

ISLAMIC BANKS AT THE THRESHOLD OF THE THIRD MILLENNIUM

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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 1940s both in English from the Indo-Pakistan subcontinent and in Arabic from the Middle East. For understanding Islamic banking and finance, a few words on the main ideas of such writings are useful. Essentially, writings on Islamic economics describe the Islamic economic system as a market system that abides by the Islamic legal code which is called *Shari'ah*.¹ Private property and freedom of transactions represent cornerstones of the *Shari'ah*-described market. Freedom of transactions requires that exchange be based on mutual negotiation and consent. Thus, details on contractual relationships make the bulk of *Shari'ah* civil and commercial chapters. Two more axioms are of importance in the *Shari'ah*-described market: the prohibition of interest under all forms and the imposition of poor dues under the name of *Zakah*.²

The Birth of Islamic Banks

The prohibition of interest in Islamic law caused many writings to come forward with ideas on establishing banks that do not work on interest basis.³ Two Islamic banks came to exist independent from each other. In Malaysia, a pilgrimage Fund was established in the late 1950s for the purpose of helping those who want to accumulate their savings for making a pilgrimage trip to Makkah. The Fund became a full-fledged interest-free investment bank in 1962.

Around the same time, rural savings were enhanced and collected by a series of small savings banks in northern Egypt. The first of such savings banks was established in Mitghamr in 1963. An international government-funded Islamic bank was established by 22 Muslim countries

¹ *Shari'ah* is a civil legal code derived from the norms and guidelines given in the Qur'an and the tradition of Prophet Muhammad (pbuh). It was developed by Muslim Jurists throughout centuries. One of its latest versions was the legal code of the Ottoman Empire published in Turkey in the mid 19th century. *Shari'ah* still represents the main source of civil law in several Middle Eastern countries.

² *Zakah* is generally a 2.5% of liquid and mobile wealth of the rich persons. Its proceeds should be distributed to the poor in the same area or country. It is usually collected and distributed by certain government agencies. It is actually incorporated in the tax systems of several countries including Saudi Arabia, Pakistan, Yemen, Sudan, etc.

³ Probably the first such work was that of Anwar Qureshi, 1948, followed by Muhammad Uzair, 1955, and Muhammad Baqer Al Sadr, 1960.

in 1973. The membership of the Islamic Development Bank stands now at 52 countries with Togo's application for membership being under consideration as its 53rd member.

The first commercial Islamic bank was established in UAE in 1974, and until the end of 1996, 166 Islamic banks and financial institutions were in operation. These are distributed as follows:

South Asia	-	50
Africa	-	35
South East Asia	-	30
Middle East	-	43
Europe & the two Americas	-	8

Total		166 ⁴

According to the report of the International Organization of Islamic Banks, these 166 Islamic banks manage \$137 billion, about 74% of which come from deposits. Additionally, there are many Islamic windows and funds established by traditional banks in most Muslim countries and in the world financial centers that manage large sums of funds that may reach up to an additional \$100 billion.

In most Muslim countries, Islamic banks still represent a small fraction of their own domestic markets. The exceptions are Pakistan, Iran and Sudan that transformed into Islamic their whole banking systems. Many Muslim countries have only one Islamic bank that stands unrivalled in its own field of providing interest-free transactions.

The spread of Islamic banks, that grew over the past two decades at more than 10% annually, could have been faster had some countries not adopted conservative banking policies.⁵

Principles of Islamic Financing

Interest-free Islamic financing is derived from two axioms, mutual fairness in transactions and reflection of actual reality. Generally, financing can be defined as the provision of factors of production, or

⁴ 1996 Annual Report of the International Organization of Islamic Banks – Jeddah.

⁵ For instance, in Saudi Arabia only one Islamic bank was established in 1989 although several applications were submitted since 1975, and several applications are still pending.

goods and services, without requiring an immediate counterpart from the receiver. For instance, a laborer finances the employer by waiting until the end of month for getting compensation for the working hours given throughout the month, and a real capital owner finances an entrepreneur by waiting until the sale of products to get a portion of the net proceeds.

