

**Strategic Trends in the Islamic
Banking And Finance Movement***

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Introduction

The existence of Islamic banks in the second half of the 20th Century came as an offshoot of the newly rediscovered Islamic economics. Writings on Islamic economics date back to the late 1940s both in English from the Indo-Pakistani subcontinent and in Arabic from the Middle East. For understanding the strategic trends of Islamic banking and finance, it is important to look at its roots in the recent history, all of it is recent anyway! Writings on Islamic economics describe the Islamic economic system as a market system that abides by the Islamic legal code, the Shari'ah.¹ In the 1950s and early 1960s writings on interest-free banking within a mind frame implied by the Prohibition of interest culminated in the establishment of two Islamic banks far away from each other, in Egypt and Malaysia. In spite of the fact that these two experiments did not put a face of commercial banking, an Islamic commercial bank was established in Dubai, UAE in 1974 and an inter-governmental Islamic Bank started its functions in 1976 as the Islamic Development Bank.² The membership of the Islamic Development Bank stands now at 53 countries. With a few exceptions, Islamic Banks exist today in almost all Muslim countries from Indonesia to Guinea-Konakry. The Number of Islamic banks today have exceeded 200. And there is a number of financial institutions in North America, though small in size, that offer financing using

¹ The early writings are associated with the names of the founders of the contemporary Islamic movement, Maududi in India and Pakistan and Banna in Egypt followed by the famous book of Sayyid Qutb, Social Justice in Islam. Probably the first systemic work on the issue of interest by an economist was that of Anwar Qureshi, 1948, followed by Muhammad Uzair, 1955, and Muhammad Baqer Al Sadr, 1960.

² Actually, the first two Islamic banking experiences and the Islamic Development Bank are all development oriented to the extent that they have little interest in commercial banking. The Dubai I B was established and managed by a self-styled maritime businessman in a country whose banking laws were still in their infantary stage of development, this bank had then more concern about mechadise trading than about banking activities. This leaves full-fledge commercial Islamic banking to come along with the birth of the Islamic banks in Egypt, Jordan and Sudan in the late 1970's.

contractual format of what came to be known as the "Islamic modes of financing"

Two interrelated phenomena have accompanied the movement of Islamic banking and finance throughout the last four decades: the invention of new banking techniques and the rise of a new power alliance between Ulama and bankers. These phenomena are inherently related to each other because the invented banking techniques were a both a cause and an output of the alliance. They also shape the future trends of this movement for decades to come. This paper aims at shedding light on these two phenomena, their causes and their effects on formulating future trends and developments in Islamic banking and finance.

The points I intend to cover in the paper are:

- The formation of strategic alliance between Ulama and bankers, its implicit objectives and effects on future trends in the Profession of Islamic banking;
- Banking techniques Produced by the Alliance and introduced by Islamic Banks;
- Extrapolating present strategic elements into future developments of Islamic banks and the movement of Islamic banking and finance.

The Ulama/Bankers Strategic Alliance

It is interesting that first Pakistani writing on Islamic Banking came from a banking economist (Uzair) while the first Arabic writing came from a Shari'ah scholar (al Sadr). It is also interesting to note that the first two experiences in Islamic banking, in Egypt and Malaysia kept distance from Shari'ah scholars. It was therefore expected that the first two I B's, The Dibai IB and the IDB, did not pay much attention to establishing any shari'ah boards of their own.³

For two decades, from the early fifties to the early seventies of the past century, writings on the need for and possibility of creating interest-free banks were pouring onto the Muslim mind. These writings prepared the Muslim masses especially in the Middle East and South Asia to crave for Islamic banks and later to celebrate their founders as religious heroes. When full-scale

³ IDB still has no Shari'ah Board or Committee and the Dubai IB got a Shari'ah advisory Board only after its restructuring in 1999.

Islamic banks came out in Dubai and the IDB, they did not have any models of operation to follow. Probably because of the differences in the scope of their respective managements, the IDB took a direction of professional public-sector bankers/administrators while the Dubai IB took a busniss trading direction, both without much contacts with the class of Shari'ah scholars.

An Alliance Is Born

The formal systematic contact between bankers and Shari'ah scholars came during the almost concurrent preparation for the establishment of the Islamic banks in Egypt and Jordan in the second half of 1970's. Both banks required special exemptions from the banking laws and both needed to approach their respective governments, hence they used the Islamic Affairs Divisions of the government to lend them support. The birth of a new political alliance was actually witnessed when the Shari'ah members of preparatory committees became shari'ah Coucils/Boards of the newly founded banks. Both the Faisal Islamic Bank of Egypt (born 1976) and the Jordan Islamic Bank (1978) have their own formal Shari'ah advisers/counselors. This tradition continued with the establishment of the Sudanese Faisal Islamic Bank (1978), the Kuwaiti House of Finance (1979), and it went on with other Islamic banks throughout the Arab countries, Turkey, Bangladesh, Indonesia and more recently, the private sector's Islamic banks in Pakistan.

Unlike the government-enacted transformation of the whole banking sector in Pakistan in the mid 1980s, in Iran in the late 1980s and early 1990s, and later in Sudan in the mid 1990s that all used the already existing shari'ah scholarship establishment in their respective countires , the IB's in most Arab countries, West Africa, Malaysia, Indonesia, Turkey, and Bangladesh came as a result of private initiatives of a few visionary individuals like Prince Mohammad al-Faisal, Saleh Kamel both of Sausi Arabia, Ahmed al Yasin of Kuwait, Sa'id Lutah of UEA, Sami Hamoud of Jordan, and Abd al Halim Isma'il of Malaysia. These private initiatives were influenced at the beginning by intellectuals of the caliber of Ahmed al Najjar and Issa Abdu Ibrahim, both from Egypt. But what may be called the Islamic capitalists (if the term can loosely be used) found their true allies in the Shari'ah scholars rather than in the Islamic intellectuals. When Prince Muhammad al Faisal grabbed the idea of Islamic banking he was able to give it a momentum that has carried his stamp since 1976 with the Faisal Islamic Banks spreading from Pakistan to Guinea. Although he remained in close association with Ahmad al Najjar until the collapse of Faisal Islamic Bank

of Cypress in 1986 separated them forever, the Prince knew from the beginning that his relation with al Najjar does not buy him prospective clients not the government blessings that he needed for his Egypt's Faisal Islamic bank. At the same time he could not associate himself with the Muslim Brotherhood because of many reasons including the fact that such an association does not bring him closer to the business sector in Egypt or other Arab countries. The former Grand Mufti of Egypt made a perfect ally who could deliver acceptance and legitimacy without negative effects on the relation with the government and the prospects of issuance of a special law that the Prince needed President Sadat to do in order to permit the establishment and operation of the first (Faisal) Islamic Bank in the world.

At about the same time, discussion were going on to establish the Islamic Bank of Jordan between Sami Hamoud who needed both Islamic legitimacy and venture capital on the one hand, and the Ministry of Islamic Affairs and Awqaf and a few financiers spearheaded by Saleh kamel on the other hand. Shari'ah legitimacy was sought in the ranks of the Ministry of Awqaf and the General Office of Fatwa. Who else better than a former Grand Mufti of Jordan was to be recruited? A new strategic Alliance started to emerge between Ulama and businessmen-turned-bankers. This alliance continued to prosper and grow for the coming years till our day.

