

SUCCESS FACTORS OF ISLAMIC BANKS

Based on a study of the actual conduct of some Islamic Banks

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INTRODUCTION

- 1 Islamic banks are not different from other financial institutions in terms of their legal modalities, constitutive structures, objectives and means of achieving those objectives. The only difference lies in their description as Islamic. 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 embark on the research into the success factors of Islamic banks as financial institutions. It must be realized that maximization of profit is the objective of the highest priority for all investment institutions crated by private individuals. Consequently, all private-sector financing institutions have one fundamental objective: to make as much profit as they can.
- 2 However, profit maximization is a general proposition that must be narrowed down and explicated in detail. Similarly, the criteria of every component of this general objective must also be determined. This will be the subject of the First Section of this study. In brief those Criteria are as follows: Boosting all forms of deposits, improvement in the quality of customer services, expansion the base of banking services, protection of capital, provision of humanitarian and social services, and the factors that raise the profit margin, or what is usually called the rules of profitability management of an Islamic bank.
- 3 The Second Section will discuss the experience of seven Islamic banks in achieving their objectives and measure the extent of their success.¹ This will be accomplished through a study of their closing accounts and annual reports for the years 1999-2001.² In this section, I shall attempt to present important evidence

¹ 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.

² Reservations must be made beforehand on the results to be arrived at because this attempt 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.

that would help deducting the success or failure factors in these Islamic banks. Specifically, this will be 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.

- 4 Section Three will focus on the success factors of Islamic banks as may be derived from the real-world realities of the Islamic banks. These are in fact the results aimed at in this study. This section will be divided into a number of topics. Thus, I will study the 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 other factors of lesser importance.

SECTION I

SUCCESS CRITERIA OF ISLAMIC BANKS

LONG TERM CONSIDERATIONS

- 5 **Increasing Deposits:** In order to actualize the greatest profit possible, there is a need to distinguish between the long-term and the short-term. A bank, whether Islamic or not, is concerned with making profit in the long-term without sacrificing the short-term perspectives. Long-term profit is influenced by the growth of deposits and other funds' resource elements that give the bank the opportunities to have profit-generating invested assets. Thus we must 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 *Mudarabah* accounts, and lastly, off-balance sheet deposits in investment funds and special or restricted investment accounts. It is erroneous to think of these deposits as 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 7 Islamic banks that are the focus of this study. Therefore, in marketing and presenting any type of deposit to clients, its effect on other types of deposits should always be taken into account. In fact, Islamic banks must be able to measure this effect.

Although Islamic banks do not distribute returns to current account owners, the servicing of these accounts, despite their cost, not only increases the rate of profit, because the deposits are not subject to distribution as they are guaranteed, but these demand deposits also increase the multiplier of assets/equity rate which is reflected in the form even a greater increase in the rate of profit.

On the other hand, off-balance sheet deposits are considered an attractive way to increase the number of clients in addition to being a very important vehicle to increase the rate of shareholders' returns, because it increases the earnings from the agency activities, keeping in mind that these earnings are less affected by investment risks to which other banking earnings are subjected.

- 6 **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 it 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, even though it is theoretically not new: Improved services to customers save cost in the long-term despite their pressure, in the beginning stages, to increase spending on training

and rehabilitation.³ The principal reason for this is that improved services create a motivating work climate and environment for both clients and employees, which in turn increase clients' enthusiasm for dealing with the bank on one hand and the productivity of the employees on the other. This improves the cost effectiveness of the dollars spent on labor.

It should be noted that improving the quality of banking services does not only mean receiving and responding to clients' requests; it rather means the ability of the bank to discover a client and to offer her a service she has not previously 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 on the market segment to which it is directing its services. Are they big financiers, businessmen or monthly salary earners and 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 commensurating with the peculiarities and objectives of every segment are those that can attract the largest amount of deposits.⁴

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:

- i. 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.
- ii. 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.
- iii. 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.
- iv. Improving the working environment and making it comfortable and enthusiastic for the bank employees.
- v. 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 a lot of impact on its returns.

³ M. Ray Grubbs and R.E. Reienbach, *Client Service Renaissance*, Bankers Publishing Co, Chicago, IL 1991, pp. 7-8.

⁴ Ibid., p. 28.

For instance, it is better for a bank to award scholarships of 1,000 Dinar each to 10 school graduates in a public ceremony that will be talked about by people than awarding a single scholarship of 10,000 Dinar to the best student.

