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ISLAMIC FINANCING MECHANISMS AVAILABLE FOR ISLAMIC BANKS AND THE NEED FOR NEW MECHANISMS*

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PART I

INDUSTRIAL FINANCE MECHANISMS AVAILABLE FOR ISLAMIC BANKS

The last 12 years have seen a rapid increase in the number of institutions adhering to precepts of Islam, regarding financial relations and transactions.

These precepts may be reduced to 3 fundamental principles :

1. Prohibition of "RIBA", renting money in return for interest.
2. Using other mechanisms of direct investment as an alternative to renting money for interest.
3. A broad commitment to Islamic solidarity and to promote the development aims of individual countries and of the entire Islamic "UMMAH".

As the industrial sector is one of the main sectors of development, the activities of Islamic banks in this sector is specially important. The ISLAMIC DEVELOMENT BANK has accomplished a pilot rôle in the finance of infra-structure projects in Islamic countries.

The present workshop focuses on disseminating information about the rôle of local Islamic banks and discussing the mechanisms used and obstacles to be overcome in this field. This Paper focuses on the description of mechanisms available to Islamic banks in the field of industrial finance.

* * *

These mechanisms differ according to the following considerations:

1. The element of risk to which the financing bank is exposed, which is more in cases of Equity Participation, Profit and Loss sharing (PLS) and Mudaraba, and is less in cases of Murabaha and leasing.

2. Whether the finance was global to all the project or specified to one of its assets.

3. Whether the finance was permanent or for a fixed period, long or short-term.

We will treat the subject under the following headings :

1. Equity Participation.

2. Financing the Subordinate Capital of the Project.

3. Mudaraba

4. Leasing and buy & lease back.

5. Hire Purchase

6. Murabaha (cost + mark-up)

7. Finance of Working Capital through Mudaraba or PLS.

1. EQUITY PARTICIPATION

This mechanism is characterised by the following :

1. Though the risk is high as the bank participates in the PLS of the project, the voting rights of the bank within the General Assembly of the project and the possibility for the bank to be a member on the project's Board of Directors are a guarantee for the bank's supervision of the project and also facilitates the tasks of administrative, financial and accounting follow-up.

2. Financing through this mechanism is a permanent one and, as such, ensures that the bank keeps its right on its share in the seen and unseen reserves of the project as well as in the probable capital gains resulting from appreciation in some of the project's fixed assets, ie land.

   If the bank sells its shares before liquidation of the project, then this is reflected in the price of the shares.

3. Investment through this mechanism is general and the bank receives its share of the net profit from the project's different activities, thus ensuring a stable balance in the dividend distributed and avoiding any "surprises" like high profits or losses in case the finance is confined to a specific activity.

However, this mechanism has the following draw-backs :

1. Most of the banking laws limit the activities of banks in this field to a small portion of their assets or even their capital as it involves risk of loss.

   Most Islamic banks currently existing have been exempt from anking laws in this respect and others, but the tendency now is to subject them to a kind of regulation, suitable to them, which will mean a limitation on the investment through this particular mechanism.

2. Investment through Equity Participation is a permanent one and not easy to liquidate unless the shares are sold to a Third Party, which is difficult without having the shares of the project quoted on the Stock Exchange and having active dealings in it. It is known that liquidity is one of the main concerns of banks.

3. Related to this point is that an Islamic bank has to wait several years till the project starts realising profit to compensate for the initial years of establishment, during which time the project does not distribute any dividends and consequently the bank has to keep its share for some time, without offering it for sale, inspite of its need for liquidity.

4. The dividends distributed on shares are not deducted from taxable income of the project and also are subject to taxation on dividend, which is mostly deducted at source unless there are laws exempting non-resident shareholders from paying it as an incentive for foreign investment and also in case of double taxation treaties.

5. Laws in most countries stipulate that capital of companies, established on its soil, is denominated in local currency, except in a few cases.

   If the local currency is not convertible or subject to special limitations in this respect, and also if the foreign exchange rate is not suitable vis-à-vis foreign currencies, then in both cases the foreign investor is exposed to foreign exchange fluctuation risks on the one hand, and to the difficulty of transferring his funds abroad at the end of the project on the other. Both the capital and its yield are subject to these two risks, which vary from country to country.