From the newly-made bankers' point of view, the Shari'ah scholars, unlike other Muslim intellectuals, have close contacts with average Muslim businessmen and income earners, from whom the clientele of Islamic banks is to be derived. Most Shari'ah scholars have more daily contacts with Muslim masses than both Muslim economic and finance intelligentsia and the activists of Islamic movement.⁴ Hence, the Shari'ah scholars were seen as able to pave the ground for the acceptance of these newly established banks and to gave them credibility and

⁴ It should be noted that except for Sudan and Turkey, the 20th century Islamic movement in almost all Muslim countries has always been on non-friendly terms with the Ulama. Since Hasan al Banna in Egypt and al Maududi in South Asia, the real raison d'etre of the Islamic movement has always been conceived in terms of the failure of Ulama in discharging of their responsibility in awakening the Ummah and educating it of the relevance of its religion to contemporary social and political life. At the same time the Islamic movement relations with governments have always been hectic. Al Banna declared in 1938 that a true test of righteousness of the Muslim Brotherhood would be found when a visible expression of hostility from stooge governments and a corrupt Ulama class exists; and al Maududi was more than once accused of apostasy by many traditional Pakistani Ulama.

legitimacy they direly needed. All that was in exchange of a declared commitment, on the part of bankers, to abide by the rules of Shari'ah not only regarding the prohibition of interest, that was practically the only issue around which Muslim professional intelligentsia hover for a long time, but also the detailed Fiqh of financial transactions related to sale, Ijarah or leasing, money exchange, debt contracts and other rules and principles that interfere with determining the Shari'ah compatibility of a given transaction. Noticeably, these details are usually known and decreed by the Shari'ah scholars (Fuqaha), while Islamic economists and finance professionals have usually little acquaintance with them.

The expansion of Islamic banking and finance has always been associated with the involvement of professional Shari'ah scholars. When the new species of International Islamic Investment Funds emerged in the mid 1990s, though managed by western bankers, brokers and houses of finance, they had to get Shari'ah scholars on board too in order to gain acceptance and legitimacy that are indispensable to win their depositors. The many seminars, meetings, conferences, and symposia that ensued since the mid 1970's in the four corners of the world have further enhanced this new alliance between Islamic bankers and Shari'ah scholars and developed mutually rewarding working relationships.

Furthermore, the role of Shari'ah scholars, essential as it is in the formation stage and in the public relation area, has always been restricted to an advisory capacity.⁵ Shari'ah boards did not participate in decision making and did not play a role in restricting the authority of the Boards of directors of the IB's. The management of IB's have at time passed decisions without consulting their Shari'ah advisers and subjected their Shari'ah advisers' opinions to tactics of delay and further review without risking the loss of public confidence. Under all such circumstance the boards of executive directors of the IB's remained behind the wheels, the management rests with them and they came to realize that the alliance with the Ulama serves their business objectives. On the other hand, all Islamic banks remains as a full-service financial intermediary

⁵ Some Islamic banks also charge their Shari'ah board with an arbitration responsibility in case of disputes with customers. This function is also part of the public relation role of the Ulama intended to assure the public that the bank abides by the Shari'ah rules.

institution that abides by the Islamic law as a code of transaction.⁶

Banking Techniques Introduced by the Alliance

Interest-free Islamic financing is derived from two Shari'ah axioms in the Fiqh of transactions: Balance between the obligations of the two parties in exchange contracts and the close tie to, or actual reflection of reality. Generally, bank financing is redefined in terms of real commodities. For the Islamic banks, financing is the provision of capital goods, inventory, consumer durables and to a limited extent services against payments at future maturity. This is what Islamic financing is all about. Islamic banks have little activities in the form of project equity financing on the basis of sharing returns, actually realized. When financing is done on the basis of sale or lease, the banker carries a risk associated with owning a good for a very short period of time. In both the cases, the play of the market forces determines the profit of the banker either directly as a rate of mark up or indirectly as a ratio of profit distribution between the financier and the beneficiary. Financing on the basis of profit/loss sharing is a kind of direct investment, in which the banker's attention is focused on the profitability of its investment.

Resource Mobilization

The Islamic banking approach to funds mobilization was suggested in the early literature on Islamic banking since the mid 1950's. That the IB receives funds on the basis of Mudarabah, if returns are to be expected or as loans if the principal is to be guaranteed was a matter settled more than a decade before the establishment of the first commercial IB. The implementation of the ideal of Mudarabah or investment deposits that sacrifices an important characteristic of time deposits, the guarantee of principal and fixed return was not

⁶ Some writers like to see in Islamic banks more than a financial institution. This is not true. For instance, in a 1997 paper, Timor Kuran said, "Islamic banking defies the separation between economics and religion. It invokes religious *authority* in a domain that modern civilization has secularized," [italic is mine]. A close look at the difference between Shari'ah, as a law, and religion indicates that Islamic banks are not religious organizations. They are civic institutions that elect to abide by the rules of Shari'ah. While their Shari'ah Boards have advisory capacity with no executive power in a manner similar to that of their legal advisors, the only *authority* exercised on Islamic banks is that of their boards of directors under the control of their respective central banks or monetary authorities.

easy for the IB personnel who have been trained in conventional banks.

Partners, not depositors

Yet, restructuring conventional time deposits in the form of investment deposits with an ex-post, de facto rate of return is an innovation in the banking industry. Here, the IB's upset the conventional wisdom. Could it be to a better wisdom? Perhaps, only God knows! Since the early practices of money exchangers that set the pace for European invention of banks, the relationship between depositors and bankers have always been structured as loans, guaranteed and sometimes secured. A wholesome part of the economic analysis is based of these loans and the loanability of funds! Interest, as a price determined at the time of the loan contract, is taken for granted, and treated as a cost of money in the banking profession. Islamic banking have drastically disturbed this wisdom and changed the nature of the contractual relations between the Islamic bankers and funds' owners. The new relationship is based on a partnership type of cooperation, in which cash is entrusted to bankers for investment and the returns are shared when and if they are materialized; as for the principals, they are not even guaranteed. Returns paid to owners of funds are de facto and ex-post, no assumptions or presumptions. Even the share of the bank as a Mudareb is also ex-post.

All types of earning deposits at Islamic banks follow this sharing principle, in the year 2000, a small Islamic bank went down and brought with it all the funds of its shareholders and investment depositors alike, in a substantial deviation from traditional practices. Under normal governmental fraud control, the sharing principle creates a performance incentive in bankers because their ability to mobilize resources becomes dependent on their actual performance in funds utilization. In commercial banks, the sharing principle makes resource mobilization a long-term function related to the accounting cycle in contrast with the short-term character of variations in interest rates when they are relied on in resource mobilization. It also reduces overnight deposits 'snatch out' by hastened changes in offered rates of interest.

The application of sharing on the deposits side also changes the attitude of management towards doubtful debts and other potential liabilities and losses that burden the bank's balance sheet. As shares of profit are distributed to depositors at the end of each accounting cycle, any attempt to cover up, hide, or brush aside potential liabilities would have a cumulative negative

effects on shareholders that take the form of implicit redistribution from shareholders to depositors.

One more change comes along at times of tight monetary policy by the central banks. Commercial Islamic banks can count on passing on the negative effect of such contractionary policies to their depositors or, at least, distributing it between the bank and depositors rather than carrying the burden of such policies all alone to an extent that may expose them to solvency.⁷

With regard to current accounts, the Alliance with Ulama strengthened the bankers' position and legitimized their stand in depriving owners of current accounts balances from any return. With help and support from allied Ulama, the IB's fell in the same trap of conventional banks with regard to their treatment of current accounts. Current accounts balances are considered loans on the bank in spite of the fact that certain percentage of them is actually invested and its return is reaped by the IB's shareholders. This is legitimized on the ground that current accounts' balances are guaranteed and therefore have no right to any share in the profit.⁸ Keeping in mind that shareholders' equity usually makes a small proportion of the bank's investable funds, this practice disproportionately boosts their return. This legitimization of the Shari'ah Boards, can easily be refuted on the ground that the percentage of shareholders' equities to the Islamic banks' assets is small to a level that renders useless any guarantee of

⁷ Most Islamic banks create an investment-risk reserve fund or provision to stabilize the actually distributed returns (profits) to investment-deposit holders. With the help of such funds, Islamic banks were practically able to stabilize the return on deposits from year to year. Furthermore, investment-risk funds were also utilized to support distributed profits in low-return times in order to maintain a competitive status of Islamic banks vis-a-vis interest-giving banks within the same market environment. This reserve fund is financed from the share of profit distributable to investment deposits.

