 2000. In the case of Islamic Bond, National Shari‘ah Board issued *Fatwā* No. 32/DSN-MUI/X/2002 on “Obligasi Syariah” (Islamic bond) and Fatwa No. 33/DSN-MUI/X/2002 on “Obligasi Syariah Mudharabah” (*Muḍārabah* Islamic bond).

<sup>8</sup> Zuhaily (1984), pp.864-872.

<sup>9</sup> Dewan Syariah Nasional, Fatwa No. 15/DSN-MUI/IX/2000 pp.87-90.

<sup>10</sup> Zuhaily treated *muḍārabah* asset as trust (*wadia*) in the hand of *muḍārib*. See Zuhaily (1984).

<sup>11</sup> For more details on this subject, see Hassan (1997).

<sup>12</sup> Among others, statement by Governor of Bank Indonesia, *Republika* daily, 22<sup>nd</sup> August 2003.

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## Islamic Banking in Brunei and The Future Role of Centre for Islamic Banking, Finance and Management (CIBFM)

*Hjb Salma Hj Abdul Latiff\**

### 1. Introduction

*'We have now come to the moment we have been waiting for, after such a long wait for that which we have been wanting to achieve or possess as conscious Muslims'*

These words form part of a royal address of His Majesty The Sultan and Yang Di Pertuan of Brunei Darussalam during the launching ceremony of the Islamic Bank of Brunei Berhad in 1993. It represents the very aspiration of the leader, the government and the people of Brunei Darussalam to have a bank whose method of operations blends with the teachings of Islam – the official religion of Brunei Darussalam.

Brunei Darussalam is an independent Islamic Sultanate situated on the northern coast of Borneo Island. With an area of 5,765 square kilometres, it is home to about 350,000 people. Its economy is dependent on the immense reserves of petroleum and natural gas. With such resources, it allows the people to enjoy one of the highest per capita incomes in Asia. The Sultanate of Brunei Darussalam goes back to the 14<sup>th</sup> century, and the presence of this long-established monarchy provides the enviable political stability for Brunei. The way of life in Brunei is very much encircled around its religion. The country has no nightclubs, no serving of alcohols in restaurants and public places, and the '*halālness*' of food is ensured by the relevant Government departments. With such features, the cardinal concept of 'Melayu Islam Beraja (MIB)' or 'Malay Islam Monarchy' is maintained and upheld. Therefore, it is not surprising that His Majesty The Sultan, decreed such

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words as quoted above, when he launched the official opening ceremony of the first Islamic bank. This bank would provide the people of Brunei a step-a-giant step, towards living a life that adheres to the teaching of Shari‘ah law. Islamic bank not only abolish the element of ‘*ribā*’ or interest, but also it provides a better socio-economic foundation for the country.

## 2. Brunei’s Banking Industry

When banking first began in Brunei in 1935,<sup>1</sup> with the establishment of a Post Office Savings bank, Islamic bank was non-existent. This establishment did not last due to the Japanese occupation in Brunei and they destroyed all the bank’s records. After the Second World War in the mid forties, Hong Kong and Shanghai Banking Corporation began to operate in Brunei and registered as a branch of a foreign bank. This was followed by Standard Chartered Bank in May 1958. During this time, due to lack of financial regulations, the banks' practices were solely based on English law. With the vast revenues emanating from the oil and gas production which fuelled the Brunei economy with rapid momentum, other regionally registered banks such as Malayan Banking (1960), United Malayan Banking Corporation (1963), and Overseas Union bank (1973) were attracted to joining the viable banking sector. Citibank made their presence in Brunei in 1971. Two local banks, National Bank of Brunei Berhad (1964) and Island Development Bank (1980) were also set up to enlarge the banking industry. However, due to malpractices, National Bank of Brunei was closed down in mid 1980s. Since then the only other local conventional bank that has been established in Brunei is Baiduri Bank Berhad in 1994. The other newly established local banks are based on the Islamic Shari‘ah method of operations. Currently, there are ten main banks operating in Brunei, three of which are Islamic based banks.

## 3. The Development of Islamic Banks

His Majesty The Sultan of Brunei initiated the formation of Islamic bank in Brunei. In his royal speech to the Islamic Religious Council Meeting held in September 1990, he stressed that the establishment of an Islamic bank is important because it is a ‘*farḍ kifāyah*’ obligation for each Muslim country and Negara Brunei Darussalam. This command initiated the beginning of many more meetings organised by the Islamic Religious Council which resulted in the setting up of a committee known as Formation of Islamic Bank Committee.<sup>2</sup>

Given the natural setting of Brunei, a Malay, Muslim Monarchy, the introduction of Islamic banking is in fact a preferred method of operating banking transactions. The last two decades have witnessed rapid changes in the banking sector with the emergence of Islamic banking. As mentioned before, there are now three Islamic banks operating in Brunei.

### **3.1 Tabung Amanah Islam Brunei (TAIB)**

Brunei's first significant commitment to developing a complete Islamic system began in September 1991 with the official opening of Tabung Amanah Islam Brunei (TAIB).<sup>3</sup> In his opening address, His Majesty stressed the importance of inculcating Islamic methods of banking. Spoken in Malay, he said, as translated in English.<sup>4</sup>

***'In the bands of Islamic believers, you will find expertise and wealth, including the expertise of executing Islamic banking rules. The Islamic people have established their own bank. This is evidence that Islamic banking rules can be executed if we wish to have it, an achievement which is considered impossible without the interest element. Such an achievement also confirms that Islam transcends in all time and place.'***

*(Di tangan umat Islam terdapat kemahiran dan kekayaan, termasuk kemahiran untuk melaksanakan hukum. Orang-orang Islam sudah menubuhkan banknya sendiri, iaitu bukti jelas bahawa hukum Islam dapat dilaksanakan apabila kita mahu, di mana perkara ini dahulunya dianggap mustahil jika tanpa riba. Kemudian di satu aspek yang lain, kejayaan seperti ini juga membuktikan bahawa agama Islam adalah sesuai bagi setiap-tiap zaman dan tempat.)*

To further stress the country's commitment to Islamic banking and finance, His Majesty, in his royal address assured the people of Brunei that His Majesty's Government will bear all the risk in the event of unexpected consequences. With the grace of Allah S.W.T., this has not proved necessary as the organisation has managed very well in administering the bank.

TAIB is not a commercial bank but is an Islamic trust fund. It offers, to the public, services that comprise of mainly savings and loans accounts. TAIB has been successful because of its concentration in this niche market of savings. The public has a variety of options to choose from when opening a savings account; ranging from accounts such as '*Akaun Simanja*' (for children below 12) to '*Akaun Belia*' (for youths) and accounts for adults. Another popular form of savings account is '*Tekad Haji Akaun*' which is especially for

prospective pilgrims to save for the 'haj' pilgrimage. Savings accounts are based either on 'al-muḍārabah' or 'al-waḍ'ah'. The loan account, which is mainly based on the principles of 'bay' biḥaman 'ājil', is extended for the purchase of cars, pieces of land, building and renovation of houses, computers and others. To encourage the young Bruneians to aspire to higher educational levels, 'Akaun Galakan' has been introduced and it extends loans for tertiary education. As an incentive, if the students succeed in getting excellent results, the Ministry of Education will pay a certain portion of the principal financing amount. More recently, TAIB has responded to the call of the local businessmen and started to offer loans for small and medium size business as well as corporates. Since savings accounts are liable for payment of zakāt, TAIB ease the obligations of savers by ensuring that the appropriate zakāt payments are deducted at source. TAIB financing to local businesses is normally for the purchase of assets such a machinery and equipments where a term loan is extended to cater for such financing. This is because TAIB, being a trust fund, does neither offer trade- financing facilities nor current account facilities.