2. FINANCING THE SUBORDINATE CAPITAL OF THE PROJECT

In some countries the law accepts Subordinate Capital to partipate with the equity capital in PLS, but it must be for a limited period only, after which time it has to be repaid.

This mechanism of finance is characterised by both positive and negative aspects. The positive ones are :

1. The balance in the dividend distributed, as mentioned previously in "Equity Participation", No 3.

2. The investment through this mechanism is limited in period since its beginning and the management of the project has to return this capital at the end of the period or before, on an instalment basis according to the financing plan, for which this capital was required.

3. Investment through this mechanism does not necessarily have to be provided in local currency and this helps banks from other countries than the host country to advance such finance in convertible currencies, without being subject to foreign exchange fluctuations and it also facilitates transfer abroad without being subject to limitations of foreign exchange regulations.

4. The dividend or profit realised by the financing bank through this mechanism could be treated tax-wise as interest, and consequently deducted from the taxable income of the project. Equally, non-resident financing parties are exempt from taxes, thus encouraging foreign banks to finance through this mechanism.

However, the negative aspects of this mechanism are :

1. The bank does not have, in case of financing Subordinate Capital, any voting rights in the General Assembly of the project as it is not a shareholder and therefore has no right to become a member on the Board of Directors of the project. Consequently it does not enjoy the positive rights of shareholders in the equity.
2. The bank, in this case has no right in the reserves of the project, nor in its capital gains. Should the bank be refunded, it receives only its capital and usual profits without taking into consideration these elements.

3. MUDARABA

The Mudaraba mechanism could be summarised by one Party providing the finance and the other providing management or labour and both Parties sharing the profits according to pre-fixed ratios. In case of loss, this is all afforded by the Party advancing the finance while the other Party wastes only his effort, unless the loss is due to negligence or mis-management from his side, in which case he alone affords the loss.
We can summarise the positive aspects of Mudaraba as follows :

1. It provides the contractual framework of the sharing of both capital and management in the profits of the project, without charging any fixed expenses, either as financing cost (interest), or as management cost (salary). As such the project has flexibility in fixing the sales price of its products in a more competitive way in the market.

   Such flexibility increases if the use of this mechanism is extended to cover most of the financial needs of the project in such a way as to include, besides fixed assets, raw materials necessary for production.

2. This mechanism of Mudaraba is also flexible in practice as it could either be applied for the whole of the project's activities or confined to just one.

However, Mudaraba has its negative aspects as well :

1. The first is that there is no similar legal framework in the Modern Company Laws to regulate the provisions of transactions carried out on the basis of this mechanism, as is the case, for example, in Equity Partici-pation, where legal provisions regulate the relationship.

   In order not to leave the Mudaraba-based relationshsip in a legal "vacuum", it is necessary to draft a special, detailed contract in such a way as to cover all its aspects, as there is no law to fill the gap, if any.

   It is not enough in such a contact to refer to provisions of Islamic law, as such provisions - like many others - are subject to controversy among the different schools of thought. In order to avoid gaps in the contract, which may invalidate it, the different provisions which the two Parties intend to apply should be provided in detail and the contract being the law of the Parties is complete in itself. Therefore, there should be no need to refer to external provisions unknown to both Parties.

2. The limitation on Mudaraba by a time period invalidates it as the principle in Islamic law is that Mudaraba continues until liquidation of all transactions carried out by the manager (MUDAREB) and the proceeds of these transactions become liquid money, which is called in Islamic law, TANDEED.

   The non-limitation of the period of Mudaraba results in the difficulty for the bank to plan its cash flow and it becomes wiser that the bank classifies financing through Mudaraba under long or medium-term finance, though in fact, it may be liquidated before.

3. The interference of the financing party in the management invalidates the Mudaraba contract according to Islamic law. This means that the use of this mechanism will be limited to cases of complete confidence in both experience and honesty of the manager. Such requirements are difficult as the bank is responsible for the good management of the funds of its shareholders' and depositors' who have trusted the bank and it is not wise to delegate such confidence to a Third Party as confidence nowadays is no longer based on personal relations but on systems and instruments.