⁸ There are voices, among non-allied Ulama that defend the owners of current accounts. For instance, the analysis of Hassan Abdulla al Amin to the effect that these accounts deserve a return was discarded by the allied Ulama. Al Amin argues that demand deposits cannot be considered loans because they lack the intention of lending and the contractual relation calls them deposits. Accordingly, demand deposits must be considered deposits in the Fiqhi terms, i. e., "Wadi'a" and the Rulings of Wadi'a must apply to them. He continues that these deposits are given for safeguard purposes and the bank uses them in its investment activities in violation of the Fiqhi rules of Wadi'a. This violation has two effects: it imposes a guarantee of principal on the user, and it gives the owner all the return that resulted from the utilization of the Wadi'a. Hassan Abdulla al Amin, al Wadai' al Masrafiyyah fi al Shari'a al Islamiyyah, Dar al Shuruq, Jeddah 1980.

such liabilities in case of a default,⁹ Additionally, the revealed preferences of current accounts' holders indicate a tendency to value withdrawal facilities more than return on their balances. If the IB's ease up the restrictions on withdrawal from investment deposits, current accounts holders would tend to change their minds and move their balances to Mudarabah.¹⁰

The use of Mudarabah and lending as foundation of the relationship between the IB's and their sources of funds created a theoretical confusion within the ranks of Islamic economic and banking analysis. On the basis of the Egyptian pioneering experiment of the 1960's and in an attempt to keep away from debt-producing finance, characteristic as it were to Riba financing, Islamic banking has been perceived as a profit sharing paradigm.¹¹ Two versions of this paradigm are theorized. A two-tier Mudarabah version that sees an Islamic bank as a simple financial intermediary whose only role is to channel venture capital from savers to businesses. The second version accommodates demand deposits. It is a two-window paradigm that allows demand deposits under 100% reserve conditions, side by side with the Mudarabah deposits that are to be channeled to businesses on Mudarabah basis too. From the point of view of this perception, Islamic banks failed their theory and paradigm and went astray in the fold of mainstream banking because they failed to maintain a Mudarabah-based financing.¹²

Funds Utilization

In the real world, all Islamic banks have drifted away from the basic feature of the prescribed paradigm! The main financing mode they use is Murabahah not Mudarabah. The Alliance with Ulama was in a sense the savior of Islamic banks from this perception that dominates the western-educated Islamic intelligentsia. Ulama were able to provide the IB's with a legitimacy

⁹ Monzer Kahf, "Profit Distribution in Islamic Banks". Review of Islamic Economics Studies, Vol. 3, No. 2, 1996, pp. 113-140 (Arabic).

¹⁰ Islamic banks usually impose restrictive measures on investment deposits, Faisal Islamic Bank of Egypt is the only IB that allows withdrawal from Investment deposits on a 24 hour notice. As a result, its balance sheet shows low balances on its current accounts and high investment accounts. This is in contrast with all other Islamic banks.

¹¹ Mohsen Khan and Abbas Mirakhor, "Monetary Management in an Islamic Economy" in Journal of Islamic Banking and Finance, V.10, July to September, 1993, and Mohammad Anwar, Modelling Interest-Free Economy, the International Institute of Islamic Thought, Herndon, Va, 1997.

¹² Abbas Mirakhor, "Progress and Challenges of Islamic Banking", Review of Islamic Economics. V.4, No.2, 1997, pp. 1-11.

umbrella that allowed them to face the challenge of this intelligentsia. This can be considered an area of success and great achievement of the alliance between the Ulama, as Shari'ah boards members, and the bankers, especially if we notice that both the IDB and the Dubai IB had to wait until this alliance was born to be able to come out of the shell of idleness and use their funds in a rewarding manner. The early writing didn't provide sufficient clues for funds placement. It was the strong argument of Sami Homoud since 1976 that carried the IB's Shari'ah board to a new level of modes of financing, while the early writings as well as the experiences of Egypt and Malaysia have concentrated on direct investment under the terms of Musharakah and Mudarabah.¹³

Commodity Financing

Financing commodity production and exchange is the undisputed most remarkable contribution of the banking system. The role of bankers in economic growth of the United States, especially the expansion to the West, and of Europe and Japan is apparent. Even in developing countries, like Egypt, the initiatives of its early bankers, during the second quarter of the twentieth century in financing commodity production and exchange are outstanding. Somehow bankers lost that original focus. Rescheduling, debt discounting and finance wholesale have become the essential features of the banking sector. Islamic modes bring financing back in line with commodity production and exchange. They bridge the gap between the financial and the real markets. As Islamic banks restrict their financing to the three modes or principles of sale, lease and equity, Islamic financing becomes available only to help in the creation or exchange of real goods and services, i.e. it has a one to one relationship with the real goods market.¹⁴

¹³ The early writings on Islamic banking envisions the IB's to provide funds on the basis of Mudharabah. This turned out to be demanding on the IB's personnel as it requires knowledge in project evaluation, market forecasting, etc. in addition to a different type of follow up with the beneficiaries of finance. It is interesting to note that even the theoretical writings have never made any reference to *Murabahah* until Sami Hamoud's dissertation that was published in 1976. As for the *Ijarah* (leasing) and especially *Ijarah wa Iqtina'* (purchase/leasing) it only entered the theory of Islamic banking in the 1990s. (See Monzer Kahf, *al Ijarah al Muntahiyah bi al Tamlik* [lease leading to ownership] presented to the 12th annual meeting of the OIC Fiqh Academy, held in Riyadh September 22-28, 2000.

¹⁴ It has been the practice of Islamic bank to finance less than 100% of a transaction and to leave certain percentage to be financed by

Additionally, Islamic financing upsets the conventional rule of thumb of micro finance that 'shareholders equity is used to finance fixed assets and bank credit should finance current expenses, payroll and inventory.' Except in very rare cases, the IB's do not finance payroll and current expenses because the Islamic modes require a commodity base, a delivery before you resell. Customers of Islamic banks can rely on bankers to finance capital goods and inventories of inputs and intermediate and final goods but can hardly hope to finance labor compensation. The IB's finance such economic activities as: (1) the establishment of new productive projects, (2) purchase of producer/consumer goods, or, (3) lease of productive machinery, equipment, housing and consumer durables.

The Islamic banking restriction of finance to commodity production and exchange is deep rooted in the Shari'ah. Shari'ah specifically excludes two main categories of conventional financing from its profit-seeking finance: (a) general purpose financing that aims at simply supplementing government and/or corporate budgets, whether for seasonal or non-seasonal purposes. This financing is normally dependent on the trustworthiness of the beneficiary; and (b) rescheduling finance in all its forms that include changing maturity of debts or changing their final owners. These two categories are left in Shari'ah to a task of the philanthropic finance only as the Qur'an (2: 280) and the Sunnah indicate.