Finally, raising the quality of banking services depends on improving three elements: correct banking professionalism, knowledge of clients and establishing personal rapport with them. Correct banking professionalism is the first point of departure for creating confidence in the bank and its employees. Improving professionalism therefore centers on improving the bank employees' knowledge and perfection of their banking job, such that anyone of them can offer a professional, brief and accurate explanation of all banking services that the client may have in mind. It also focuses on the staff being able to carry out client's needs quickly and accurately, which would make the client give generously her confidence to and rely on the employee, and consequently on the bank itself. Knowledge of clients is based on continuous relation with them which is, to some experts, the most important managerial rule⁵: Success in banking services means the ability to interact with and relate to the client's desires, anticipate her wishes, and offer services that are specific to these desires and wishes.⁶

There are several parameters by which the quality of banking services offered to a customer can be measured. These include sounding out customers' pleasure through periodic questionnaires, which are then analyzed and studied. There is also computing the time it takes to perform services and linking that with the record time. Another parameter is that which computes 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.

7 Expanding the Base of the Banking Services:

Numerous studies conducted by research bodies with various inclinations in America have shown that 80-90% of bank customers' material assets are kept outside the bank that customers deal with. This ratio increases every time bank activities are restricted to current accounts, granting loans and issuing credit cards.⁷ This means that ample opportunities exist for banks to attract new deposits and investments even without expanding its customer base. Only at the end of the last century that many Islamic banks turned towards expanding the base of their services by extending services of agency for investment such as creating investment funds and 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 largely depends on the 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

⁵ Merlin Gackle, *Bankers as Brokers: the complete guide to selling mutual funds and other fee-based investment products*, Probus Publication Co., Chicago, Ill 1994, p. 60.

⁶ Ray Grubbs, p. 75-86.

⁷ Merlin Gackle, p.59

investments assets.⁸ This principle is even truer for the Islamic banks because the nature of these banks is based on new innovations in the art of banking that are far from the prominent pillar 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 growth certificate for advanced 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.

The measure of expanding the base of banking services is in checking 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.

8 Preservation of Capital:

Protecting capital is the most important considerations in maximizing profit in the long run because evaporation and loss of capital not only cause banks to loose new deposits, they also cause the loss of the means to achieve the very objectives of their existence!

Undoubtedly, one of the most important elements in capital preservation is 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 (*Mudarabah*) 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 *Mudarabah* and *Musharakah*, these attempts should take into account that *Musharakah* and *Mudarabah* 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 regards 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 the 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 that is not limited to central bank guidelines and to what is usually known, in conventional

⁸ Ibid., pp.61-72

banking, as the rules of banking prudence,⁹ but should include tying *Mudarabah* and *Musharakah* investments to long-term investment deposits, setting red lines of potential risks and for checks and balances rules in taking investment decisions. Such rules of prudence must be applicable to even the CEO of the Islamic banks as well as to other decision makers.

9 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 Shari'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 Zakah is left to the individuals -investors or shareholders- to spend it on causes they consider closer to Allah, since Zakah is a religious obligation, first and foremost. But it is erroneous to think that good deeds are limited only to the enjoined Zakah. One of the distinguishing factors of the Islamic bank is its commitment to Qur'anic 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 fulfillment 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. Since the prophet, pbuh, has promised replacement for every spending and that money is not going to diminish as a result of spending, then the means of substitution should be an increase of customers' confidence in the bank and their

⁹ There are numerous writings about this issue, including Jeremy F. Taylor, *The Prudent Management of Modern US Banks*, Quorum Books Publishing Co., London & Connecticut, 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.

conviction about its sincerity about the Islamic characteristics it declares. Consequently, their interest in dealing with the Islamic bank is going to grow.

SHORT-TERM CONSIDERATIONS

10 Factors of Raising the Rate of Profit:

Profit increase above the existing levels with competing Islamic and conventional banks is in the final analysis the final objective and the quantitative criterion for measuring the success of any bank, in general, and for the success of the Islamic bank in particular. 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 I 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.

- i. 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 Mudarib/agent of the returns on unrestricted, restricted and special investment deposits.
- ii. 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.
- iii. 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.

- iv. 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.
- v. 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.
- vi. Compliance with an institutional approach of information flow to management to enable it to take timely decisions: Decision making close to the time of implementation is one the elements of making profit as well as the most important in safeguarding 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 by tying 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, rather than 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 reduces cost effectiveness and engrosses the top management in trivialities that take up the time that is better devoted to planning and drawing up growth programs.