Islamic financing is no more than that, in its full, plain and straight sense. Islamic financing is just a name for providing factors of production, goods and services for which payment is deferred. Islamic banks provide financing in the form of equipment, machinery and other producers' goods, and in the form of consumers' goods, for deferred payment. They also provide means of payments as principal in projects on the basis of sharing the actual, real outcome of a production process.

In profit sharing finance, both finance giver and receiver share the real results or output, of a productive project rather than throwing the burden of the project's risk on one side and relieving the other as interest-based financing does. When financing is done on the basis of sale principle, the financier carries a risk associated with owning a good and providing it to users. In both the cases, fair play of the market forces determines the rate of profit distribution between financier and beneficiary.

As the Islamic system assigns to private property a corner-stone role in its socio-economic order, an owner has full right to the increase, growth, benefit and profit resulting from one's property. If the management of a property is entrusted to someone else (through financing), the manager's efforts that contribute to growth and profit is also recognized, and actual returns should be distributed between the two parties.

In lending, the lender gives real balances or goods (be it lifetime savings or any other loanable goods) to the borrower against a conceptual right, that we call debt. Hence, lending changes the nature of what is owned from real balances to a legal commitment, which is purely an inter-personal, abstract notion. A debt is incapable of growing or increasing because it is purely conceptual, it is a relation between a person and another person. In contrast, the same savings and/or real goods may be given on sharing bases. The owner holds to the right of ownership and the manager exerts efforts for making the goods grow and increase through exchange or industry, like a peasant who buries seeds in the soil and serves them, or like a trader who buys merchandise and finds

a good market for it. Ownership remains in the hands of the finance provider and the work is given by the finance recipient.

Finance on the basis of profit/loss sharing opens a way to *direct investment*, where the attention of the bank is focused on the profitability of an investment. This, inter alia, creates close working relationships between banks and fund users. As long as returns are commensurate with risk, direct investment would not shy away from high-risk projects, or from financing small and micro-enterprises. In contrast, direct investment does not seem to be favored by traditional banks.⁶

Salient Characteristics of Islamic Banks

An Islamic bank is a full-service intermediary financial institution that abides by the Islamic law.⁷ Islamic banks are established as common stock companies in their countries.⁸

The commitment of Islamic banks to abiding by the Islamic law determines their main characteristics. They are banks that practice all conventional banking operations, provide conventional banking services within the legal framework of their respective countries and under the supervision of their respective central banks. A bank's commitment to the Islamic law is manifested in redefining its modes of operation and relationships with suppliers and users of funds in order to make them compatible with Shari'ah.

Islamic banks accept demand deposits in current accounts the same way as known in the conventional banking practices, but their term deposits are reformulated as investment deposits whose contracts stipulate that the bank does not offer interest on these deposits. Investment deposits are given to Islamic banks on the basis of profit sharing.⁹

⁶ Dimitri Vittas and Yoon Je Cho, "Credit Policies: Lessons from Japan and Korea," World Bank Research Observer, Vol.II, No.2 (August, 1996), pp. 277-98.

⁷ Some writers like to see in Islamic banks more than a financial institution. This is not true. In a recent paper, Kuran (1997) said, "Islamic banking defies the separation between economics and religion. It invokes religious authority in a domain that modern civilization has secularized." One must know the difference between Shari'ah, as a law, and religion. The only authority exercised on Islamic banks is that of their respective boards of directors and the supervision of central banks.

⁸ All banks are state-owned in Iran. In Sudan and Pakistan, there are state-owned banks, and private common-stock companies banks.

⁹ Actually realized net profits at the end of each investment period are distributed between depositors and the bank on a predetermined contractual ratio of profit sharing (in contrast to predetermined interest as a rate of principal).

Islamic banks' financing is granted on the basis of either of three modes: sharing, sale, and leasing.

Sharing Modes

The principle is simple as much as it is natural. Islamic banks provide financing to projects on the expectation of a share in the return. Obviously, if a project loses, all capital providers and finance contributors lose proportionately together. There are two forms of applications of this principle: **full equity sharing** and **non-voting equity financing**. In full equity sharing, the bank sits on the board of directors and participates in formulating policies and managerial decisions, while in non-voting financing, the bank fully entrusts managerial decision-making to the fund user. Both forms of sharing modes may be formulated to share **net income** or **gross output**. They may also be **permanent, declining or timed**.