The establishment of a strict tie between financing and the processes of commodity production and circulation not only upsets the conventional wisdom of corporate finance but also imposes a tap on the size of financing as it makes it tailor-cut to the size of production and exchange. This works in the direction of eliminating "parasitic" financing that aims at servicing already existing debt. Needless to say, the financing layers that burden the real markets in interest-based economies have to be reduced if not totally abolished, if the Islamic modes of financing find their way to become the backbone of mainstream banking.

Beyond the elimination of interest

While the attention of the Islamic economic and finance intelligentsia was centered on the elimination of interest, the alliance between bankers and Ulama was able to shape the IB's not only as interest-free financial

the customer under what they call "the margin of serious commitment."

intermediaries, but as intermediaries of ethical standards too. The alliance of Ulama and bankers defined an Islamic bank as one that abides by all the Shari'ah rulings and the IB's introduced a new dimension in the practice of the banking profession that is the inclusion of a **moral criterion in the process of investment selection.**¹⁵ Good bankers are always conceived as moneymakers who have commitment only to the ethics of their profession. The latter normally relate to trust worthiness and fair play. 'Islamic' banks have to stand to the characteristics they choose for themselves by formal and genuine adherence to the Islamic values in investment. Since Shari'ah has a few other prohibitions besides that of the Riba, abiding by the Shari'ah-defined moral standards in investment becomes tantamount to being 'Islamic.' Islamic banks are bankers who do not finance any commodities/services that are condemned in Shari'ah. Thus, financing of tobacco, gambling, casinos, drugs, alcohol, weaponry, environmentally harmful products, etc. are excluded from the working map of IB's.¹⁶

Are Islamic Banks Bankers or Traders?

The alliance of Ulama and bankers failed to emphasize specialization in Islamic banking. As a result, two operational approaches have characterized commercial IB's since the birth of the first commercial IB's in late 1970's. An approach to Islamic banking operations as a mere financial intermediary function in which the bank

¹⁵ The moral commitment of Islamic bank is intrinsic because the Shari'ah rulings are always morally loaded. On the other hand, during the period of struggle against apartheid in South Africa, several voices started calling for boycutting the oppressors. This culminated in a movement to include moral criteria in investment. While all Islamic banks are by definition morally committed, only a few other bankers apply self-stylized moral standards.

¹⁶ This must bring the issue of financing terrorism. The history of IB's and of their main shareholders and management staff indicate that they cannot accommodate terrorists or terrorism financing. Unfortunately, our government did not offer any evidence that connect any Islamic bank to financing terrorism and the action it is taking against some Islamic banks and their ceo's and managers has no legal or moral grounds. Unfortunately once more, there are elements in our government who do not like the Islamic banks and do not Islam and Arabs, who were able in the vagueness of the aftermath of 9/11, to make their political views accepted in the files and ranks of decision making in the American government. It is a very grave mistake to attack Islam, the Islamic way of life and Arab culture under the excuse of fighting terrorism and drying their sources of finance. It is also a grave mistake to give a political definition to terrorism that includes those who fight for the liberation of their lands from occupation and foreign/alien rules.

does not take any business initiative and acts only on the requests and initiatives of its customers. This approach is exemplified in the behavior of the Islamic Bank of Jordan, the Faisal Group of banks and most other Islamic banks. According to this approach, a financing transaction must always begin from the user of funds. Alternatively, the Kuwait finance House promotes a business approach. In addition to financial intermediation, this approach allows the IB's to open show rooms, maintain warehouses and buy goods that the bank offers to customers on a mark up (Murabahah) basis. This approach is equally supported by most of the allied Ulama who call on the IB's to compete in the goods market. Inadvertently, the special laws and decrees, that established Islamic banks in Kuwait, Egypt, Sudan, Jordan and probably all other countries that issued acts for specific IB's, seem to permit Islamic banks to buy and sell goods without restricting them to an intermediary financing role only. This approach is a cause of annoyance to both Central banks and the Muslim economic and finance intelligentsia. This unease became apparent especially when the Kuwait central bank started exercising its formal control on the KFH and resulted in stalling the proposed act of Islamic banking in Kuwait because of the strong opposition of the supporters of the KFH.

Strategic Trends of the New Alliance

The strategic alliance between Ulama and Islamic "Bourgeois" creates a new power structure in the socio-political arena in the Muslim countries that affects both the short-run struggle for economic and political influence and the long-run weaving of the Islamic finance and banking movement.

The Benefits of the Strategic Alliance

Several factors contribute to bringing a segment of the Muslim rich and Ulama into alliance. On the part of the Muslim Bourgeois and bankers, their alliance with the Ulama afford them several benefits. First, it is the best reach out tool to Muslim masses to convince them to deal with the new banks. This is especially important if we keep in mind the long history of suspicion and apprehension Muslims usually maintain towards the entire banking sector, foreign and national including central banking authorities, the often secularist media where the new Islamic banks advertise and generally toward their own governments that license such banks. Second, the new alliance is also used as leverage for breaking new

grounds of clientele, those people who did not use the facilities of the banking system in the past because it relies on the forbidden interest. This alliance is also used in competing with the conventional banks and attempting to attract a good proportion of their depositors and finance users. A study conducted in the mid 1990s by the Department of Islamic Financing Services in the National Commercial Bank of Saudi Arabia indicates that more than a third of the clients of a conventional branch would be willing to shift to the Islamic financial services once they are convinced they are 'truly Islamic'.¹⁷ Third, this alliance is also used for public relations, something the new bankers very much need especially in asserting their new stands, and argument toward the governments, the media, and the central bank. as well as in their competition with conventional banks.¹⁸ Fourth, the alliance creates a kind of buffer used in support of the main shareholders and professional managers of Islamic banks, who are usually drawn from conventional banks, in their dialogue with depositors, dormant shareholders, and users of finance. Further, Shari'ah boards are also used by bankers to bail them out

¹⁷ Sa'id al Murtan, "Transformation to Islamic Banking: the Experience of the NCB" paper presented at the Seminar on Islamic Banking, Casablanca, April 1999.

¹⁸ While Islamic banks received considerable image boost from the Ulama, the so-called "Islamic investment companies" found it irrelevant to hire any Shari'ah advisers. These companies draw their clientele from two categories of people: those who could be reached by direct and indirect (through words of mouth) personal contacts and those who have overwhelming lust for quick windfall profit to the extent that creates a blinding effect regarding potential risks. The earliest of such companies popped up in Saudi Arabia in the mid 1970s and it ended wiping up the savings of a large number of people while its owner/founder rests in a jail in Makkah. The same experience was repeated in Egypt, and on a smaller scale in Syria, in the late 1980s. Abusing loopholes in the laws, several companies were established in Egypt under the name of Islamic investment companies. They were able to collect huge savings from the public and their main practice was to distribute high rate of return, actually taken from new deposits. They mainly counted on the pyramidal cumulative effect of new deposits, with very little actual investment. In spite of the fact that Islamic Banks and their associated Ulama as well as most Academic Islamic economists and financiers took very strong stands against these companies, a few outspoken Egyptian Islamic Activists allied with them and strongly defended them and attacked what they called "the government conspiracy against the Islamic investment companies." The point to be made here is that the lack of support of Ulama did not lend these 'Islamic' investment companies public acceptance and consequently had a negative influence on them while the alliance with Islamic activists did not help compensate for the absence of Ulama!

vis-a-vis the depositors and shareholders as can be seen from the Shari'ah board report of 1998 of Bank al Taqwa.¹⁹

From the point of view of the Ulama, this new alliance brings them back to the forefront of the political scene at a time they needed this boost very much especially that most of them were left on the side by the rising Islamic political movement.²⁰ The new alliance gives them a sense of achievement. With this new role they are actually working to fulfill the implications of the Islamic Fiqh they've been teaching all their lives. It improves their image among Muslim masses. It is, in a sense, a fulfillment of their life-long preaching to abide by the Islamic teachings in business transactions. This alliance also gives the Ulama a new source of income and a window to a new lifestyle that includes air travel, sometimes in private jets, staying in five-star hotels, being under the focus of media attention, providing their opinions to people of

¹⁹ The bank management flopped down in 1998. The bank's report at the end of the year showed a loss of over 23% of the principal to both Mudarabah depositors and shareholders. The Shari'ah board exceeded its usual limit of authority in checking violations of Shari'ah and reporting that 'the management did not violate the Shari'ah rules' and went as far as stating that the board of directors and the management did the best and soundest finance and investment decisions and the loss was only a result of the South-East Asian crisis as claimed by the management itself in its end of the year report. The fact was revealed in the year 2000 in a letter from the management indirectly indicating that in a breach of established banking rules and wisdom, the management put most of its eggs in one basket, by investing in one single project more than 60% of the bank's assets!