Currently, TAIB has five branches across Pan Brunei and two subsidiaries. One of the subsidiaries, Insuran Islam TAIB Sdn. Bhd. provides *Takaful* insurance services, and the other subsidiary, Darussalam Holdings, provides packages for those who wish to perform 'umrah' or 'haj'. Both of these subsidiaries have been successful in their operations and they provide invaluable services to Bruneians.

### **3.2 The Islamic Bank of Brunei Berhad (IBB)**

Two years after establishing the trust fund, Brunei officially opened its first fully-fledged Islamic commercial bank called 'The Islamic Bank of Brunei Berhad' (IBB). The opening of this Bank was an event that the Government of Brunei and its people were awaiting for as reflected by the Sultan's royal opening address (Baki, 2000).

*Alhamduillah, this dream has now come true from the blessing of our good intentions to comply with the demands of the shara' which are very challenging...Personal Muslim customers will surely be more confident and relieved with the presence of this system of Islamic banking, as a way out of transgressions due to riba, apart from hoping for lawful benefits and profits from it all which are more barakah (blessed). Similarly, the departments and agencies of my government will be able to concentrate their financial business*

***management in this system of Islamic banking as a method or step in practising Islamic regulations and hukm (rulings) within the administration and the financial business of the country.***

IBB was initially incorporated on the 2<sup>nd</sup> July 1980. It was then known as 'Island Development Bank Berhad'. In June 1986, with the appointment of local Directors to the Board and the reshuffle in management structure, the name was changed to International Bank of Brunei Berhad. Although there were management changes, it was still practising the conventional method of banking. The bank was renamed again in 1993 to its present name, when it started practising Islamic banking principles. The bank began concentrating on becoming a bank for the laymen of Brunei as well as a bank for the local businessmen. This was to assist the locals to use Islamic banking facilities and to deposit their funds in a bank that is 100 per cent owned by the Government.

Although there were teething problems, the bank managed to successfully attract the public to use its facilities. Other than Muslims customers, the bank has also successfully attracted non-Muslims through its current accounts, based on *al-mudārabah*, which allow the customers to receive a share of the Bank's profits. This feature is not available in the conventional banks where current account is basically an account that receives and pays on demand with no interest paid to the customer.

The conversion to Islamic banking should not be based solely on replacing interest with profit sharing concept. It must also assist in achieving the socio-economic objectives of an Islamic society. To achieve this objective, IBB has participated in many community services where finance is needed, it also extends '*qard hasan*' facilities where loans are extended to those who are in grave need of funds without any charges whatsoever and period of repayment is very generous. Other than that, the bank is also in the process of opening a '*zakāt*' counter and act as an '*amil*' (agent) for easing the general public in fulfilling their obligations of paying *zakāt*.

IBB has 13 branches across Pan Brunei, it is currently the bank with the largest number of branches. This strong network across the country enables the bank to reach the public at large from the prominent businessmen in the main business centres to the farmers in the remotest places, such as the Temburong District. Each branch provides the complete range of commercial banking facilities from the basic saving accounts to the more sophisticated trade financing facilities. With a strong and experienced local workforce of 360 officers and staff, the bank has managed to keep abreast

with the developments of the banking industry internationally and the benefits arising from these developments are passed on to the customers.

Besides being a commercial bank, IBB has invested in other related financial activities through its subsidiaries. Currently, there are four subsidiaries and each of them specialises in separate distinct activity as shown in Table - 1.

**Table – 1: List of Subsidiaries as at 31<sup>st</sup> December 2002<sup>5</sup>**

<i>Name of Subsidiary</i>	<i>Principal Activity</i>	<i>IBB Share of Ownership</i>
IBB Capital Asset Management	Funds Management by 2 Equity Fund companies <sup>6</sup>	100%
Saujana Sdn Bhd	Aircraft leasing of 2 Boeing 767 to RBA on <i>Al-Ijārah</i> principle of financing.	52.5%
IBB Transport Sdn. Bhd.	Vehicle leasing of 21 fuel tankers to Brunei Shell Marketing based on <i>Al-Ijārah</i>	100%
IBB Kredit Berhad	Lease financing on the principle of <i>Al-Ijārah Thumma Al Bay</i> <sup>c</sup>	100%

### 3.3 Islamic Development Bank of Brunei (IDBB)

Islamic Development Bank Berhad (IDBB) was initially established as a conventional bank in March 1995. It was then known as the Development Bank of Brunei (DBB), a fully government owned banking institution. It was formed to take over the functions of the then Economic Planning Unit whose main task was to assist the local *Bumiputras* to setup businesses by extending specifically tailored loans to meet their individual business needs. In order to progress more actively and effectively in this direction, His Majesty ordered that the unit be transformed to a properly structured development bank so as to better meet the demands of the local businessmen.<sup>7</sup>

On 4<sup>th</sup> April 2000, The Sultan instructed the bank to operate on Islamic banking principles. The conversion required changes in transactions processing system, and accounting system. Malaysia's experience and the available technology were studied. Appropriate software were chosen that accommodate the conversion of the extant system with the ease modification.

It took two months to install the new system for savings, current and deposit accounts, which comprise the main database for the Bank. Trainings were also arranged for all management and staff to understand the Islamic concepts of banking. Successfully conversion of IDBB as the second Islamic bank in Brunei was completed on 1<sup>st</sup> July 2000.

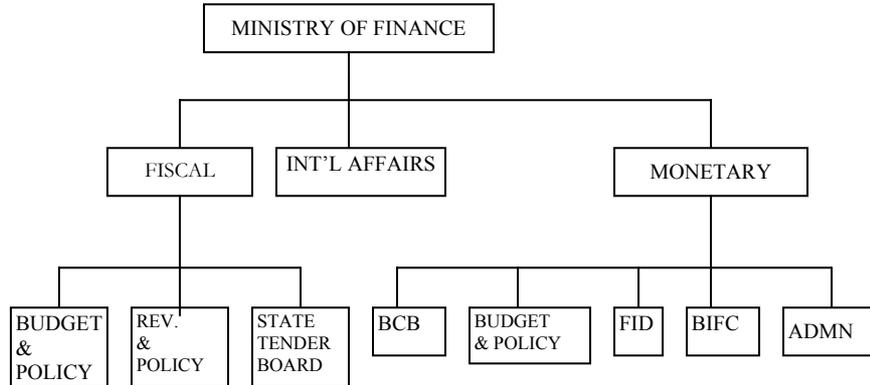
A year after the conversion, in February 2001, IDBB opened its first subsidiary company, Takaful IDBB Sdn Bhd. The company is wholly owned by the Bank and acts as the insurance arm, providing a wide range of Islamic insurance products that cover for property and life, in conformity with Shari'ah principles, including General *Takāful* Business and Family *Takāful* Business. Now, about three years after the conversion, IDBB has introduced many new Islamic products such as Eze-Net Islamic Internet Banking and more recently the first Islamic credit card in Brunei.

#### **4. Brunei Financial Regulatory Setup**

The regulation of financial and banking sector in Brunei falls under the authority of the Ministry of Finance. Financial Institutions Division (FID), a division within the Ministry, has the task of supervising all banks and financial institutions operating in the country, including Islamic banking. All banks in Brunei operate within the operational framework as regulated by the Banking Act of 1956. However, for the Islamic banks they also have to satisfy the regulatory framework set by the Islamic Banking Act Cap 186.