Sale Modes

In this group of modes, the bank is asked to buy goods and sell them to users (producers/ consumers) against future payment. Sale modes may take several forms. The simplest of them is derived from regular sale contract in which the bank sells goods, equipment and machinery to users at an agreed upon marked-up deferred price.

Islamic banks also practice two other forms: **construction/ manufacturing contract** and **deferred delivery contract**. The construction/ manufacturing is usually employed to finance land development, infrastructure, and industrial and residential construction; while deferred delivery is generally an agricultural financing contract that provides farmers with funds needed for their operations against delivery of grain at the season.

All sale-based modes can end with one lump sum deferred payment or in installments spread over a period of time.

Leasing Modes

As practiced by leasing companies and recently in many traditional banks, leasing modes may have a variety of forms with fixed or variable rents, declining or fixed ownership, operational or financial, along with different conditions regarding the status of leased assets at the end of the lease period.

Contributions of Islamic Banking

The actual practice of Islamic banking over the past three decades and the rise of Islamic banks as a new species of banks reveal three innovations in banking traditions: (1) a new kind of relationship between banks and depositors, (2) integration of financial and real market in financing, and (3) incorporation of ethics and moral values in investment decisions.

Relations with Depositors

Since the early practices of the money exchangers in the 15th century and over the past five centuries, the relationship between depositors and bankers was based on a lending contract. The interest paid by bankers represent the cost of money that is made available for utilization and placement by the banks. By virtue of the same lending contract, the return of depositors is determined at the time of making the deposit. Islamic banks have drastically changed the nature of this contract. The new relationship is based on a partnership type of cooperation, in which cash entrusted to bankers for investment purposes with the returns being shared between depositors and bankers, while losses are borne by fund owners. Thus, returns paid to depositors as well as the bank's own income from financing represent distribution of net profit at the closing of a financial period.

This sharing principle makes a substantial deviation from traditional practices. It brings about the principle of sharing to the financing arena and creates a performance incentive within the minds of bankers that relates their ability to attract deposits to their actual performance in funds utilization, a matter that can only be manifested by best performance as well as depth of future planning a lot more than simply an overnight change in the interest rate offered to depositors. This deepens the deposit market and makes it more stable. It reduces a bank's ability to sneak out investment deposits from other bankers by announcing a higher interest rate at the entrance of its offices. It also changes the attitude of management towards doubtful debts and other potential expenses and losses that burden the bank's balance sheet. As shares of profit are distributed to depositors, any attempt to cover up, hide, or push away potential liabilities has a future cumulative effects on

shareholders and members of the boards of directors larger than their effects on future depositors.

The experience of the Pakistani banks (in which all deposits were turned into profit sharing basis since the early 1980s) indicates that the principle of profit sharing offers an important cushion for banks to lean on at times of recession. When the Pakistani Monetary Authority was putting pressure on banks to reduce their credit facilities through different policies including credit rationing, ceilings and other contractionary policies, banks were able to absorb this pressure by passing substantial part of it in terms of reduced returns to depositors.¹⁰

Closing the Financing Gap

The second contribution of Islamic banks, as witnessed over the last part of the 20th century, is the bridging of gap between financial and real markets. Since Islamic banks limit their financing to the three aforementioned modes or principles, Islamic financing is thus offered only to help in the creation or exchange of real goods and services, i.e. it has a one to one relationship to the real goods market. Islamic banks can finance such economic activities as: (1) the establishment of new productive projects, (2) purchase of producer/consumer goods, or, (3) lease of productive machinery and equipment and consumer durables. Two main categories of traditional financing are totally excluded from the arena of Islamic banking practices: (a) general purpose financing that aims at simply supplementing government and corporate budgets, whether for seasonal or non-seasonal purposes. This financing usually depends on the trustworthiness of the finance users with complete disregard of the purpose for which funds are used; and (b) increase in indebtedness as a result of debts rescheduling.