²⁰ It is worth our attention to note that In the Islamic history Ulama played leading and very critical roles in advising rulers and defending the general public against the rulers' atrocities and sometimes against outside aggression. The Islamic History is full of examples like Ibn Hanbal, al Nawawi, Ibn 'Abd al Salam, Ibn Taymiyyah, etc. In the past the Awqaf was the main source of finance for education, Islamic as well as secular. Starting from the days of Muhammad Ali in Egypt, the control on Awqaf was transferred to the government. The Awqaf Act of 1856 in the Ottoman Empire extended the government authority to Awqaf and made the Ulama government employees. That made them lose their independent source of finance and virtually the leadership status. Gradually they took a position on the peripheries of the political stage. Although the European invasion of the most of the Muslim land caused revolutionary reactions that were led in several instances by Ulama, the majority of them remained invisible in forgotten corners. The 20th century Islamic movement was in part a reaction to this dormancy, but it took a turn in the 1940's and 1950's when it presented itself as a substitute of existing regimes and rulers instead of being a substitute of Ulama. This is in contrast with the Islamic middle Ages' Ulama who did not pose threats to their rulers.

high social and economic ranks, who come running for listening, being commissioned to undertake paid-for Fiqh research and to find new solutions to Fiqhi problems the new breed of bankers face, etc. Alliance with bankers also gives the Ulama new stands in the social hierarchy, usually higher than they were used to. In some Islamic banks, Shari'ah scholars reached positions like vice presidents, even we find a Shari'ah scholar who serves as a deputy governor of the central bank.²¹ Bringing the Ulama back under the main lights of vividness in the Muslim society was itself a great achievement for them and a great fulfillment of their aspirations. They, in fact, became celebrities in their respective countries, and even outside their borders.

Trends of Islamic Finance and Banking

This new alliance resulted in creating new strategic trends that affect the Islamic banking industry, the Ulama and the Muslim society as a whole. Additionally the expansion of Islamic banks and their modes of financing played a very important ice breaking role that points to important future trends in finance and banking. It proved: *It can be done*. No surprise that Islamic banks were able to maintain a rate of growth of more than ten percent over a three decades period.

First: The alliance of Ulama and bankers enhances the **engineering of new financing modes**. At the beginning, there was only one financing mode, Mudarabah. The discovery-cum-introduction of Murabahah enabled Islamic banks to finance imports and domestic trade, Murabahah actually gave momentum for the establishment of commercial Islamic banks. Ijarah to the purchase orderer was invented by the Ulama/bankers alliance. Salam and parallel Salam were also added to be used in financing agriculture and light industries. Even the "conservative" IDB, that restricted its financing to Musharakah and Murabahah for many years, went on the wagon of financial engineering and added Ijarah to the purchase orderer and later developed its own financial contract of a three parties' Istisna'-and-Parallel-Istisna' to become the IDB new and main contract of financing development projects. The development of new financing contracts never ends and the coalition between Ulama and bankers continues to introduce new modes of financing that include: swap sale of a bundle of investments consisting of debts and real assets as a form of secondary market financing contract, combination of deferred-payment sale with cash sale to

²¹ Both stories come from the Sudan's Bank al Tadamun and The Central Bank.

provide liquidity financing and to substitute interest-based debts. The cooperation of Ulama and bankers reach the public debt market and was able to develop short-term and long-term public financing instruments in Sudan and Iran with the help and blessing of the IMF. Most of the new modes of Islamic finance have gained acceptance world-wide and exceeded the boundaries of Islamic banks toward the mainstream banking.

Second: The **expansion of Islamic** banks led many profit seekers to enter this new market. This has become an added element to further expansion of Islamic banking. The Ulama have actually delivered the needed public acceptance and Islamic banking has become known to the general public in the majority of Muslim countries. Islamic banks have been growing by expanding their equities, deposits, assets and investment and by adding new banks along the way. Over the period of 1990-1997 the assets of twelve major Islamic banks grew at a rate of 8.2%, their deposits grew at 7.9% and their equities at 9.0%, in contrast with 5.6, 4.9 and 5.6% for twelve conventional banks of similar size from the same countries. Moreover the total investment of these twelve IB's grew at 9.6% compared with 3.3% for conventional banks during the same period.²² Additionally, scores of new Islamic banks were created and/or converted from the conventional banking practices especially in Indonesia, Bangladesh, Saudi Arabia, Bahrain and Qatar. Hence, it is safe to take a 10% as a conservative rate of growth of the Islamic banking industry that was sustained over the past three decades.²³

Third: The bankers/ Ulama alliance enhances the **Shari'ah research**. The IB's have a stake in promoting Shari'ah research in the financial area. According to the late Sheikh Mustafa al Zarka, Fiqhi research preceded other areas of Islamic studies in its revival since the beginning of the 20th century. Perhaps one can say that the last 3 decades of the century have a lot more of Fiqh research in the financial and economic areas than in any other field. Although there are no statistical data to substantiate this trend at the level of scholarly publications and Ph.D's and Masters' dissertations, a glimpse at the OIC Fiqh Academy for the first thirteen

²² Munawar Iqbal, "Islamic and conventional banking in the nineties: a comparative study," Islamic Economic Studies, No. 2, V 8, Muharram 1422H, pp 1-27.

²³ Directories of Islamic banks over the past few years, and Fuad A. Al-Omar, "Future of Islamic Banks under the Globalization of Economies" (in Arabic), paper presented at a workshop on "Islamic Banking and Financing Facing the 21st Century", Bahrain, Nov. 10, 1997.

years of its activities, 1985-1997 tells the whole story. Out of 97 resolutions it adopted 51 relate to financial and economic issues.²⁴ A percentage that fairly reflects all Fiqhi research in the last quarter of the twentieth century, especially when we take into account that several specialized seminars and workshops are held every year on the sponsorship and initiative of the IB's. Furthermore, the new alliance helps modernize Fiqhi opinions and rulings. It helps addressing contemporary transactions from a Shari'ah point of view. Since it has always been the contention of Ulama that not only interest is prohibited, Islamicity of a Bank meant submitting all its contracts, transactions and manuals to the Shari'ah Bords for clearance. This required that Fuqaha sit with bankers, financiers and economists to learn the details of every single transaction and to get acquainted with new terminology, procedures, and methods for the sake of developing Fiqhi opinions on these issues that are new for Fuqaha. Modernization of research in Fiqh has been taking a long journey from letters of credit, guarantee and acceptance to foreign exchange hedging, syndicated financing, investment swaps, time sharing, etc. An ever expanding long list of new issues is daily put on the desks of Shari'ah boards and subjected to Shari'ah securitization in seminars, workshops and conferences called for by and held under the auspices of Islamic bankers.