The Brunei Currency Board (BCB)<sup>8</sup> is also another division within the same Ministry. Other than issuing currency notes and coins, its other salient role is to control and maintain the circulation of Brunei currency whereby the external and liquid assets must exceed the statutory limits of 70 per cent and 30 per cent respectively<sup>9</sup>. A currency inter-changeability agreement exists between Brunei and Singapore that allows the currency to be interchangeable at par value. It must be noted that prior to the establishment of FID in 1993, banking matters were under the supervision of the currency board. Whilst this Board handles the local currency issues, the Brunei Investment Agency (BIA), another division established in 1995, is entrusted to handle the foreign investments and the country's reserves.

**Organisational Structure of Ministry of Finance<sup>10</sup>**



Brunei International Financial Centre (BIFC) is another division within this Ministry which provides the infrastructure to conduct regional and international business. Under this department, various international legislations have been introduced in recent years such as the International Banking Order (2000), International Business Companies Order (2000)<sup>11</sup>, Securities Order (2001) and International Insurance and *Takāful* Order and others. These legislations provide the legal framework for Brunei to establish global business partners.

As described above, there is no central bank in Brunei and the Ministry of Finance holds jurisdiction over financial activities of the country and regulates the banks operating within the country through the various Banking and Finance Acts.

**5. Evaluation of the Performance of the Islamic Banks vis-à-vis Conventional Banks in Brunei**

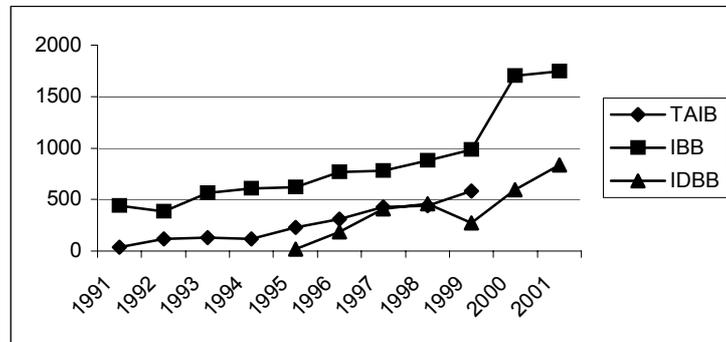
It is now about thirteen years since the first Islamic financial institution was established in Brunei. During this period we have witnessed a rapid growth as evident by the number of branches that have been opened throughout Pan Brunei, subsidiaries extending related banking and financial activities such as insurance, *al-ijārah* vehicle financing and also *al-rahn* pawning. Furthermore, the range of Islamic products offered by Islamic banks has also grown remarkably. Another perhaps more effective method of evaluating the performance of Islamic banks in Brunei is to analyse the

movement of assets and deposits shifting from the conventional banks to the Islamic banks. Such empirical study is useful as it is no longer a speculation since it is supported by key data. However, obtaining such data is difficult since not all statistics are available for in-depth studies. In the following analysis, I shall try to show trends in the movement of key variables, but would advise that in some cases the data is incomplete.

### 5.1 Total Deposits

Total deposits, in this context, comprise of current, fixed, savings accounts and other deposits. It does not include amount due to banks (within or outside Brunei) or other miscellaneous liabilities. The records for these diagrams are sourced from the respective Islamic banks' annual reports, Brunei Darussalam Statistical Yearbook and reports from the Financial Institution Division in the Ministry of Finance. Detail breakdowns of deposits can be found from 1998 onwards, however records based from the Statistical Yearbook go as far back as 1991. Due to the constitution of TAIB, which is considered as a trust fund rather than a commercial bank, the figures from the Government sources normally exclude TAIB records.

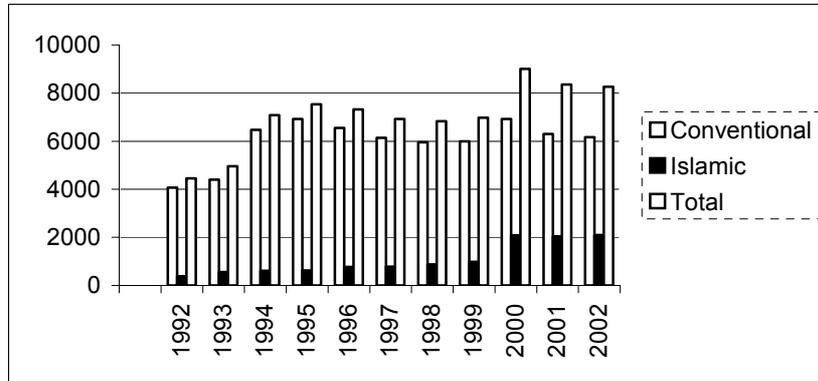
Firstly, looking at Islamic institutions, we see a steady increase of total deposits (Diagram 1). The diagram also shows that after the conversion IBB (1993) and IDBB (2000), there is no negative effect on total deposit; on the contrary, there is continuous upward trend for all the Islamic banks. There is a sharp increase in deposits in year 2000, which is not only contributed by IDBB conversion, but in fact largely due to a sharp increase in IBB's deposits by 73 per cent of its previous year deposit. This trend in deposits did not cut off at year-end but in fact, remained consistent into the end of the following year, hence we can assume the increase to be a long-term.



Source: Compiled data from Annual Reports of Respective Banks

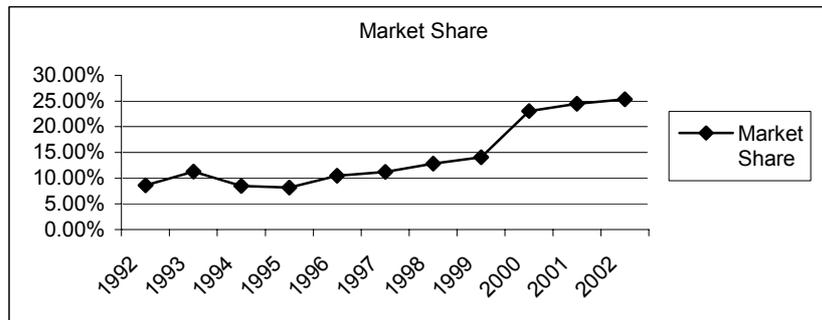
**Diagram 1: Total Deposits of the three Islamic Institutions**

Secondly, we make comparisons of the Islamic banks total deposits vis-à-vis the conventional banks. Although there is a marked increasing trend in deposits of current, fixed and savings account for both Islamic and conventional banks (see Diagram 2), the level has stagnated in the last two years. The market share of the Islamic banks for deposits stood at around 25 per cent, but we must be reminded that this does not take into account TAIB's deposits.



Source: Brunei Currency Board, and Ministry of Finance.

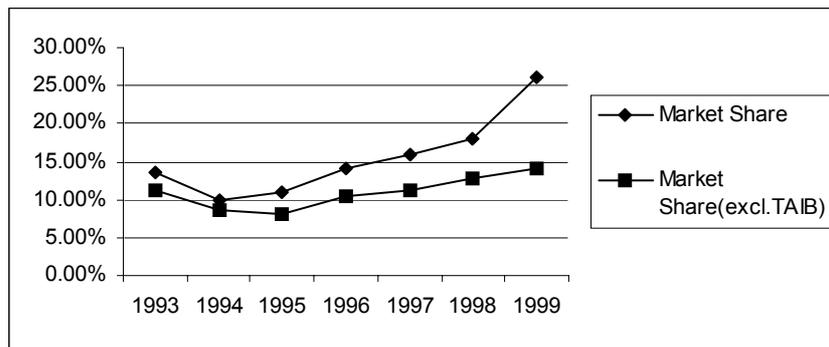
**Diagram 2: Breakdown of Conventional and Islamic Banks Total Deposits.**



Source: Brunei Currency Board, and Ministry of Finance.