SECTION II
EXPERIENCE OF SOME ISLAMIC BANKS IN MEETING
THEIR OBJECTIVES

11 In this section we shall 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. This period, no doubt, is short that the trends of key variables in the bank cannot be measured. Nor can any long-term results be derived.

I must make reservations beforehand about the results we would arrive at. This is because this attempt is not aimed at the totality of Islamic banks. Likewise it did not do a random sampling of the banks. It is merely a study of available financial information and annual reports. In addition, the available information cannot explain all the causes of differences between banks. This is because any explanation of the differences requires an identification of the various management methods in those banks in terms of a bank's relations with customers, employees; in terms of salary levels and other job compensations and the quality employees' technical qualification, the levels of their knowledge of banking, generally and Islamic banking, in particular. Also to be considered are the kinds of services offered to customers, methods of providing them as well as categories of financial products and their development over time and other information that are not available in the published annual reports.

Despite these reservations, this section of the study can still provide very important evidence that will help in determining the success and failure factors in Islamic banks, whether in the countries where the 7 banks contained in this study are located or in other Arab and Islamic countries. The reason is that we have concentrated on the fundamentals pointed out by the figures themselves. Numbers have their unavoidable indication that cannot be neglected!

12 Growth of Assets and Invested Assets:

Islamic banks vary greatly in their ability to increase their overall assets generally and their invested assets in particular. In tables 1 and 2, we have shown the growth of assets and invested assets respectively.

We observe in table 1 that while one of the banks (bank C) was able to increase its assets by 96% over three years followed by bank G with a growth of 42%, we see a decline in the assets of another bank (bank F) by 18%!

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 raises the amount of money the bank can invest, but it also 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 to a higher level of

investment quality. The two points are reflected in an increased profitability of the Islamic bank.

Table 1: percentage growth of total assets

Bank	1999/1998	2000/1999	2001/00	2001/1998	AVERAGE
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 we examine the growth of assets in table 1, we would find that the general increase in assets alone does not give the complete picture. We should then attempt to understand the phenomena and factors behind that increase. Here we would find 2 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.