Fourth: The alliance of the Ulama and the IB's contributes to increasing **social and economic coherence** in the Muslim societies, through schemes that end with the finance beneficiaris become owners of their productive assets such as financing programs addressed to small craftsmen, taxi drivers, house financing schemes and micro financing programs. The Ulama normally encourage and support such programs. In Sudan for instance, the Islamic Bank of Sudan-West set a successful program for small farmers and craftsmen financing. This was followed by a similar program to finance micro industries by the Sudanese Faisal Islamic Bank.²⁵ In Jordan, the Islamic Jordan Bank takes pride of a successful scheme to help Taxi drivers become owners on a declining Musharakah mode of finance. Also the Arafah Islamic Bank and the Islamic Bank of Bangladesh have

²⁴ The remaining 46 are distributed as follows: 20 medical, 11 administrative, 14 miscellaneous and one on quires from the American Muslim community on about 30 issues, many of them are financial.

²⁵ Othman Babikr, Financing micro industries, the experience of the Sudanese Faisal Islamic Bank, IRTI, Jeddah 19997.

their own Micro-financing Programs that, although smaller in size in comparison with Gramin Bank, takes pride too in declaring much lower charge to the beneficiaries than the more than 22% per annum interest charged by Gramin Bank to poor finance users.²⁶ In my studies of Islamic banking and finance, I did not come across any statistical analysis of the I B's finance beneficiaries on the basis of the amount provided and the business size of recipients and I think such a study will be very useful. But from my repeated visits to many Islamic banks, reading their reports and chatting with their officers and from the general information about the size and distribution of the credit markets and the share of Islamic banks in the respective markets in countries like Turkey, Bangladesh, Sudan, Jordan, Tunisia, and Algeria, it is fair to expect that most of the Islamic banks' financing is channeled to middle and small sized entrepreneurs. I know from personal contacts and observation that in five of the six Islamic banks established in Sudan before the "Salvation Coup" of 1989 financing has been instrumental in creating a new and rising class of non-traditional businessmen.²⁷

This new alliance also resulted in bringing together, on common ground of Islamic banking and finance, some of the important segments of the rich strata in the Muslim societies (bankers and big businesses) and middle class people (lawyers, economists, depositors, bureaucrats, and small entrepreneurs who use a lot of the banks' financing) and even the poor and the economically unfortunate,²⁸ who benefit from the fringe activity of many Islamic banks, especially the

²⁶ Reports of the 1998 and 1999 of the three banks named in the text.

²⁷ Actually two more Islamic banks were established in 1988/89, The Islamic Bank of Sudan-North and the Bank of Workers, but they both didn't have much activities before the coup. It should be noted however that a few Islamic banks restrict a considerable part of their financing to closed circles of main shareholders and their partners and associates. This is noticed especially in one Islamic bank in Sudan and one in Saudi Arabia.

²⁸ Most Ulama come from the poor class anyway. This is because of the structure of the education system in the Muslim countries. With the introduction of the western education system and its emphasis on learning science for career and employment, both financial resources of the traditional Islamic education and the job opportunities open for its graduates became very thin. Since the beginning of the twentieth century, Shari'ah teaching became the monopoly of poor children whose parents cannot afford sending them to public or private schools, as most Shari'ah schools provide meager boarding facilities subsidized by charities and the remnants of Awqaf.

distribution of Zakah.²⁹The social and political impact of this rapprochement is yet to be fully studied, but it has become normal for many poor and middle class people to defend and befriend Islamic bankers and their activities even in very a poor country like Yemen.

Fifth: the alliance creates an atmosphere of **fresh political rapprochement** between the Islamic movement and governments in the Muslim, especially Arab countries. Keeping in mind that capital is coward and does not like to enter in adversaries with governments especially in non-democratic systems that prevail in almost all the Muslim countries, IB's have always been very sensitive in selecting a type of Ulama that is acceptable to both governments on the one hand and general masses on the other hand. They were particular in avoiding extremists on both sides. They did not ally themselves with the so-called government-cheering Ulama, because that would make them loose credibility in the eyes of their expected or potential public. Yet, at the same time, they avoided those Ulama who are known as spokesmen of, or deeply allied with the Islamic movement in order to avoid creating adversities with their mostly dictatorial and unpredictable governments. Ever since the establishment of the first Islamic bank in Dubai, Islamic bankers relied on some kind of working relationship with the governments as if they've learned well the lesson of the Meet Ghamr experience. All other IB's followed suit in either entering into some kind of partnership with their respective governments or keeping friendly contact with the authorities while avoiding any relations that may annoy the ruling class on employment level as well as on business level. Depending on the type of government of the host country, the Islamic banks' policies of selecting members of the boards of directors and main officers varied from keeping strict association with professional technocrats to presenting persons of known lack of commitment to Islamic teaching.³⁰ At the same time, Islamic bankers did not shy from utilizing the

²⁹ Most Islamic banks take charge of distributing the Zakah due on shareholders' equity, and some of them obtained the consent of their depositors to deduct and distribute their Zakah. This allowed some of the IB to create sizable Zakah distribution departments that keep relations with the poor and needy and with other local charitable agencies. This is very evident in the Social Naser Bank and the Faisal Islamic Bank of Egypt and the Kuwait Finance House.

³⁰ Although there is no statistical data to substantiate this claim, a close look at the lists of CEOs of Dar al Mal's central office and affiliated banks and al Barakah Group's banks especially in Tunisia, Algeria, Mauritania, and Bangladesh support it.

services of "moderate" Islamic movement activists as long as the latter do not disturb the banks' tranquility with governments, especially that these moderates have always maintained good relations with the IB's type Ulama. Hence many moderate activists have been finding peaceful havens in the Islamic banks, especially in Egypt, Jordan, Bangladesh, and Indonesia.

The alliance and the rise of IB's actually helps, among several other factors, in the emergence of non-hostile relationships between the moderate slice of the Islamic movement, mainly professional technocrats and open-minded Ulama on the one hand and their respective governments on the other hand. This is of special importance, as it comes at a time when many elements within the Arab Islamic movements were calling for revising the movement's positions on relations with governments and on strategies of political change. Those reconciliatory reformists who abandoned the decades-long official banner of Sayyid Qutb "Take Islam all together or leave it" for a stage-wise implementation of Shari'ah, or gradual Islamization without attaching much of value to the theorem that it all starts with changing the political system. Many of the reconciliatory reformists are absorbed in IB's and under the banner of allied Ulama without antagonizing their governments. In a sense, this alliance helps reformulate the power structure and its distribution in these countries. If we take exception of Sudan, Turkey, Pakistan, and Iran, Islamic banks in other Muslim countries helps changing the map of socio political power and bringing about a form of new power center, though still small, that consists of a segment of the Ulama, those who are involved in Islamization of the economic, financial, and banking transactions both on the research side as well as on the application side, a substantial slash of the Islamic movement, a new and rising Islamic rich class of bankers, entrepreneurs, and executives, and a good portion of the non-antagonistic (to the Islamists) secularist intelligentsia who are associated as professionals and bureaucrats.³¹

The Future of Islamic Banking and Finance

Islamic banking is a movement of development and renovation in banking profession and practices. By their

³¹ We have to keep in mind that Islamic banks-cum-Ulama have different trends in a few 'special case' areas. The economic-political scenes in Sudan, Turkey, Pakistan and Iran have their own peculiarities that affected the shape and products of the alliance of Ulama/bankers, especially with regards to interaction with the Islamic movement. Analysis of these special cases is outside the limits of the present paper.

very existence, the IB's exemplify a practical potentiality and empirical success of the idea of a banking system that is morally friendly, depositors' responsive and at the same time related to the actuality of the real market of production and exchange. In other words, the Islamic banking ideals fit nicely within the theoretical framework of mainstream banking rather than an alternative Paradigm.