Linking bank financing to the processes of production and commodity circulation not only reduces the size of financing and makes it tailored-cut to the size of production and exchange, but also eliminates “parasitic” financing that aims at servicing already existing debt. All that reduces the cumulation of upside down financing pyramids and increases the stability of a banking system.

¹⁰ The application of sharing principle in resource mobilization in Islamic banks has always been associated with creating 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 at low-return times in order to maintain a competitive status of Islamic banks vis-a-vis interest-giving banks within the same market environment.

Ethics and Banking

It has been noted for a long time in all societies that banks are institutions that deal with money, not with *ethics*. The very idea of Islamic banking brings in ethical values to the center of banking practices. Islamic banks are bankers that abide by the Islamic law. The *Shari'ah* itself is loaded with moral values. Since the establishment of the first Islamic bank in 1973, it became apparent that Islamic banks are not permitted to establish any financing relations with commodities, services and individuals whose moral practices are dubious. Thus, financing of tobacco, gambling, casinos, drugs, alcohol, weapons, environmentally harmful commodities, etc. are completely excluded from the working map of Islamic banks.

One can hardly claim any link between the new movement of observing moral values in investment as we start seeing in some Western funds and the moral commitment of Islamic banks, to an extent that allows to conclude that the recent Western moral movement towards financing is an outgrowth of Islamic banks. This moral movement came about for different reasons. But at the same time, one has to recognize that Islamic banks' commitment to moral values as well as their actual observance came many years before the early signals of moral commitment in Western investment funds and that the recent spread of Islamic mutual funds and investment companies, with their obvious moral commitment, is, in fact, a mere extension of the Islamic banking ideas and principles to the area of mutual funds.¹¹

In addition to the above three contributions, the Islamic banking movement was able to extract deposits mainly from cash "*kept home*" by tens of millions of religious persons in the Muslim countries who never wanted to deal with traditional banks because of the religious prohibition of interest. In other words, the establishment of Islamic banks served to pull the legs of many new comers in the financial market; those with whom traditional banks working in Muslim countries failed.

¹¹ Especially, since 1995 onward at least 10 new mutual funds were established in several parts of the international tax shelters by Middle Eastern (Islamic) investors in collaboration with American and European funds managers, such as Willington of Boston and Fleming of London; all such funds have declared moral commitments.

Challenges Faced by Islamic Banks

As an invention of the last four decades of the 20th century, Islamic banking represents a movement of development and renovation of the banking profession and practices. By their very presence, Islamic banks exemplify the practical potentiality and the empirical success of the idea of creating a banking system that is morally friendly; a system that relates to the actuality of the real market of production and exchange. In other words, the ideals of Islamic banking are becoming entrenched and well established, but the same is not necessarily true about Islamic banks that face several challenges.

Some writers perceived Islamic banking as financial intermediation that **must** work on the basis of a profit sharing paradigm in both funds mobilization and funds utilization.¹² They theorize two versions of this presumed paradigm. Paradigm version one requires the financial institutions to receive funds on profit-sharing basis and to distribute funds on the same basis of profit sharing. This, they call, the two-tier Mudaraba version. The second paradigm version is called the two windows. It requires banks to hold a 100% reserve on the demand deposits that are guaranteed by the bank and a zero percent reserve on the investment deposits that are used by the bank to finance risk-bearing investments.

According to this perception of Islamic banking, all Islamic banks have, actually, deviated from the basic feature of their paradigm, as their main actual financing mechanism took the form of Murabahah (mark up) sale. Consequently, the essential challenge faced by Islamic banks in the mind of such writers centers around their ability to abide by the “presumed” Islamic banking paradigm, i.e., increasing profit sharing financing and reducing sale financing.¹³

This approach is not supported by the methodology of social sciences. In Islamic banking operation, sale and leasing based financing represents more than 80% while the profit sharing financing takes less than 20%,¹⁴ and social scientists are required to approach the phenomenon of Islamic banks with an analytical mentality that can discover rational explanations of this behavior rather than attempting to

¹² See, for instance, 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.