**Diagram 3: Market Share of Deposits of Islamic Banks (IBB & DBB)**

TAIB's annual report is available up to year ended December 1999 therefore we can only ascertain its effect on the banking industry up to that year. Up to 1999, IDBB was then still a conventional bank and hence the Islamic bank's share during the period of 1993 to 1999 as shown in Diagram 4, comprised of TAIB and IBB. We highlight that with TAIB figure added on, the market share as at 1999 is a high 26 per cent. We can therefore deduce that if we can project and include TAIB's share of deposits into the diagram for 2002 (given that TAIB performance since 1999 to current has been steady), the current market share of total deposits would be higher than the current 25 per cent.



Sources : Brunei Currency Board, MoF, and Annual Reports of TAIB and IBB.

**Diagram 4: Market Share of Total Deposits with and without TAIB's share**

## 5.2 Total Equity and Reserve

Total equity which comprise paid up capital, reserves and undistributed profit, measures the financial strength of the bank. For Trust Fund, this would comprise of reserve carried forward, profit and dividend paid out.

### 5.2.1 TAIB's Reserve

TAIB started with slight teething problems and then managed to overcome the difficulties and then continue to grow in strength up to the present time. With a Government fund of Brunei Dollar (BND)10 million for initial reserve fund, the trust fund is showing a high total reserve of BND26 million in 1999 and expected to be much higher than this figure by now. Dividend paid out during the 9-year period ending 31st December 1999, averaged at BND11.2 million per year, an impressive performance for a trust fund that began with some difficulties.

There is no current annual report at hand to analyse the present performance of the Trust Fund. However, with the increasing number of customers opening accounts in particular for Haj pilgrimage and no adverse reports, we can anticipate continuing progress and stronger performance for the future.

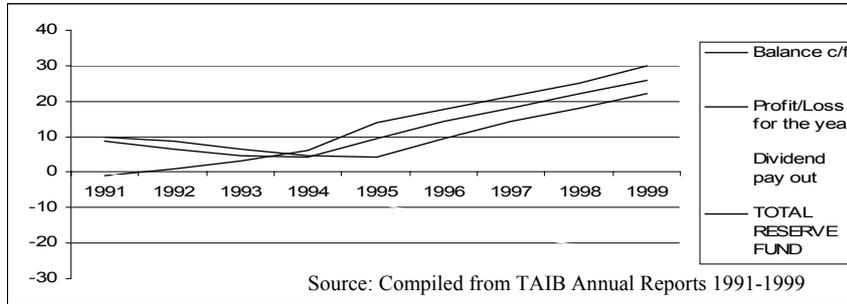
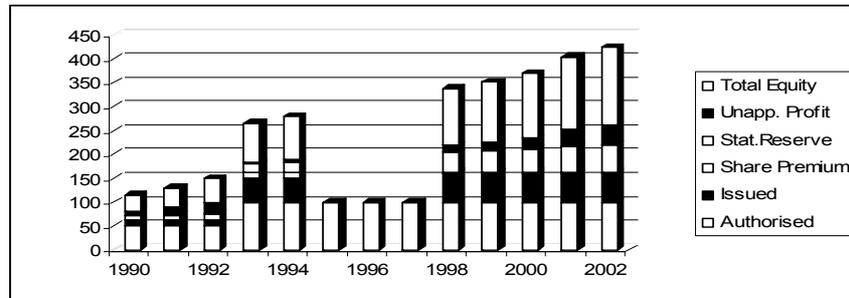


Diagram 5: TAIB's Reserve Funds (1991-1999)

### 5.2.2 IBB's Equity

Issued capital of BND12 million was increased in 1993 by way of bonus share issued by capitalising its unappropriated share by BND24 million and by issuing 14 million ordinary shares for cash at a premium of BND1.00 per share by public offer. The authorised and issued share capital were also subdivided in 1993 from shares of BND10.00 each into shares of BND1.00 each, and an increase in the authorised share capital to BND100 million at BND1.00 each. The increases in both authorised and issued share capital was to support the growing activities of the bank – in terms of rising deposits on one hand and affording of loans and advances on the other.

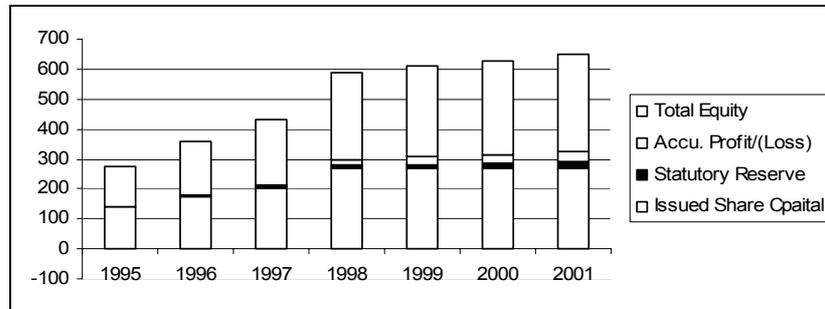


Source: Compiled from Annual Reports of IBB. No info for 1995 to 1997

Diagram 6: Total Equity of IBB (BND Millions)

In 2002, the bank boasts a high total equity of BND162 million which far exceeds its extant authorised capital and will facilitate further growth in terms of expanding its branches or creating new subsidiaries to fuel the country's financial activities.

### 5.2.3 IDBB's Equity



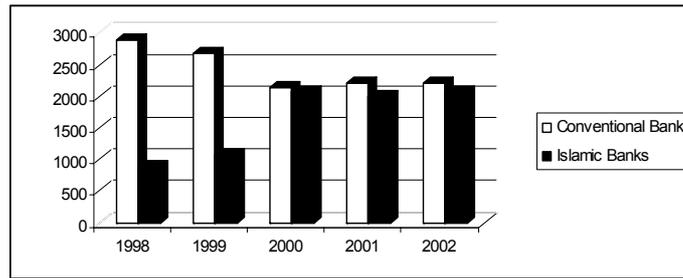
Source: Compiled data from IDBB's Annual Reports.

**Diagram 7: IDBB's Equity Capital from 1995 to 2001 (BND Million)**

IDBB started off as a conventional bank in March 1995, with an authorised share capital of BND400 million. As with most organisations it started with a loss, of slightly more than half a million, but immediately bounced into profit the following year. Since then the Bank has strengthened year after year. The gradual increase of issued share capital from BND139 million to its present BND271 million indicates the country's commitment to assist businessmen in undertaking developments for economic growth.

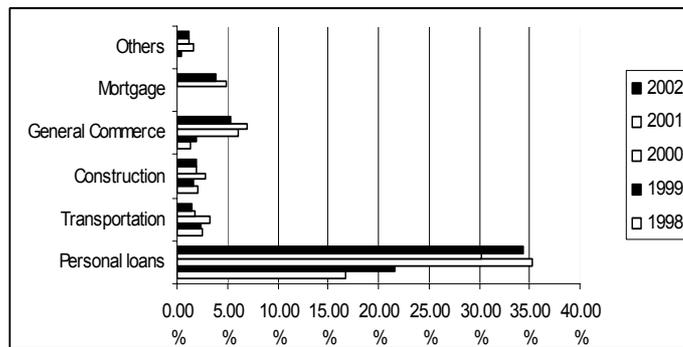
Overall, all the Islamic banks have performed remarkably well with the shareholders' funds strengthening year after year. This facilitates the banks to invest further in new subsidiaries and new products.