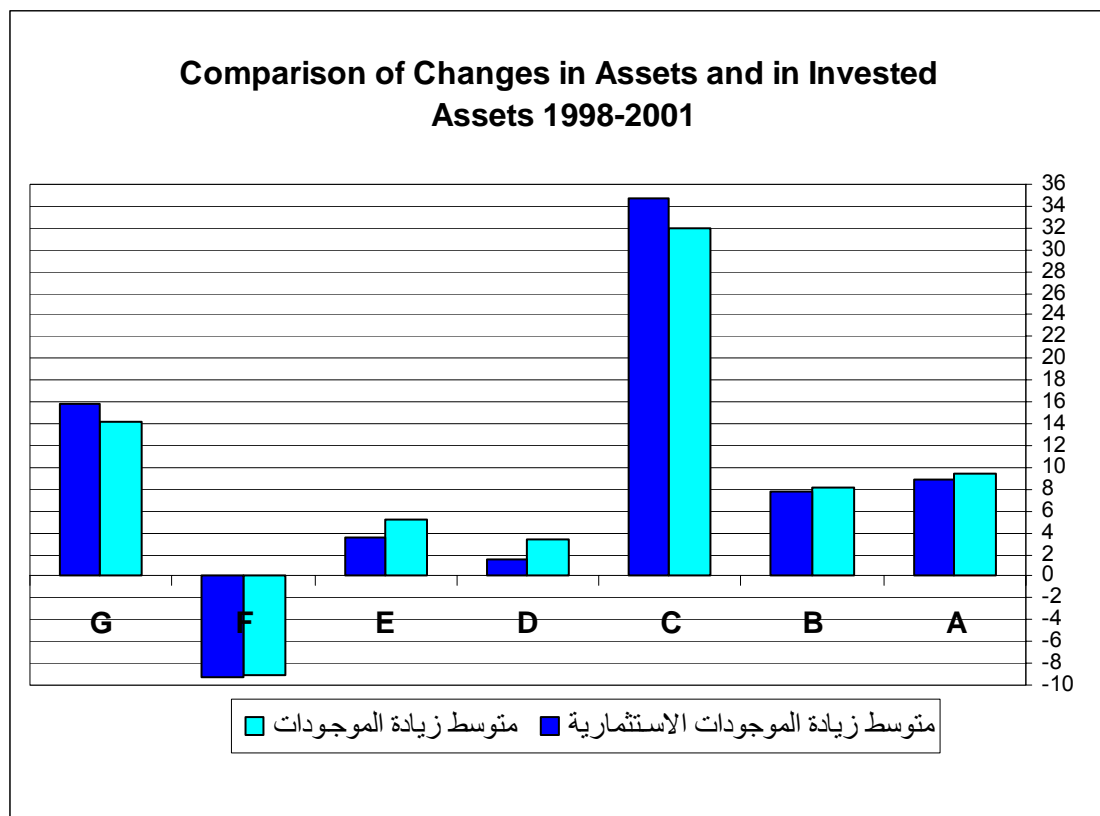


Figure 1

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, we observe that banks D and E whose assets rose by 10% and 15% respectively, recorded that increase during a boom of 2001 for one of them, with a very modest increase in the two other years, and for the other during a boom in 1999, but coupled with a decline of its assets in 2000 and 2001. For bank B whose assets grew by 52%, 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 make an almost negligible increase. This leaves bank A, which was able to maintain a stable annual average that was above the average growth of all the seven banks, thus giving it a total increase in its assets that rose by 28% in the three years as evident in figure 1.

On the other hand, it is 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 one of the indicators of the ability of the 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 increase in invested assets

Bank	1999/98	2000/1999	2001/00	2001/1998	Average
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 this table 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%. 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	99/98	00/99	01/00	01/98
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	90.85	-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.

13 Increase in Cash and Bank Deposits:

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

BANK	1999/98	2000/1999	2001/00	2001/1998	Average
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 *Murabahah* 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	Average	99/98	00/99	01/00	01/98
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.

14 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

BANK	1999/98	2000/1999	2001/2000	2001/1998	Average
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% or 170% 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

BANK	1999/1998	2000/1999	2001/2000	2001/1998	Average
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% 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

BANK	1999/98	2000/1999	2001/2000	2001/1998	Average
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 tot take a brief look at the changes in depositors' share of profit, in terms of absolute changes and deposits' 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

BANK	1999/98	2000/1999	2001/2000	2001/1998	Average
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	Average	99/98	00/99	01/00	01/1998
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 defense” is imperative for the Islamic bank should take: improved services and high confidence/reliability can be leaned on if high returns become temporarily scarce.

15 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

BANK	1999/98	2000/1999	2001/2000	2001/1998	Average
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%, 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's 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.

Table 12: Percentage of expenses/invested assets

BANK	1998	1999	2000	2001	Average	99/98	00/99	01/00	01/98
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

Four banks were able to reduce their cost/invested assets index. Two of them were able to reduce this index by 56% and 33% respectively during the three years. This index rose in three other banks by 45%, 35% and 25 % 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.

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 Dinar 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% 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	1999/1998	2000/1999	2001/2000	2001/1998	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% and 24% 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% and 24% 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 *Murabahah* and *Istisna'* investments hovers around 10%, 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%

to 6.46%, 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 *Murabahah* 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	Average	99/98	00/99	01/00	01/98
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

This 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 *Murabahah* 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 *Murabahah* with its low return. As for bank A, it got no more than 4-5% return on its investment in local *Murabahah* 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 *Murabahah* that did not exceed 6.55% and 5.66% of its invested assets in 2001 and 2001 respectively.

Additionally, the average column in table 14 shows that all banks have weak asset turn over ratios. This is caused by the fact that most of their assets were held in the form of debts that come from *Murabahah* and *Istisna' contracts*. Debts assets cannot be turned into liquid for reinvestment. Efforts to change the financing structure from *Murabahah* to financing *Musharakah*, (an alternative to *Murabahah especially* in financing letters of credit which is different from the known production partnership) and to expand the *Murabahah/Ijara* 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 enables them to raise the rate of asset turn over. 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. Decreases in this index can be attributed to a reduction of expenses much more than

an increase in revenues while 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: percentage of expenses to revenues

BANK	1998	1999	2000	2001	Average	99/98	00/99	01/00	01/98
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

16 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. Even though it is possible to say that the management is expected to make profits comparable to profits from other uses of capital in its environment, that is, despite the taxes on profits.

Table 16: Net profit/invested assets

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

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% 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% to 1.2% over the three years. Also a look at the profitability index in banks F, B, C, and to some extent, E and A, indicates a weakness in their ability to improve profits rates.

Finally, table 16 emphasizes the result we arrived at earlier: low turn over in all these banks while a high turn over rate is a major factor of profit making in conventional banks.