¹³ Abbas Mirakhor, “Progress and Challenges of Islamic Banking”, *Review of Islamic Economics*. V.4, No.2, 1997, pp. 1-11.

¹⁴ *Directory of Islamic Banks*, 1996.

judge them by pre-conceived ideas and dogmas. Islamic banks gained their Islamic character because they abide by the Islamic law, which accommodates three sets of modes of financing. Hence, if some writers happens to prefer one of these sets over the other Islamic banks cannot be described as deviating, or diverging,¹⁵ from their normal path because they used their assets wisely and profitably!

Hence, the presumed challenge to “use funds on the basis of profit sharing” does not carry sufficient weight to attract the appetite of Islamic bankers.

The real challenges to Islamic banks comes with liberalization, deregulation, and globalization of financial services, all are coming with the third millenium. The reason is simple, that is the environment in which they gained their working experience. Although Islamic banks and financial institutions were able to enter some Western markets,¹⁶ their base markets remain in the Muslim countries, many of whose economies are narrow, small and loaded with restrictions and other market distortions.

Functional liberalization of the banking activities must serve the objective of Islamic banks, theoretically at least, as deregulation gives more room to this newly introduced relationships on both sides of banking operations: fund mobilization and fund utilization. Thus, functional liberalization allows traditional banks to take up these new forms for their own financing transactions and benefit from the innovation of Islamic banks, and carry them further, especially, with the help of their longstanding experience. Liberalization of banking practices would allow the reformulation of banks' lending to be in accordance with the above mentioned three principles of Islamic financing and to benefit from remodeling some of their deposits on share-holding basis.

On the other hand, Islamic banks will be faced with tremendous competitiveness challenges as a result of the geographical openness of globalization and regionalism. Islamic Banks are still new, small and dispersed, and globalization puts them face to face with the international banking giants. At the same time, because they have been working within limited scopes in their respective small domestic markets. Over the past three decades, Islamic banks were not able to benefit from the trend of regionalism as that which empowered several European banks with

¹⁵ Luca Errico and Mitra Farahbaksh, “Islamic Banking: Issues in Prudential Regulation and Supervision, IMF Working Paper No. WP/98/30.

¹⁶ The Directory of Islamic Banks cites 8 of them.

muscles and abilities to compete at the international level, depending on a strong and vast regional market.

A quick look at the statistical reality of the 166 Islamic banks and financial institutions referred to at the beginning of this paper, we will find them tending to be small and contained within small markets, as seen from Table 1.

Table 1: Distribution of Islamic Banks and Financial Institutions

Islamic Banks and Financial Institutions	Number	Average Capital \$ 000,000	Average Assets \$ 000,000	Average Number of Branches
South Asia	50	19	904	178
Africa	35	6	56	19
South East Asia	30	4	126	9
Middle East	43	150	1982	300
Europe & Americas	8	70	119	5
TOTAL	166	44	826	137

Source: Derived from the Directory of Islamic Banks and Financial Institutions, 1996, The International Association of Islamic Banks, Jeddah, Saudi Arabia

Although the average capital of Islamic Banks is US\$ million 44, only seventeen have a capital of US\$ million 100 or more, of them nine are state owned Iranian banks, while the capital of ninety-two Islamic banks does not exceed US\$ million 10. The same picture appears in their assets. The average total assets of an Islamic bank is a little more than US \$ million 800, but only twenty three of them have total assets that are above US\$ one billion US\$, of them 10 are in Iran, while eighty-five have assets of less than US\$ million 100.

By the same token out of total branches of 22711, only sixteen banks have 20,645 branches, eight of them are in Iran with more than half this figure and seven are in Pakistan and one in Saudi Arabia. While the average number of branches is 137 for all the 166 Islamic banks, the smallest 10 banks have an average of less than three branches and the largest sixteen banks have an average of 1291 branches.

Furthermore, except for the Islamic banks and financial institutions that work in three countries that transformed their entire banking system into an Islamic one (Pakistan, Iran and Sudan), no Islamic bank occupies the status of first or second largest domestic bank in its own country.