There is a tradition in the literature on Islamic banking and economics to perceive Islamic banking as a profit sharing paradigm.³² Two versions of this paradigm are theorized. A two-tier Mudharabah version that sees an Islamic bank as a venture capital simple financial intermediary; and a two-window that allows demand deposits under 100% reserve conditions. In reality all Islamic banks have turned away from the basic feature of this preconceived paradigm! The main financing mode they use is Murabahah not Mudharabah. From the point of view of this perception, Islamic banks failed their theory and paradigm and went astray in the fold of mainstream banking.³³ According to this approach the major challenge faced by IB's is to come back to their resumed paradigm. The Alliance with Ulama was in a sense the savior of Islamic banks from this perception that dominated the western-educated Islamic intelligentsia. Ulama were able to provide Islamic banks with a legitimacy umbrella that allowed them to face the challenge of our intelligentsia.

The real challenges to the IB's arise from liberalization, deregulation, and globalization of the financial services; all are coming with the expansion of the WTO. This will open the economies of the Muslim countries to giant financial institutions that have stronger muscles, higher efficiency and more endurance to adversities than the new, small and fragmented Islamic banks. On theoretical grounds functional liberalization of the banking activities must serve the objectives of Islamic banks since deregulation allows more flexibility to accommodate new relationships in fund mobilization and utilization. While functional liberation accommodates the new 'Islamic' modes of financing it avails conventional banks the opportunity to compete for the 'Islamic' business, as deposits as well as placement opportunities.

³² Mohsen Khan and Abbas Mirakhor, "Monetary Management in an Islamic Economy" in *Journal of Islamic Banking and Finance*, V.10, July to September, 1993, and Mohammad Anwar, Modelling Interest-Free Economy, the International Institute of Islamic Thought, Herndon, Va, 1997.

³³ Abbas Mirakhor, "Progress and Challenges of Islamic Banking", *Review of Islamic Economics*. V.4, No.2, 1997, pp. 1-11.

While the banking industry is witnessing a strong trend of integration, Islamic banks continue to be small and fragmented and rest on a presumed privilege of captive clientele. In spite of a rate of growth of equity that reached 9% over the past decade, the average capital of an IB is still less than US\$ million 50 and the average total assets is less than US\$ m 900.³⁴ Over the last five years, two more Islamic banks were created in each of Bahrain, Bangladesh and United Arab Emirates. There was one conversion from conventional to Islamic banking in Saudi Arabia, and one merger of two small IB's and an Islamic investment company in Bahrain. At the same time a mega bank like the HSBC is expanding its Islamic finance operations and several American banks are considering going into the "Islamic market" within and without the USA. We must also remember that IB's have an edge over conventional banks that offer Islamic financing. Commercial Islamic banks can count on passing on the negative effect of contraction in monetary policy to their depositors or, at least, distributing it between the bank and depositors rather than carrying the burden all alone to an extent that may expose them to solvency.³⁵ Because of their small size the IB's are not able to enjoy the advantages of economies of scale. They also lack, or have limited accessibility to efficient technology and suffer a handful of other technical, organizational and managerial problems. To mention only a few: Islamic banks suffer from lack of standardization of Shari'ah opinions, low level of know-how on the part of both management and personnel, inadequate and sometimes dysfunctional supervisory standards, both internally and

34 Directory of Islamic Banks and Financial Institutions, 1996, The International Association of Islamic Banks, Jeddah, Saudi Arabia, (the 1996 is the last report published by the IAIB, it is closed now). It should be noted that 92 of the reported 166 IB's had a capital of no more than \$m 10 and only 17 had a capital of \$m 100 or more, of them 9 are state owned Iranian banks. Same is also true for the average total assets, although average total assets is US\$ Million 826, only 23 banks have assets of more than one billion of them 10 are Iranian, (numbers are inflated because of the use of official rate of exchange in transforming data from Iranian Rial to US\$); and there are 85 IB's with assets of less than US\$ Million 100.

35 Most Islamic banks create an investment-risk reserve fund or provision to stabilize the actually distributed returns (profits) to investment-deposit holders. With the help of such funds, Islamic banks were practically able to stabilize the return on deposits from year to year. Furthermore, investment-risk funds were also utilized to support distributed profits in low-return times in order to maintain a competitive status of Islamic banks vis-a-vis interest-giving banks within the same market environment. This reserve fund is financed from the share of profit distributable to investment deposits.

externally by the central banks, lack of creativity in marketing, and inadequate sensitivity to customer satisfaction.

It is very critical for Islamic banks to merge together, integrate and increase their capital and efficiency performance on the level of attracting more resources and mobilizing more investment projects. Merger between Islamic banks is not only desired, it is a must if these banks want to live in the era of mega-banks. Dwarf banks will only be outlived. If Islamic banks want to reach the open seas of international markets, they better prepare themselves with adequate size, adequate capital, and a reasonable reach for deposits and assets-creating power. Merger and expansion are the first necessity for the survival of Islamic banks, especially that the clientele of Islamic banks is no more monopolized and they outgrew their captivity. Potential resources are already viewing alternative channels in Islamic investment funds and many Islamic banking operations, windows and branches, run outside the IB's both at the international level and in the homes of today's Islamic banks.

Since the opinions on many financial transactions in the Islamic Shari'ah are not technically codified, Shari'ah Boards of various IB's very often do not see same questions from the same angles, and offer advises of varying degrees of differences.³⁶ There still are hazy areas that create differences among Shari'ah experts themselves, especially when it comes to dealing with an ever-pouring stream of new banking products.³⁷ There is a need for standardization of Islamic banking at all levels of operation. Starting with the *raison d'être* of Islamic banks, i.e., the Shari'ah codification of banking transactions. This can be achieved by forming a common platform of Shari'ah-accepted regulations instead of the different independent Shari'ah Boards that produce different opinions. There is also a need for the standardization of reports, balance sheets and other financial statements. There is a need for standardization of manuals and definitions of different transactions as well as methods of accounting. In this regard, the Board

³⁶ For instance, some Shari'ah Boards asks the Management to submit each individual contract to Shari'ah scrutiny, while others restrict their interference to studying the standardized banks' contracts.

³⁷ The self-closing of Al-Barakah Bank in London was partially caused by its inability to make the relationship between the Bank Management and its Advisory Shari'ah Board sufficiently clear to the Bank of England.

of Accounting and Auditing of Islamic Financial Institutions, established in Bahrain in late 1980's, needs to work harder and faster and to increase its acceptability to cover all Islamic banks. Standardization of Islamic banks' transactions will not only improve public understanding and reading of these institutions, it will also helps spread Islamic banking practices both geographically and functionally, and increase the ability of Islamic banking institutions to offer more services. This will improve the application of the idea of the Islamic financing itself.

Another technical problem, the IB's suffer from, arises from insufficient training of Islamic banks' personnel. The process of establishing Islamic banks and their growth happened to be a lot faster than allowing them to adequately train their personnel and fully acquaint them with their new techniques. Islamic banks had to derive their employees from conventional banks without giving them adequate training, as most of the third world corporation do not believe in training. This causes problems in understanding Shari'ah rulings and in advising bank's customers on the characteristics of different types of the new Islamic modes of financing and deposit contracts and more often than not in applying interest-based techniques on Islamic bank/customer relationships and services, etc. The personnel problem also intensified the lack of creativity in IB's. Although Islamic banks were able to grow at a rate that exceeded 10% annually over the past three decades,³⁸ this growth was accompanied by little innovations in terms of the banking services and reach out to their public.