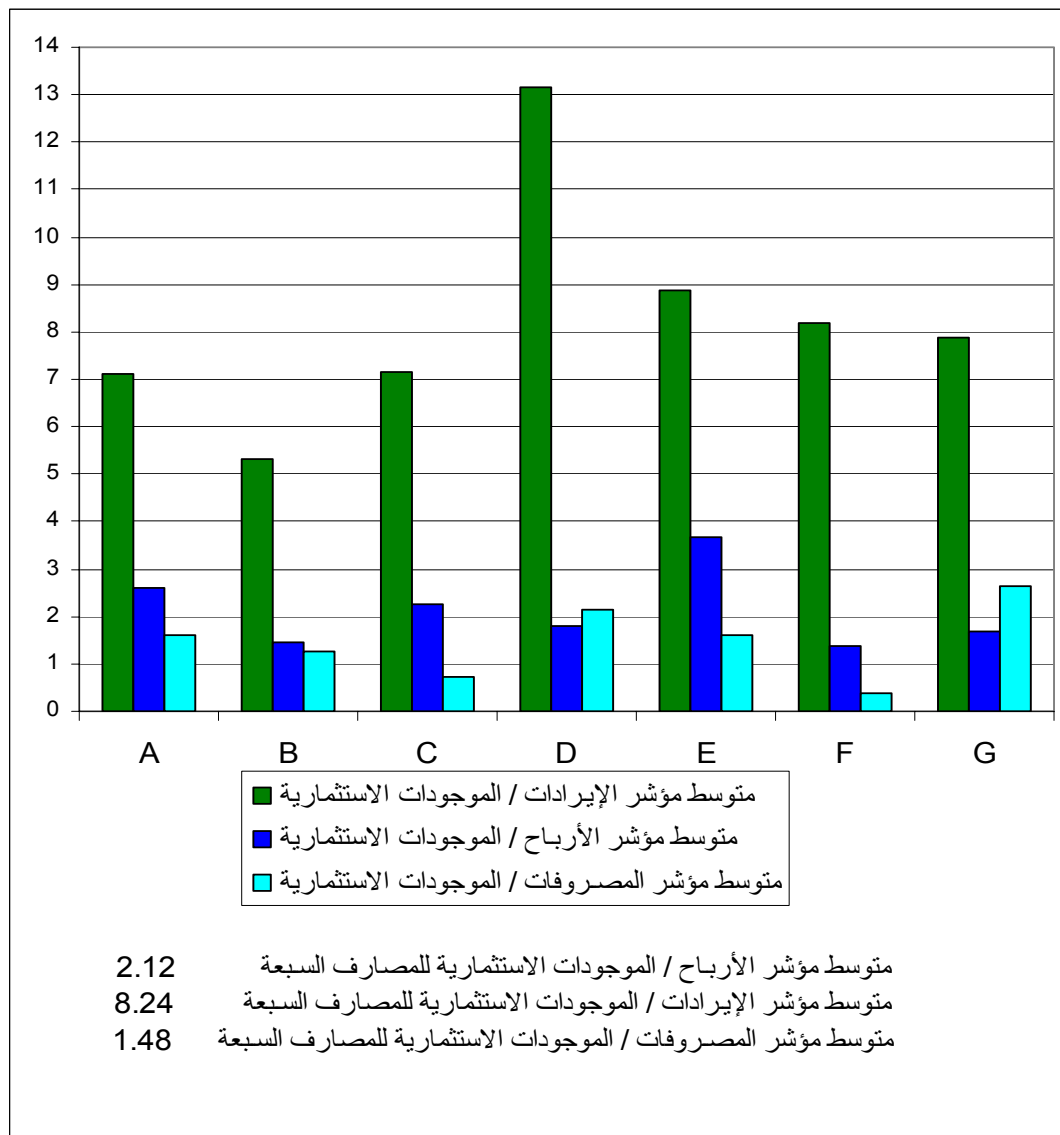


Figure 2

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 profit making weakness is characterized by an increase in spending, stability of revenues and profit and slowness in introducing any substantial managerial change in their modality of conducting their affairs and in relations with customers as well as in investment policies.

It is notice from Figure 2 that there is a difference between Islamic banks in the 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 E 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.

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% to 80% 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% and 12.4% in 1999 to 14.6% and 13.7% in 2000; then to 18.1% and 20.3% 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	1999/98	2000/1999	2001/2000	2001/1998	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

On another hand, banks A and D suffered a decline in their profit rates. It is striking particularly in the case of bank A where the decline is attributable to a clear reversal of key investment revenues from *Murabahah*, *Ijarah*, etc. Whereas bank B was able to achieve profit growth rates that exceeded by far the growth in its revenues. This is

probably due to a change in services pricing as happened with bank F. Finally, Bank G maintained a stable growth rate in its net profits.