### 5.3 Loans and Advances



**Diagram 8: Loans and Advances by Conventional and Islamic Banks for 5 years, 1998 to 2002 (BND Million)**

The diagram above provides evidence of a marked shift in affording of loans and advances to the public. The market share for loans extended by Islamic banking in 1998 is 23 per cent, but within two years, it increased to 49 per cent. However, in the next following years, the growth has remained stagnant at the same level. A further analysis of the breakdown of lending (see Diagram 9), indicates that although the high growth in the loans and advances took place it is more in the direction of consumption rather than production. Lending to manufacturing sector for the total five years averages at a low BND6.7 million as opposed to BND99 million by the conventional banks.



Source: Financial Institutions Division, Ministry of Finance.

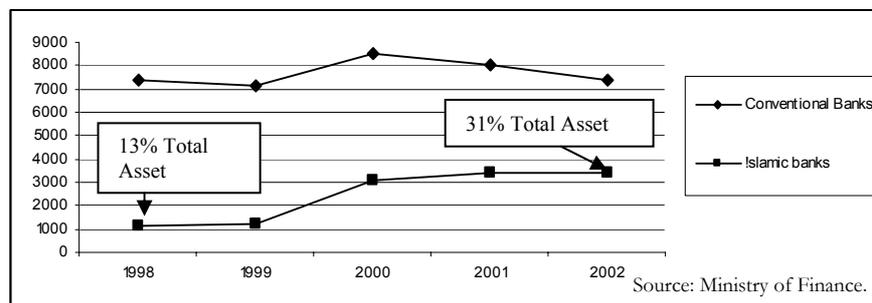
**Diagram 9: Breakdown of the market share of Islamic Banks to main lending sectors.**

Islamic banks have to shift its lending direction to productive projects such as agriculture, construction, general commerce and professional services. Islamic banks have to be active in lending to these sectors which will assist the Brunei Government in its effort to diversify Brunei economy and facilitate local businessmen to venture into these sectors.

Islamic banks have maintained a close scrutiny on the provisions of bad and doubtful debts. The policies practised by the banks for provision of debts are similar to international standards. Loans are divided into substandard, doubtful and loss provisions. High provisions of 55 to 100 per cent are made on doubtful and loss loans after taking into account all realisable collaterals to back the lending. Currently, the provision for bad debts as a percentage of total loans and advances for the Islamic banks group is in single digit. This is a good indication of cautious lending and the banks must continue to practise due care to ensure that the provision for bad debts do not turn to double digits. Stringent credit lending policies and firm covenants must continue to be the cornerstone of lending to ensure that the lending portfolio comprises of performing loans.

#### 5.4 Total Assets

Total assets comprise of cash, placements and balance with banks in and outside of Brunei, loans and advances, investments and other miscellaneous assets. Although we have the information of banks' assets from 1991, the subdivision between Islamic and conventional banks is only available from 1998 to 2002 as shown in Diagram 10.

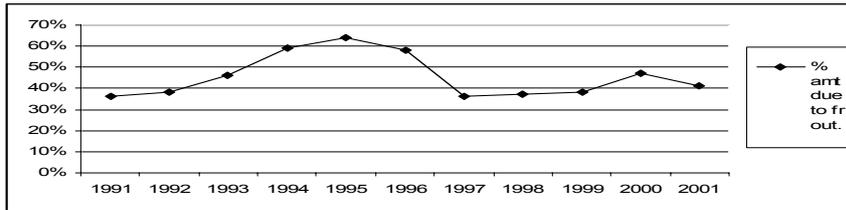


**Diagram 10: Total Assets of Islamic Banks vs. Conventional Banks**

Overall banks assets increased by 27 per cent between 1998 and 2002, but Islamic banks growth rate of total assets during the same period had been a remarkable 210 per cent. In 2000-2002, the trend in the conventional banks

as a group shrank slightly by 12 per cent. A plausible reason is IDBB's conversion to Islamic bank in 2000. However, we must be again reminded that the above figures, which are derived from Government Statistics, excludes TAIB, which, in fact, if included, will raise the figures for Islamic banks even higher than what is shown above.

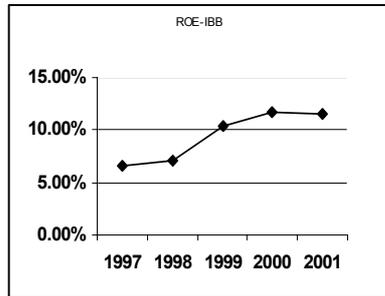
However, although total supply of funds is growing, a large proportion of the funds are parked outside of Brunei, in overseas banks (see Diagram 11). This may indicate either lack of lucrative local investments or the more attractive investment rates offered by banks outside Brunei or both. Most banks in Brunei parked their overnight surplus funds in neighbouring country Singapore to gain from interest given for overnight deposits.



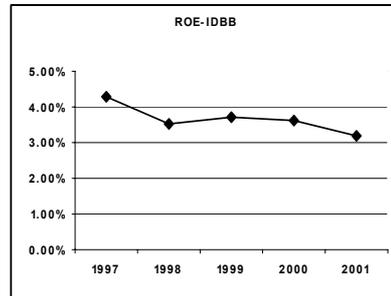
Source: Brunei Currency Board, Financial Institution Division, Ministry of Finance.

**Diagram 11: Percentage of Amount due from Banks Outside over Total Assets from 1991 to 2001.**

### 5.5 Profitability Ratio – Return on Equity (ROE)



Source: IBB, compiled from Annual Reports



Source: IDBB, compiled from Annual Reports

**Diagram 12: ROE of IBB and IDBB**

The above diagrams traced the ROE of both IBB and IDBB. ROE is measured by taking the profit after taxation and *zakāt* over ordinary share capital and reserves. The amount of *zakāt* is calculated based on a set formula on net profit before income tax to comply with the principles of Sharī'ah.

IBB, after 10 years of operating as an Islamic bank has maintained an upward trend in ROE. The average rate of return on equity for the period 1997-2001 for IBB was 9.5 per cent. The benchmark for rate of return on equity for the Top 1000 banks in the world was 15.08 per cent during 1994-1998.<sup>12</sup> Iqbal (2000)<sup>13</sup> conducted a survey on 12 Islamic banks operating in various Islamic countries and stated that only six out of the twelve Islamic banks scored higher rates than 15.05 per cent. Although the period is not the same, it gives us an objective benchmark of IBB performance on profitability. The rate of return on equity confirms that IBB has built the foundation for going forward with success for the second ten years.

IDBB has also performed well given that it only had two years of experience as an Islamic bank. Similar to IBB, the bank has had its fair share of teething problems. In 2001, IDBB earnings from operating income after tax was recorded at BND10 million. As a new Islamic bank, IDBB is building a strong footing in Islamic banking and will progressively achieve positive growth.