The IB's perform poorly in the area of exercising creative efforts to mobilize resources and direct them toward new investments. Customer satisfaction does not usually have high priority in Islamic banks because they do not feel the pinch of competition.³⁹ As most Islamic banks work unrivalled in their respective economies, they tend to rely on their own "committed" clientele.⁴⁰ One

³⁸ The Annual Directories of Islamic banks over the past few years, and Fuad A. Al-Omar, "Future of Islamic Banks under the Globalization of Economies" (in Arabic), paper presented at a workshop on "Islamic Banking and Financing Facing the 21st Century", Bahrain, Nov. 10, 1997.

³⁹ An exception may be in Bahrain where three full-service and several off-shore Islamic banks compete in a small economic environment.

⁴⁰ The establishment of a second Islamic bank in Jordan caused furies on the part of the existing Islamic bank that used all kinds of propaganda to terrify customers away from the new bank by questioning the Islamic legitimacy of the newly established bank

area where monopolistic practices may be found is the substantial difference between the rate of return on investment deposits and the rate of return on shareholders' equity. Although, the difference between the investment deposits and share capital is minimal in regard to responsibility toward losses.⁴¹

The IB's fell in the same trap of conventional banks in their treatment of current accounts. Current accounts are considered loans on the bank but a percentage of them is actually invested and its return is reaped by the IB's shareholders. This is legitimized on the ground that current accounts' balances are guaranteed. Keeping in mind that shareholders' equity represents a small proportion of investable funds, this practice disproportionately boosts their return. This legitimization, approved by the Shari'ah Boards, can easily be refuted on the ground that shareholders' equities make only a small proportion of the Islamic banks' assets,⁴² below any adequate level that can stand behind the IB's guarantee of such liabilities in case of a default. This makes the claimed guarantee useless. Additionally, the revealed preferences of current accounts' holders indicate a tendency to value withdrawal facilities more than return on such balances. If the IB's ease up the restrictions on withdrawal from investment deposits, current accounts holders would tend to change their minds.⁴³ Furthermore, the IB's restrictions on investment deposits can only be described as highly exploitative. Most IB's add funds deposited effective the beginning of following month and funds withdrawn effective beginning of the current month and one IB does not accept investment deposits at less than US\$ 265,000,

on the ground that it was established by a traditional bankers' capital. Similar fears were raised against the Islamic branches of the National Commercial Bank in Saudi Arabia. Sa'id Martan, "Islamic Branches and Windows of conventional Banks: Experience of National Commercial Bank", paper presented at International Seminar on Contemporary Application of Islamic Economics", Casablanca, April 20-23, 1998.

⁴¹ In the Bahrain Faisal Islamic Bank prior to 1998, shareholder's rate of return has been above 16% for several years, while investment deposits' return was only 4-5%.

⁴² Monzer Kahf, "Profit Distribution in Islamic Banks". Review of Islamic Economics Studies, Vol. 3, No. 2, 1996, pp. 113-140 (Arabic).

⁴³ Islamic banks usually impose restrictive measures on investment deposits, Faisal Islamic Bank of Egypt is the only IB that allows withdrawal from Investment deposits on a 24 hour notice. As a result, its balance sheet shows low balances on its current accounts and high investment accounts. This is in contrast with all other Islamic banks.

thus forcing all small depositors to use the zero-income current account system and reaping the return of the investment of more than US\$ six billion in demand deposits for the shareholders of paid up capital of only US\$ Million 400. Improvement of banking services with regard to investment deposit holders, current account holders and users of bank financing is an important prerequisite to increase the ability of the existing IB's to stand the forthcoming uphill competition, especially from the new branches and windows of conventional and well placed mega banks.⁴⁴

The lack of adequate personnel training also reflects on the IB's relations with central banks. Except for countries that transformed the whole banking sector, the relationships between IB's and central banks have mostly been bumpy. This is partially caused by the inability of the personnel, who themselves are not familiar with their own modes of operation, to adequately explain the special characteristics of their transactions to central bankers. Yet, the main reason for unpleasant relations with central banks lies in the fact that the specially devised laws of establishing IB's, did not adequately address the peculiarity of supervision that is consistent with these "special banks." When governments enacted these laws, the very nature of Islamic banking and finance was not yet clear.⁴⁵ At the same time central banks could adapt their regular tools of control and supervision to fit the specificities of this new species of banks and banking transactions. Communication was thus difficult on both sides. Until today, no standard supervision criteria for Islamic banks are developed by any central bank, even in those countries that have several Islamic banks working under the authority of their respective central banks, such as Egypt and Qatar. Central banks still apply the same tools they use with traditional banks.⁴⁶

⁴⁴ E.g., Citicorp of New York established an Islamic Citibank in Bahrain (1995), the National Commercial Bank of Saudi Arabia that established more than 46 Islamic branches between 1992 and 1998, and the recently established full-service Islamic Bank by the Arab Bank of Jordan (1998), The Arab Investment Banking Corp in Bahrain (2000), in addition to Islamic banking services offered by many traditional banks from New York to Geneva to Cairo to Kuala Lumpur.

⁴⁵ This is a main reason for the tough argument in the Kuwaiti parliament between supporters of the Kuwait Finance House and the Central bank, the latter wants to rightly restrict the KFH to financial intermediary and the former holds to the authorities granted in the special 'Princely Decree of its establishment.

⁴⁶ In their paper on "Islamic Banking: Issues in Prudential Regulation and Supervision", Luca Errico and Mitra Farahbaksh (IMF

Conclusion

The survival and advancement of Islamic modes of finance and deposits does not depend on the growth and development of Islamic banks. Islamic modes of finance have already found their way to mainstream banking, although they are still offered mainly to Muslims. On the other hand, the sharing mode was not able to penetrate the mainstream deposits market except on a partial basis in a few conventional banks that offer Islamic windows in countries like Egypt and Malaysia. It is apparent, however, that the use of the Islamic financing and deposits modes is not a *sin qua non* to elimination of interest from a conventional bank and if I borrow the terminology of al Ghazali we shall need a "Takhliyah" in addition to the "Tahliyah" to be able to reduce or eliminate the layers of monetary assets that burden the real commodity market as a result of the interest-enabled rescheduling, discounting and debts wholesale! Moreover, a country-wise transformation of the banking system is needed to obtain the claimed macro-financial effects of Islamic banking.⁴⁷

What is at stake under the pressure of deregulation and globalization, is the future of IB's, not that of Islamic finance. Improvements and actions are needed at the level of IB's themselves, at the level of central banks, and at the level of governments, where Islamic banks operate.

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working paper No. WP/98/30) suggested to apply the CAMEL of the Basle Committee on Banking supervision with higher than 8% capital adequacy (which is the Basle Committee minimum level for OECD countries). This suggestion may be refuted on ground that unlike the theoretical model used by Errico and Farahbaksh, Islamic banks' assets consist mainly of debts, while most of their liabilities are investment deposits. This makes their capital needs smaller than those of conventional banks. This line of argument borrows support from the practice of the Gambia's central bank in excluding investment deposits of the Arab Gambian Islamic Bank from liquidity requirements (information from the Chairman of the Board of Directors of the AGIB).

⁴⁷ It would be an interesting subject for a master thesis to study the effect of Islamization of the banking sector in Pakistan, Iran and Sudan on the size of rescheduling, discounting and wholesale financing in those countries and on the financing facilities afforded on tobacco and other "unethical" production and exchange.

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