At the international level, some studies indicate that an adequate size for a bank to be able to efficiently compete must be at least between U.S. \$500 million and one billion, in terms of assets.¹⁷ There are only 33 Islamic banks that pass the minimum level of this test, 23 of them are state owned in Pakistan and Iran. Also a glance at the Directory of Islamic banks indicates that very few of them have capital in excess of US\$ million 500.¹⁸

Additionally, although there are 16 Islamic banks with a large number of branches, there are only 193 across-the-political-boundaries branches, of which 160 branches belong to 10 banks in Iran and Pakistan, let alone having branches in the international financial centers. This is especially true for Islamic banks in the Middle East and South Asia.

All the above is in spite of the fact that most private sector's Islamic banks are owned by the two large groups of Dar-al-Mal Al-Islami and Al-Barakah. It seems that both holding companies opted for small national banks rather than big regional ones.¹⁹

In addition to all the problems of size and economies of scale, Islamic banks and financial institutions suffer a whole spectrum of several technical and organizational problems. To mention only a few: Islamic banks suffer from lack of standardization of Shari'ah opinions; unclear and sometimes ambiguous relationship between the management and Shari'ah Advisory Board;²⁰ low level of know-how on the part of both management and personnel; inadequate and sometimes unsuitable supervision standards, both internally and externally by the central banks; lack of creativity in financial engineering and marketing; and inadequate sensitivity to customer satisfaction.

17 Allen N. Berger and D.B. Humphrey, "The Dominance of Inefficiencies over Scale and Product Mix Economies in Banking," *Journal of Monetary Economics*, Vol. 28, 1991, 117-148.

_____, "Megamergers in Banking and the Use of Cost Efficiency as an Antitrust Defense," *Antitrust Bulletin*, Vol. 37, Fall 1992, 541-600.

_____, "Measurement and Efficiency Issues in Commercial Banking," Z. Griliches, ed., *Output Measurement in the Service Sectors*, NBER, University of Chicago Press, 245-279.

¹⁸ Actually only three banks, all of them Iranian, have a capital between 500 and 750 million U.S. dollars (Directory of Islamic Banks, 1996)

¹⁹ The two holding groups are registered in Bahamas and Saudi Arabia respectively. They are themselves not large enough to be able to sustain large Islamic banks. According to published data, both are below the one billion dollar mark.

²⁰ Although the principle with regard to the power of Shari'ah Board is clearly defined; that a Shari'ah Board is not a managerial organ of an Islamic bank, the nature of its relation with the Management is not yet adequately crystallized.

Since the opinions on many financial transactions in the Islamic Shari'ah are not technically codified in all Muslim countries, Islamic banks were led to depend on their own Shari'ah experts. Consequently, each Islamic bank sets up its own Shari'ah Board that advises the Management on Shari'ah requirements in their contractual relationships. Shari'ah Boards of various Islamic banks very often do not see the matter from same angle, and offer advises of varying degrees of differences. Additionally, the relationship between the Shari'ah Advisory Board and the bank's management is sometimes ambiguous.²¹ To this, one may add the fact that there are still hazy areas that create differences among Shari'ah experts themselves, especially when it comes to dealing with the ever continuous stream of new banking innovations.²²

Another technical problem 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. Essentially, Islamic banks were forced to derive their employees from conventional banks, thus causing problems in the performance, understanding Shari'ah rulings, advising bank's customers on the characteristics of different types of the new Islamic techniques of banking relationships and services, etc. However, this problem of personnel training may be justified on the ground that Islamic banks are still new and did not accumulate sufficient historical experience.

This problem had effects on intensifying the lack of creativity in Islamic banks. Although Islamic banks were able to grow at a rate that exceeded 10% annually over the past three decades.²³ This growth was accompanied by very little innovations in terms of the banking services offered to their public. In other words, notwithstanding the fact that Islamic modes of financing are themselves new in the banking arena, Islamic banks did very little on creating new saving/investment instruments to mobilize resources and direct them toward new investments.

²¹ 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.

²² 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.

²³ See consecutive 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.

Furthermore, difficulties of Islamic banking personnel were also reflected in their relations with their respective central banks. Except for Pakistan, Iran and Sudan, the relationships between Islamic banks and central banks have mostly been bumpy. This may be explained partly by the inability of the newly appointed personnel of Islamic banks to adequately explain the special characteristics of their transactions to central banks.