As for TAIB, it is not plausible to apply the rate of return on equity for measuring its profitability. There are a couple of reasons to this; firstly, as stated in their annual report, TAIB does not pay *zakāt* because the Syariah Advisory Council is of the opinion that it is not subject to *zakāt*, and secondly the trust fund is funded by reserve which is the cumulative effect of income over expenses over the years of operations. Nevertheless, based on its latest available audited accounts of 1999, the trust fund reported a profit of BND24 million. If we were to date back to its humble beginning, the trust fund started off in 1991 with BND 10 million as opposed to a reserve of BND26 million in 1999.

## **6. The Next Step Forward**

Overall, Islamic banks have proved to be successful and active participators of the banking industry. Their presence in the industry has grown in strength year after year since initiation. The analysis of their financial performance has indicated that Islamic banks can be serious competitors to the conventional banks.

However, the next step forward is very important in terms of sustainability. What would be the right direction for Islamic banks to adopt? This depends on how the Government intends to expand its economic activities.

The Government of His Majesty has many times expressed its plan to make Brunei a financial hub for Islamic banks. This intention was first mooted in the Government's Fifth National Plan. There are strong incentives for the investors to invest in Brunei, for example, there is no restriction on importing capital from any country, or on overseas remittances of capital or profit. Non-resident accounts can be maintained and there is no restriction on borrowing by non-residents. Furthermore, over the last fifteen years, Brunei Darussalam has poised itself as a Muslim country, where Muslims around the world can expect that activities conducted are adhered to Islamic principles, from the food and drink that they consume to social gatherings and business dealings. This in itself presents a competitive edge.

However, the present level of development of Islamic finance in Brunei is not sufficient to attract the investors since it does not offer any new Islamic instruments nor Brunei Darussalam has an Islamic financial market to facilitate Islamic investments. Brunei Darussalam has to develop a financial intermediary market for the transaction of Islamic bonds and other money market instruments.

An example would be to initiate *ṣukūk al-ijārah* (leasing bonds) or *ṣukūk al-muḍārabah* bonds. *Ṣukūk al-ijārah* can be used for the purchase of large capital assets such as oil tankers or aircrafts where the bond is asset-backed and a fixed income stream is established through a master *ijārah* agreement via a SPV. *Ṣukūk al-muḍārabah* is another bond facility where the Government or venture capitalist may issue revenue bonds to finance certain Government projects, for example, the construction of a highway. The income is derived from the fees collected from users of the facility, for example, toll fees can be steadily collected from the users of the highway.

However, to open up a bond market, several measures have to be undertaken to lay the groundwork. To develop an Islamic inter-bank money market for buying and selling of Islamic financial instruments would require a more sophisticated financial market environment with legislation to form the legal framework and financial intermediaries to support and undertake the transactions. The vision in setting up an Islamic inter-bank money market by linking the Islamic institutions and the instruments will give Brunei Darussalam the depth to the Islamic financial system.

Another pre-requisite of Islamic banking and finance is capacity building. To design, develop and implement Islamic financial instruments, Brunei Darussalam requires the necessary skill and manpower. Here, the Centre for Islamic Banking, Finance and Management (CIBFM) can play an important role in the development of Islamic banking in Brunei Darussalam.

## **7. The Centre for Islamic Banking, Finance and Management (CIBFM)**

The establishment of the Centre for Islamic Banking, Finance and Management (CIBFM), was first initiated in early 2000. The previous Vice-Chancellor, Allahyarham Dato Paduka Seri Setia Professor Dr. Hj Awang Mahmud Saedon Bin Haji Othman, showed great enthusiasm in setting up of this Centre and together with the Ministry of Finance began to form the initial its idea. This enthusiasm is very much shared by the present Vice-Chancellor, Dr Haji Ismail Bin Duraman who has continued in supporting plans to develop the Centre by ensuring that the groundwork for the Centre is progressing as scheduled. The mission statement of the Centre is to provide necessary support for Brunei Darussalam to create, propagate and maintain a unique Islamic foundation for banking, finance and management operations. This mission is in line with the University's aspiration to not only play an academic role but more importantly, to assist the Government in their national development plans.

The Centre is considered an important endeavour for the University as well as for the country because of the goals that it aims to fulfil, which are:

- To provide a foundation of learning for the people of Brunei in their ongoing pursuit for the establishment of an Islamic financial and banking hub, regionally and internationally;
- To provide the necessary infrastructure for Brunei to propagate and maintain Islamic banking, finance and management institutions;
- To act as a centre for the implementation of Islamic knowledge by working in coalition with the Government Ministries as well as with the banking and business communities.

The Centre will be under the umbrella of the University in the same capacity as other faculties. It will be autonomous in so far as managing its own activities, but the monitoring of academic standards and the awarding of certificates are centralised at the University senate level.

- Educational foundation

In order to provide opportunities for learning, the Centre has initiated several structured programs at various levels which will require the approval of the University academic planning committee. However, to set the learning in progress, a minor in Islamic banking and finance has been introduced two years ago, offering the students at undergraduate and post-graduate levels the opportunity to learn Islamic business knowledge such as Islamic accounting, Islamic management ethics, Islamic business and finance, Islamic jurisprudence, Islamic transactions and many others. This program is currently being set up as part of the specialised and minor program offered by the Department of Business Studies, one of the three departments which formed the Faculty of Business, Economics and Policy Studies. Other departments and faculties within the University are also offering Islamic knowledge, and the Centre will pull together the teachings relating to business, management and banking under the roof of the Centre to gain from the synergy of combined knowledge.

Other than offering programs to undergraduate and postgraduate levels to University students, the Centre has the mission to provide short courses and programs to those outside the University's community. These target groups are the bankers, businessmen, young professionals and the interested public at large in Brunei and abroad, who wish to pursue knowledge in Islamic banking, business and management studies. In order to ensure the practical relevance of the course, the Centre will ensure the participations of the professionals and experienced businessmen and bankers to provide valuable practical knowledge and information of the business world.

- Resource Unit

The Centre will be equipped with a resource unit which will be accessible to University students as well as the business and public at large. The plan is to equip the resource unit with the latest technology in terms of accessing information via internet and other electronic devices. This would allow networking with other Islamic centres and agencies as well as the banking and business communities. The resource unit will be housing books, journals and magazines from publications over the world. The Centre would also plan to get the collaboration of the banks in Brunei to participate in maintaining the resource unit as one of the best resource centres in the region.

- Forums, conferences and seminars

This Centre has established relationships with many Universities from abroad as well as organisations that are promoting Islamic knowledge. The

networking will set the foundation for the Centre to organise conferences and seminars by securing eminent speakers and practitioners. A good example is this conference itself where Universiti Brunei Darussalam and Islamic Development Bank, Jeddah join hands to make this meeting possible. The gatherings of eminent scholars and practitioners such as this is very rare and its value is immeasurable – it is a meeting of minds and Insha' Allah the experienced and the new-comers of this discipline will intermingle and learn and nourish one another.

- Research Centre

Perhaps one of the most important roles that the Centre will play is to promote research work in the area of Islamic banking, finance and management. It is suggested that banks, in particular the Islamic banks, can play a role here which will help in developing the Islamic financial market. As mentioned earlier, Brunei needs to create a more sophisticated financial centre. Endowment from banks to recruit researchers in this area will be one of the first stepping stones towards this direction. Government departments such as Ministry of Finance can also benefit in this area by financing researchers to work in depth on certain projects that can assist in implementing Islamic financial instruments.