Table 18 relates net profit to equities. Since the profit figures we are using are those before deduction of reserves and Zakah, 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: Percentage of net profit/equities

BANK	1998	1999	2000	2001	99/98	00/99	01/00	01/98	Average
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 equity profitability maintained a high level in two of the seven banks. Its average over four years reached 22.82% and 17.91% 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 range in three banks but dropped 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% for the four years and 11.71% for 1999; both figures are less than the achievement of American commercial banks that made an average of 13.5% in 1999, the year on which we have figures. Similarly, while the highest American bank achieved 39.0%, the highest Islamic bank did not achieve more than 23.1% in 1999 and 22.82% average three years.¹⁰

Table 19: Percentage of Equity Growth

BANK	1999/98	2000/1999	2001/2000	2001/1998	Average
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

¹⁰ Robert J. Hendershott, Darrell E. Lee and James G. Tompkins "Winners and Losers as Financial Service Providers Converge," in the Financial Review V37, No.1 Feb. 2002, pp.53-72.

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 bank's profit if we examine retained earnings as we take from table 19. 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 is the one that was capable of raising the average increase of equities as was the case in banks G and E, both of which were able to raise equities by 42% and 30% 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.

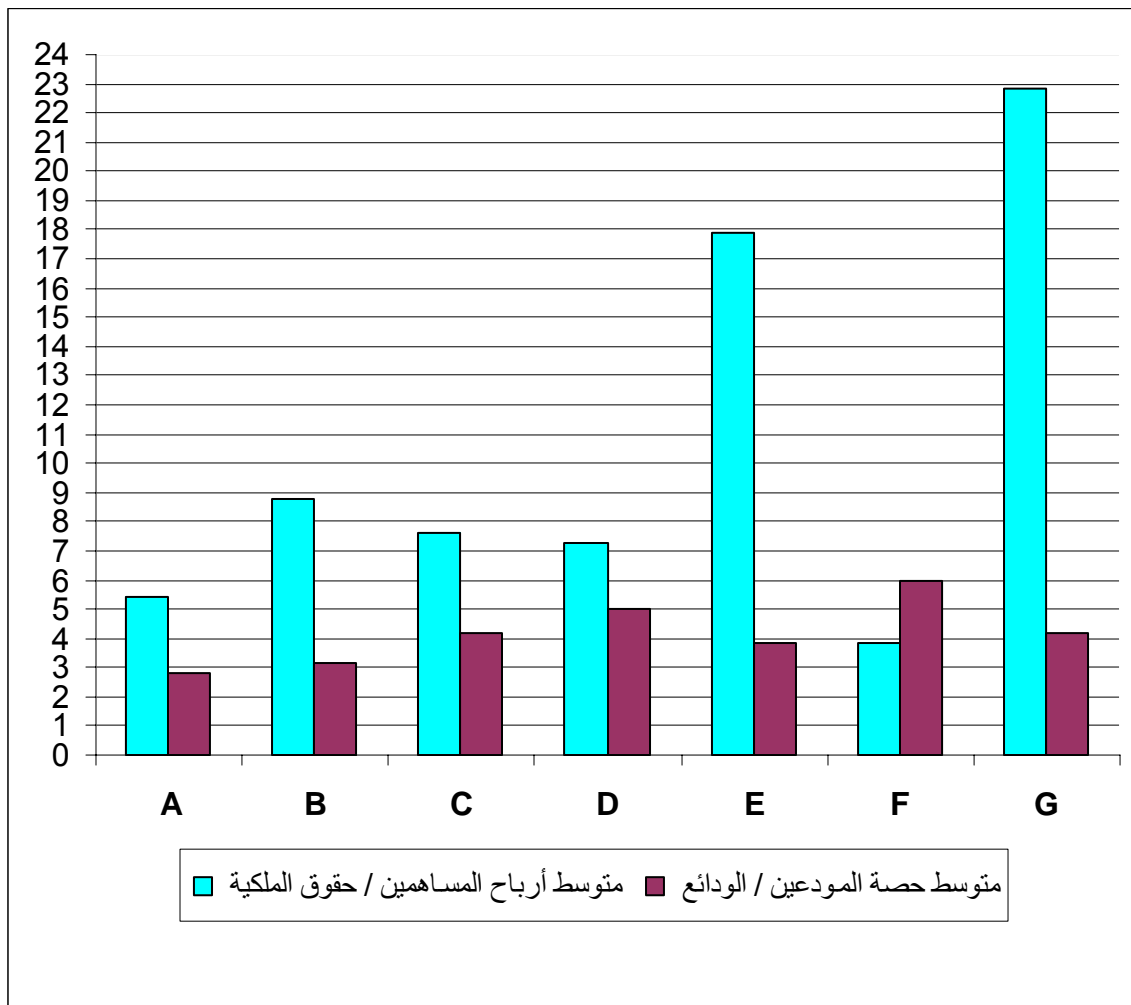


Figure 3

17 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 from two angles only: The effect on customers of transparency in adherence to the Shari’ah and 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 report have always carried expressions that do not tell the reader more than “the bank’s operations are in compliance with the noble Shari’ah,” not even on issues that interest the reader such as the relationship between the depositor and the shareholder. The Shari’ah report on bank C for example says that the management ha promised to implement in the future the recommendations made to it by the Shari’ah board. There is no reference to what these recommendations are or why they were made.

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

**Table 20: Average Zakah and Sadaqah in Some Islamic Banks
1998-2001**

Bank	Average Zakah and Sadaqah	Average equity	Zakah and Sadaqah/ equity	Average profits	Zakah and Sadaqah/ 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 Zakah and Sadaqah to equity hovers around less than one tenth of 2½ known rate in the noble Shari’ah in bank C and 2/5 of 2 ½ in bank G. Their ratios to profits range between 2.9% and 6.7%, whereas Zakah rate for those who uphold the view that profits should be subjected at a rate similar to that of farm products is 10% of 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 which represent an open opportunity for institutions and individuals 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 by western companies to humanitarian and social services in their countries.

SECTION III

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.

18 Banking Efficiency:

Banking efficiency is the extent to which a bank's management is able to increase its assets and maximize its profits in the long-term, which is the more important, and in the short-term, which is also important. 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 not of negotiation, although so many bankers, even those associated with the Islamic banks, behave as if these two different kinds of relationships are the same. This different nature of bank/depositor relations suggest that the management policy of an Islamic bank should to 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 is positively related to 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 carries involves errors because of 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 using the figures from which Figure 3 is derived 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 (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 (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 (columns 4 and 5). These processes bring us to Table 21 below in which the last two columns depict actual averages of depositors' share and shareholders' profit.

Table 21: Efficiency in Islamic Banks 1998-2001

Banks	APD* Shareholders' Profit fixed at 22.82%	APD Shareholders' profit fixed at 3.81%	APS* Depositor's share fixed at 5.98%	APS Depositor's share fixed at 2.79%	Actual APD	Actual APS
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

* 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%, the best of the banks in terms of managerial efficiency, represented by the average profit realized would be bank F that realized 35.79% profit, followed by banks G and E, with 32.70% and 28.74% 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%, 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%, 5.98% and 5.55% 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% and 10.83%, or shares to depositors not exceeding 2.92% and 4.09% 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 to depositors shares that is 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% percent in bank A, followed by bank C with a loss of 7.81% and then bank B with a loss of 6.36%. But if all the banks realized the shareholders' profit of the most profitable bank, i.e. at 22.82%, distribution of the profit share to depositors will again put bank G in the lead, followed by banks F and D with 4.16%, 4.08% and 3.36% distributed shares respectively. Bank B will have the lowest distribution that is no more than 0.56%, followed by bank A with a distribution of no more than 1.16%.

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 information gets to, and is received by, the management on time.

One of the very important factors in raising efficiency is continuous 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 behavioral 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 American 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 person¹¹. 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 investments¹². 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% and 45.3%, respectively, of their gross revenues from off-balance sheet investments. The effect of off-balance sheet investments on their net profits was 42.7% and 141.6% respectively.¹³

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 to the Egyptian Faisal Islamic Bank when international Islamic banking suffered some extraordinary

11. Ihsan Isik and M kabir Hassan, "Cost and Profit Efficiency of the Turkish Banking Industry" in *Financial Review* V 37 N0. 2 May 2002 pp. 257-280, they quote Berger and Mester Studies.

12. Ibid.

13 . We took the average for 2000 and 2001 for lack of information on 1998 and 1998.

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.¹⁴

In Sections I and II, I mentioned the most important aspects that require improvement and change – reduction of expenses, increasing earnings, increasing the turn over 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.