Yet, the main reason for unpleasant relations with the central banks lies in the fact that although Islamic banks were mostly established by new and specially devised laws, enacted by their respective governments, central banks are not able to develop tools and approaches of control and supervision that are adaptable to 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 the traditional banks.²⁴

Another problem also arises from the very circumstances that led to the establishment of Islamic banks. Islamic banks were essentially established because Islam prohibits interest, and because Muslim masses all over the world were yearning for financial intermediaries that are interest-free. Islamic banks have very often capitalized on the sentiments and feelings of their masses and exercised varying degrees of monopoly powers. Except for the three countries mentioned above, most Islamic banks stand unrivaled in their own countries. Hence, they were able to charge high fees for their banking services, high mark up and high profit-sharing ratio for their financing. In comparison, interest charged by the traditional banks pales into insignificance.²⁵

²⁴ In their paper on “Islamic Banking: Issues in Prudential Regulation and Supervision”, Luca Errico and Mitra Farahbaksh (IMF 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 argued 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).

²⁵ As an example, a newly established Islamic investment mutual fund, publicized and sponsored by one of the Islamic banks in Bahrain, charges both a management fee of 1½% of the value of managed assets, and 20% of net profit to the sponsoring management, again, as a share of the manager in the Mudarabah (=funds entrusted by the owners to a manager).

What is needed to face these challenges?

In its contributions to contemporary banking practices, Islamic banking offers innovations that proved their own merits. These innovations create a new dimension in banking and this might give a major reason for their adoption by many conventional banks. Hence, the survival of Islamic banking does not depend on Islamic banks, and the challenges mentioned in the previous section are faced by the Islamic banks, not by Islamic banking. What is at stake under the new trend of deregulation and globalization, is the future of Islamic banks, not that of Islamic banking. Improvements and actions are needed at the level of Islamic banks themselves, at the level of central banks, and at the level of governments, where Islamic banks operate.

1. 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 survive in the third millennium, as we are entering an age of giant bankers in which dwarfs will 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 ability for creating assets. Merger and expansion are the first necessity for the survival of Islamic banks, especially that the clientele of Islamic banking is no more monopolized by the existing Islamic banks. We are going to enter the third millennium with many Islamic investment funds, many Islamic banking operations, windows and branches, run outside Islamic banks by the giant traditional banks, both at the international level and in the homes of today's Islamic banks.

Merger and expansion of Islamic banks is related, to a large extent, to the expansion of Islamic financial market itself, and probably as we enter an age of globalization, the members of the Organization of Islamic Conference (OIC) may prepare themselves by opening up their markets to their own Islamic banks.

2. There is a dire 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 which needs operational standardization. This can be done by forming a common platform of Shari'ah-accepted regulations instead of the different Shari'ah Boards that are presently working independent

from each other and giving different opinions. There is a need for standardization of internal supervision, techniques, terminology, contracts, forms used, etc.

There is also a need for the standardization of reports, balance sheets and other financial statements. There is a need for standardization of manual and definitions of different transactions as well as methods of accounting. In this regard, the Board of Accounting and Audit of Islamic Financial Institutions that was established in Bahrain in late 80's by a group of Islamic banks, needs to work harder and faster and to generalize its acceptability by all Islamic banks.

Standardization of Islamic banks' transactions will not only improve public understanding and public reading of these institutions, it will also help 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.

3. There is a dire need to increase efficiency in providing banking services in all Islamic banks. Customer satisfaction does not usually have high priority in Islamic banks because they do not feel the pinch of competition.²⁶ As most Islamic banks work unrivalled in their respective economies, they tend to rely on their own "committed" clientele.²⁷ One area where monopolistic practices show themselves 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.²⁸

Furthermore, Islamic banks fell in the same trap of conventional banks in their treatment of current accounts. Current accounts are treated as loans on the bank and the return on the proportion invested (within a bank's investable funds) is reaped by the Islamic bank's shareholders. This is legitimized on the ground that current accounts' balances are guaranteed since the bank is responsible for returning them on

²⁶ An exception may be in Bahrain where three full-service and three off-shore Islamic banks compete in a small economic environment.