- Strategic partners with Brunei banking and business community

Currently, banks and business organisations look to the neighbouring countries for the training of their human resources which is costly. With the presence of the Centre, banks and business organisations can discuss their training needs and custom made courses can be designed to close the knowledge gaps of each individual organisation. Working as strategic partners with these organisations is a win-win situation, because not only will the organisation incur less expenses, the Centre will be able to understand the problems encountered by the organisations and assist in reaching solutions.

- Publications

A long-term objective is also hopes to have the Centre take lead in publicity in the area of its interest. We expect students and researchers to write papers and project assignments that are of quality and that are useful for public consumption.

For the Centre to achieve its objectives as listed above, it would require a staff of high calibre that is willing not only to serve the University's community but also to work closely with the public. At the initial stage, the Centre will work with adjunct lecturers from various other Faculties, in particular the Faculty of Business, Economics and Policy Studies and the

Sultan Haji Omar Ali Saifuddien Institute of Islamic Studies Lecturers from these faculties will be required to assist with the teaching requirements. In the long run, the Centre will have its own permanent staff to support its activities. Currently there are several permanent lecturers who have been recruited for the Centre. However, these lecturers will be able to contribute most effectively on their return after obtaining a doctorate level qualification. In the meantime, the Centre will depend on lecturers that will be recruited from abroad, those who are well acknowledged in their respective fields of specialisation. Researches will also be given teaching responsibilities and to transfer their specialised area of knowledge to the students. Since the Centre will be running in full force in 2006, a complete team of specialised lecturers would be on hand to provide the necessary support as required by the Centre.

## 8. Conclusion

This paper documents the progress that Islamic banking has achieved in Brunei since its introduction twelve years ago. It presents a detail analysis of the financial performance of the Islamic banks of which it confirms that the first step in the development of Islamic banking has taken place in Brunei Darussalam. The paper further states that the country is ready to take the next giant step; which is for the country to develop an international Islamic financial market. One of the prerequisites needed to carry out such a noble plan is to ensure that the country develops its capacity building requirement so as to put in place the skills and knowledge needed for creating and implementing a more sophisticated financial environment. In this respect, the Centre will contribute and play an important role of ensuring that skills and knowledge are acquired by the people of Brunei Darussalam to support the Government's National Development Plan of making the country an Islamic financial hub. However, other prerequisites such as legal framework, standardising Shari'ah compliance regulations, introducing new Islamic financial instruments, establishing rating agencies and other infrastructures are essential to turn this into reality.

Islamic banking is rapidly growing in Brunei Darussalam. Since the introduction of Islamic banking, the banking industry has experienced tremendous change. Based on the principle of *farḍ kifāyah* (religious obligations), we have to ensure that Islamic banking continues to grow. This is to sustain its existence and to present itself as a proven alternative to conventional banking. To keep the momentum going, the next giant step as mentioned above must be taken seriously. Twelve years ago, we never

thought it possible for Islamic banks to thrive and prosper. Are we now ready for the next step?

To conclude this paper, it would be most appropriate to quote the royal address made by His Majesty during the launching ceremony of the Islamic Bank of Brunei, in 1993:

***The system of Islamic finance that we are striving at is a vision and a far-reaching mission which extends beyond the demands of this life. It will Insha' Allah be inherited by our descendants. May it last and remain strong and successful so as to stand as proof in front of Allah that we have indeed been steadfast and sincere in carrying out Islamic regulations in Negara Brunei Darussalam.***

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## Notes

<sup>1</sup> Ebrahim (2001).

<sup>2</sup> Baki (2000), pp 87.

<sup>3</sup> Salma L. (mimeographed).

<sup>4</sup> Salma L., Razali M. Z. and Ismail D. (2003).

<sup>5</sup> IBB Annual General Meeting Report 2003, pp 16.

<sup>6</sup> Based on two Equity Funds, namely Global Equity Fund and IBB Asia Equity as certified on the seal of Trust Deed dated November 1995 and December 1996 respectively.

<sup>7</sup> Salma L. (mimeographed).

<sup>8</sup> BCB was established by the 1967 Currency Act in Chapter 32 of the Laws of Brunei

<sup>9</sup> [http://www.finance.gov.bn/bcb/bcb\\_index.htm](http://www.finance.gov.bn/bcb/bcb_index.htm) (20<sup>th</sup> December 2003).

<sup>10</sup> <http://www.finance.gov.bn> (20<sup>th</sup> December 2003).

<sup>11</sup> This legislation contains provision for tax-free facilities at highly competitive cost levels. Brunei is more concerned with attracting a critical mass of good business than a fee-based income stream at a high cost to end-users. For details see <http://www.bifc.finance.gov.bn/> (20<sup>th</sup> December 2003).

<sup>12</sup> Iqbal (2000), p. 379.

<sup>13</sup> Iqbal (2000), p. 379.

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## Glossary

ʿ <i>Adl</i>	Justice.
ʿ <i>Tbādāt</i>	Duties of man due to God.
ʿ <i>Illah</i>	Reason/characteristic behind a Sharīʿah ruling such that if a particular reason/characteristic is found in other instances, the same ruling will apply.
<i>Abkām</i>	Plural of <i>bukm</i> . (For meaning, see below).
<i>Ajeer</i>	Lessee or worker on wages.
<i>Amānah</i>	Trust.
ʿ <i>Amil</i>	Agent who acts to perform a task.
ʿ <i>Aqd al-muaqd al-mudāf</i>	See <i>Bayʿ al-mudāf</i> .
<i>Arboon</i>	See <i>Arbūn</i>
<i>Arbūn</i>	Earnest money (see also <i>Bayʿ al-arbūn</i> ).
<i>Bayʿ</i>	Stands for sale. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like <i>murābahah</i> , <i>istiṣnāʿ</i> , and <i>salam</i> .
<i>Bayʿ al-ʿAyan</i>	Sale of tangible objects such as goods (as against sale of services or rights).
<i>Bayʿ al-ʿĪnah</i>	Selling of something to someone at a given price (usually on credit) and then buying it back from him at the same time at a different price (usually lower but cash). This kind of sale and buy-back is prohibited because it effectively means exchanging a given amount of money with a different amount of money, which amounts to <i>ribā</i> . It can be used as a subterfuge for <i>ribā</i> dealings.
<i>Bayʿ al-Dayn</i>	Sale of debt. According to a large majority of <i>fuqahāʾ</i> , debt cannot be sold for money except at its face value but can be sold for goods and services.
<i>Bayʿ al-Mudāf</i>	A sales contract in which delivery of both the commodity and the payment is deferred e.g., forward sales in modern times. Such contracts are not permitted by the Sharīʿah.
<i>Bayʿ Bithaman Ajil</i>	Another term used for <i>bayʿ muʿajjal</i> . For meaning see below.
<i>Bayʿ Muallaq</i>	A hung sale; a sale which is not closed yet due to some problem in the attached conditions. The sale will be completed as soon as the problematic condition is rectified.