19 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 Islamic bank also has the reputation of the Shari'ah board. 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 Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions. What every Islamic bank requires, today, is real and effective supervision on the implementation of standards and collective religious rulings in their actual deals and transactions with others including customers, depositors and shareholders, as well as effective Shari'ah supervision on innovations by the 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 includes the appointment of a Shari'ah expert 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 the safety of its deposits, and gives depositors a sense of security on their investment and current deposits and a rest of mind based on the sufficiency of capital to cover all future exigencies. 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

¹⁴ Robert Scheitzer, Samuel H. Szewizyk and Raj Varma, "The Effect of Bank Debt Downgrades on Stock Prices of other Banks," *Financial Review* V.36, No. 4, Nov. 2001, pp. 139-156.

Islamic bank is not merely a commercial bank, but combines the qualities and commercial and investment banks together. Table 22 indicates that capital adequacy in some Islamic banks does not instill enough confidence especially if we take into account their excessive reliance on current and demand deposits as in banks A and E both of which occupy the lowest ranks in capital adequacy.

Table 22: percentage of equity/total assets

BANK	1998	1999	2000	2001	Average	99/98	00/99	01/00	01/98
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% in American commercial banks and 30.2% in American investment banks¹⁵, we find that the index of 2001 dropped to 5.91% in bank A and 7.41% percent in bank C. Capital adequacy witnessed a continuous decline since 1998 in the two banks, while it hovered 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.

Table 23: percentage of current accounts to total deposits

BANK	1998	1999	2000	2001	Average
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

The Islamic bank should have at least 1/12 capital adequacy. This is very important to maintain soundness of the bank and to attract all types of deposits.

Another factor in confidence building is the ability of the bank to show qualitative superiority in providing integrated services that meet all the financial needs of the clients may have. Apart from some narrowly specialized banks, expansion and diversification of banking services instill confidence in the bank and build business loyalty of the customers. With expansion and diversification come speed and effectiveness of services provided to customers as they assure them of the bank's ability to achieve.

¹⁵ Ibid.

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.

20 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 benefits from all the bank's circumstances and from the outstanding services it provides to customers especially the services of the Mudarib that are very often priced on imitation basis instead of profit maximization basis.

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.

21 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 point is a strict commitment to sound banking practices/wisdom in observing strict self-set 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 *Mudarabah* accounts' owners 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.¹⁶ 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.

22 Providing Humanitarian and Social Services:

Integration in its local environment/community is an important factor of success for the Islamic bank. This must be more characteristic of Islamic than conventional banks since the *raison d'être* of the former is to accommodate the community's faith and beliefs. Additionally, 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 compulsory Zakah. We noticed in sub-section 17 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-Qurud al-Hasanah* (interest-free loans), which is a pioneering project, with a balance close to 10% 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 meager compared with the bank's contribution.

23 Other Minor Factors With substantial Promotional and Moral Impact:

There are a few Shari'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 of 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 percentage of Mudarabah deposits that is kept liquid (un-invested), the Share of the bank as a Mudarib/agent even in the absence of any competitive conditions in the market and, in some Islamic banks, 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 Shari'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 Mudarabah 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 by virtue of this *de facto* rule! In 2001 bank A the total

¹⁶ 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.

amount accumulated in these two accounts was equal to 60% of net equity. Balance in these two funds should be treated as Mudarabah deposits and given their share of profit!

Third, the little attention usually paid by the Shari'ah boards of Islamic banks to fulfillment of justice in distribution of profits between depositors and shareholders. It is true that Mudarabah 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 labor relations in the Islamic bank including boycotting companies that use child labor or practice gender or racial discrimination, number of hours imposed on workers in certain Islamic banks and 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 the lack of emphasis on efficiency, hard working, wealth preservation, production growth, etc., instead of being satisfied with financial increases alone.

All these factors accumulate over one another to point out the dire need for Islamic banks and their Shari'ah boards to consciously reconsider their present approaches and behaviors if they really want to provide outstanding services to their customers and consequently gain their confidence and the continued growth of their transactions with the bank.

REFERENCES

The information about the 7 Islamic banks was taken from their annual reports of 1999-2001. 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:

Jordan Islamic Bank (million Jordanian Dinar)

	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

Bahrain Islamic Bank (million Bahrain Dinar)

	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.

Dubai Islamic Bank (million UAE Dirham)

	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

Arab Banking Corp Islamic Bank (million US Dollars)

	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	---	---	---	---

Qatar Islamic Bank (million Qatari Riyal)

	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

Shamil Bank, Bahrain (million US Dollars)

	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.

Kuwait Finance House (million Kuwait Dinar)

	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

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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