²⁷ The recent establishment of a second Islamic bank in Jordan caused furries on the part of the existing Islamic bank that used all kinds of propoganda to terrify customers away from the new bank by questioning the Islamic legitimacy of the newly established bank 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; see 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.

²⁸ In the Bahrain Faisal Islamic Bank, shareholder's rate of return has been above 16% over the last few years, while investment deposits' return was only 4-5%.

demand; and any return given on loans is considered interest in Shari'ah. Keeping in mind that shareholders' equity represents a small proportion of investable funds, this practice boosts their return.

It has been argued that shareholders' equities make only a small proportion of the Islamic banks' assets,²⁹ below any adequate level that can stand behind the bank's guarantee of such liabilities in case of a catastrophe, and current accounts' holders prefer to consider their accounts as investment deposits and forget about such a "useless" guarantee, if they are given the facility of daily transactions in investment deposits.³⁰

Additionally, at the computer age in which Islamic banks always seek Shari'ah-acceptable means of overnight investment, their restrictions on investment deposits can only be described as highly exploitative. Usually, funds deposited are added to the investable pool effective from the beginning of next month and funds withdrawn are taken out from the beginning of current month.

Improvement of banking services with regard to investment deposit holders, current account holders and users of bank financing is an important pre-requisite to increase the ability of the existing Islamic banks to stand the forthcoming uphill competition, especially that arising from the new phenomenon of offering Islamic banking services by traditional and well placed banks.³¹

4. The need for expansion and diversification in Islamic banking products: In a continuously innovating financial markets of today, and with the deregulation and liberalization of financial activities and the opening of borders for national banks to compete at the international level, the survival of the existing Islamic banks literally depends on their ability to invent and create new Islamically acceptable instruments that can cope with the ever continuous innovations in the money and financial markets that continuously attract new customers.

²⁹ Monzer Kahf, "Profit Distribution in Islamic Banks". Review of Islamic Economics Studies, Vol. 3, No. 2, 1996, pp. 113-140 (Arabic).

³⁰ Islamic banks usually impose restrictive measures on investment deposits, Faisal Islamic Bank of Egypt is the only bank that allows withdrawal from Investment deposits on a 24 hour notice. As a result, its balance sheet shows low current accounts and high investment accounts. This is in contrast with all other Islamic banks.

³¹ E.g., Citibank of New York established an Islamic Citibank in Bahrain (1995), the National Commercial Bank of Saudi Arabia that established more than 46 Islamic branches over the past six years since 1992, and the recently established full-service Islamic Bank by the Arabic Bank of Jordan, which is the first and largest traditional bank in the Jordanian economy, in addition to Islamic banking services offered by many traditional banks from New York to Geneva to Cairo to Kuala Lumpur.

Expansion and innovation of an Islamic money market and other financial instruments require generous spending of R&D by Islamic banks, which is presently at a meagerly low level. Since what is needed is a combination of applied Shari'ah abilities with strong financial engineering. The latter seems to be lacking in most Islamic banks.

In this regard, Islamic banks find very little cooperation from their respective central banks and other government authorities in most of the Muslim countries. For instance, only three Muslim countries have issued laws that organize the functions and supervision of Islamic Banks, namely, Malaysia, United Arab Emirates, and Turkey, while a proposed Islamic banking act is still lingering between offices of the central banks and Ministry of Commerce in Kuwait since 1995. This is in addition to the fact that the financial and capital markets themselves are still at their initial stages of development in most Muslim countries. A few exceptions do not exceed four or five members of the Islamic Conference Organization, namely; Malaysia, Pakistan, Turkey, Morocco and Indonesia.

Lastly, the ability of Islamic banks to continue the over 10% rate of growth witnessed over the last 30 years or so, looks very slim, unless they succeed in facing these essential challenges. However, the Islamic banking practices by traditional banks may outgrow Islamic banks in the coming years. Islamic banking will survive and continue growing in the 21st century, with or without the Islamic banks!

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