<i>Bay<sup>ʿ</sup>-Mu'ajjal</i>	Sale on credit, i.e. a sale in which goods are delivered immediately but payment is deferred.
<i>Bay<sup>ʿ</sup>-Mūrābahah</i>	Sale at a specified profit margin. The term is, however, now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. <i>Mūrābahah</i> is also referred to as <i>bay<sup>ʿ</sup> mu'ajjal</i> .
<i>Bay<sup>ʿ</sup>-Salam</i>	A sale in which payment is made in advance by the buyer and the delivery of the goods is deferred by the seller.
<i>Bay<sup>ʿ</sup> al-Arbūn</i>	A sale in which an earnest money is paid and the rest is paid at the contract settlement date.
<i>Ḍamān</i>	Guarantee, security.
<i>Ḍamān al-Dark</i>	Guarantee that the object in contract is unencumbered.
<i>Ḍarar</i>	Damage; Harm
<i>Dhimmah</i>	Liability, responsibility.
<i>Dinar</i>	Name of a currency.
<i>Dirham</i>	Name of a currency.
<i>Fatawā</i>	Plural of <i>Fatwā</i>
<i>Fatwā</i>	Legal opinion.
<i>Fard Kifāyah</i>	Collective obligation on each member of the Muslim society which is discharged for the whole society if some members fulfilled it.
<i>Fiqh</i>	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, <i>fiqh</i> covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of <i>fiqh</i> is based primarily on interpretations of the Qur'ān and the <i>sunnah</i> and secondarily on <i>ijmā<sup>ʿ</sup></i> (consensus) and <i>ijtihad</i> (individual judgement). While the Qur'ān and the <i>sunnah</i> are immutable, <i>fiqhī</i> verdicts may change due to changing circumstances.
<i>Ghabn</i>	Loss; usually a sudden loss.

<i>Gharar</i>	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
<i>Ḥadīth</i>	Sayings, deeds and endorsements of the Prophet Muhammad (peace be upon him) narrated by his Companions.
<i>Hajʾ</i> (or <i>Haj</i> )	Pilgrimage to Makkah; one of the pillars of Islam.
<i>Halāl</i>	Things or activities permitted by the Sharīʿah.
<i>Hāmish al-jiddiyah</i>	Margin payment.
<i>Ḥaq al-Tataruq</i>	Right of way or passage.
<i>Ḥaq Shurb</i>	Rights over water.
<i>Ḥaqq</i>	Right.
<i>Ḥarām</i>	Things or activities prohibited by the Sharīʿah.
<i>Hujjaj</i>	Plural of pilgrim.
<i>Idāfa al-ʿAqd</i>	Relegation of contract.
<i>Ihsan</i>	Beneficence, kindness, virtue.
<i>Ijārah</i>	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
<i>Ijārah Şukūk</i>	Tradable forward instruments against rentable assets.
<i>Ijtihād</i>	In technical terms, it refers to the endeavour of a jurist to derive a rule or reach a judgement based on evidence found in the Islamic sources of law, predominantly, the Qurʾān and the <i>sunnah</i> .
<i>Iqtaʿ</i>	Unclaimed lands.
<i>Istiṣnaʿ</i>	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against <i>salam</i> , in <i>istiṣnaʿ</i> the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
<i>Jabālah</i>	Ignorance, lack of knowledge. In contracts, it refers to lack of information with respect to the subject of the contract or the terms and conditions of the contract.

<i>Ju‘ālah</i>	Performing a given task against a prescribed fee in a given period.
<i>Ju‘l</i>	The fee or prize promised in a <i>Ju‘ālah</i> .
<i>Khiyār</i>	Option.
<i>Khiyār al-‘ayb</i>	Option to rescind a sales contract if a defect is discovered in the object of sale.
<i>Khiyār al-majlis</i>	Option to rescind a contract during the same meeting in which contract is agreed.
<i>Khiyār al-ru‘yah</i>	Option to rescind a sales contract after physical inspection of the object of sale.
<i>Khiyār al-shart.</i>	The option to rescind a sales contract based on some conditions. One of the parties to a sales contract may stipulate certain conditions, which if not met, would grant a right to the stipulating party an option to rescind the contract.
<i>Khiyār al-tadlees</i>	Option to rescind a contract if a party finds that it has been cheated.
<i>Māl</i>	Asset. Property.
<i>Mu‘āmalāt</i>	Relationships/contracts among human beings as against ‘ <i>ibādāt</i> which define relationship between God and His creatures.
<i>Muḍāf</i>	Deferred to the future.
<i>Muḍāf ‘aqd</i>	Forward contract. A contract in which commodity and price both are deferred to future date(s).
<i>Muḍārabah</i>	A contract between two parties, capital owner(s) or financiers (called <i>rabb al-māl</i> ) and an investment manager (called <i>muḍārib</i> ). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur’s loss lies in not getting any reward for his services.
<i>Muḍārib</i>	An investment manager in a <i>muḍārabah</i> contract.
<i>Muqāraḍah</i>	Carries the same meaning as <i>muḍārabah</i> . For meaning see above.
<i>Murābahah</i>	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. <i>Murābahah</i> is also referred to as <i>bay‘ mu‘ajjal</i> .

<i>Mushārahakah</i>	Partnership. A <i>mushārahakah</i> contract is similar to a <i>muḍārahah</i> contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
<i>Najash</i>	In reference to sales contract, it means contriving with the seller and bidding a higher price not with an intention to buy but simply to fetch a higher price from other potential buyers.
<i>Qarḍ or Qarḍ Al-Ḥasan</i>	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
Qur'ān (Also Written As Al-Qur'ān)	The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (peace be upon him). The Qur'ān lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.
<i>Rabb al-māl</i>	Capital owner (financier) in a <i>muḍārahah</i> contract.
<i>Rahn</i>	Collateral in a loan contract.
<i>Ribā</i>	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of <i>fuqahā'</i> to be equivalent to <i>ribā</i> .
<i>Ṣadaqah</i>	An act of charity.
<i>Salam</i>	The short form of <i>bay' al salam</i> .
Sharī'ah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'ān and the <i>sunnah</i> and embodies all aspects of the Islamic faith, including beliefs and practices.
<i>Shirākah</i>	Partnership. Technically, it is equivalent to <i>mushārahakah</i>
<i>Ṣukūk</i>	Certificates of Assets.

<i>Sunnah</i>	The <i>sunnah</i> is the second most important source of the Islamic faith after the Qur'ān and refers to the Prophet's (peace be upon him) example as indicated by his practice of the faith. The only way to know the <i>sunnah</i> is through the collection of <i>aḥādīth</i> , which consist of reports about the sayings, deeds and endorsements of the Prophet (peace be upon him).
<i>Sūrah</i>	A chapter of Al-Qur'ān.
<i>Takāful</i>	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
<i>Taşarruf</i>	Act (or ability) of someone to use something as he pleases.
<i>Wadi'ah</i>	A contract whereby a person leaves valuables with someone for safekeeping. The keeper can charge a fee, even though in Islamic culture it is encouraged to provide this service free of charge or to recover only the costs of safekeeping without any profit.
<i>Wakālah</i>	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
<i>Zakāh</i> (Also written as <i>Zakāt</i> )	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.

### **About the Book**

Islamic finance is growing fast. This progress has brought to fore a number of practical issues and challenges. While much of the research in the industry is focused on the immediate concerns, long-term direction setting basic research is getting less attention. This book balances between theory and practice in bringing together selected papers from a recent International Conference on “Islamic Banking and Finance: Fundamentals and Contemporary Issues”.

The book is divided into four parts. Part-One deals with the fundamentals and the issues faced by Islamic finance at theoretical level. Topics in this part incorporate Islamic banking theory, options contracts, and an analysis of possible sources of financial distress in Islamic banks. Part-Two addresses to the empirical issues of performance evaluation of Islamic banks, of equity funds and the attitude of bank customers. Part-Three focuses on legal issues in the practice of Islamic finance in Malaysia and Indonesia. Part-Four gives an overview of the Islamic banking efforts in Brunei. It is hoped that the book will be of interest to the academics and the practitioners in the field. Students of Islamic economics and finance will also find it useful.

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