   It is assumed that banking institutions have systems of study, follow-up inspection, financial analysis and policy planning & intervention, capable of securing the investments and performance to the level of confidence entrusted to them.

The planners of the Islamic banking system in Pakistan, being aware of its negative aspects, have developed Mudaraba contracts and limited their implementation in a form regulated by law in a way to avoid such negative results. This law, called "MUDARABA COMPANIES AND MUDARABA FLOATATION & CONTROL ORDINANCE 1980", limits the practice of Mudaraba to companies to be established specially for this purpose according to conditions set out by the said law. The law also regulates the way these companies raise public funds and it classifies Mudaraba into 4 distinct types :

1. Permanent and Multi-Purpose
2. Limited Period and Multi-Purpose
3. Permanent and Limited Purpose
4. Limited Period and Limited Purpose.

All these kinds could be with a limited capital or open-ended. The Mudaraba companies issue certificates for funds received from the public or banks, similar to Participating Investment Certificates.

* * *

A law was also promulgated in Jordan under the name "MUQARADA CERTIFICATE NO 10 FOR THE YEAR 1981", regulating issuance by public institutions of redeemable certificates, the shareholder of which participates in the profits of the projects financed by the proceeds of these certificates.

* * *

A further development in this direction is that which is taking place to establish a secondary market to deal in these Mudaraba (MUQARADA) certificates in order to allow the bearer of the certificate to obtain liquidity when needed by selling the certificate on the secondary market.

The research concerning this subject is quite advanced and reached a form similar to Unit Trust dealing or Redeemable Participating Shares, known on the world markets.

However, the idea is not yet realised (proceedings of the 7th Meeting of Islamic Banks held in Amman on 21 March 1986)

4. LEASING AND BUY & LEASE BACK

LEASING

Leasing is a contract allowed in Islamic law. It is also permitted in all countries outside socialist countries where leasing is allowed in limited cases as a result of ownership by the State, of means of production and limitations on private ownership in general.

Many countries promulgated laws for financial leasing and operational leasing and they found that the general provisions of leasing under Civil Law are not enough to meet the needs of this increasing activity.

Such special laws also provide tax benefits to encourage companies specialised in leasing (and banks which are allowed to practise it in some countries), as well as Lessee customers to adopt this mechanism.

Finance leasing differs from operational leasing in that the latter requires that the Lessor is responsible for maintenance and other duties which are not compatible with the nature of finance institutions.

The positive characteristics of the leasing mechanism are as follows :

1. The yield of the operation is fixed and known in advance and as such, the bank avoids capital risks, which are built into other mechanisms (except Murabaha). It is possible for the bank to include the yield in its realised or due income, while this is not possible in other mechanisms (except Murabaha) until the yield is realised.

2. The bank keeps the title of the leased asset, which is considered enough security for the bank.

The negative characteristics are :

1. The title of the leased asset stays with the bank as well as any appreciation in its value (as in the case of land) or depreciation due to amortisation. The bank is also exposed to the risk of having the asset unleased in case the leasing period ends before the assumed age of the asset.

   We will see that Hire Purchase overcomes this last negative point.

2. This mechanism is of a medium or long-term nature according to the assumed age of the leased asset. Therefore, Islamic banks though they started early on using leasing of real estate, instustrial equipment, ships and aeroplanes, they limited the use of this mechanism due to the nature of deposits with Islamic banks, which are mostly of the short-term kind.

These aspects could be overcome by two methods :

1. When Islamic banks accept specified deposits, ear-marked to be invested through this mechanism, whether in general or in a specified asset, then the banks are not embarrassed to invest from general short-term deposits in this mechanism.

   The specified deposit, by its nature, is limited to the period of the investment to which it is ear-marked.

2. Islamic banks could issue investment certificates, representing the leased assets and divide it into denominated units, negotiable in a secondary market and consequently when using short-term deposits in leasing the banks could get liquidity by selling these certificates through the secondary market.

   The main characteristic of the leasing mechanism which makes it suitable for this purpose is the possibility of easy accounting of the asset's value at any time, due to the pre-fixed and known income, expressed in rental and of amortisation according to the nature of the leased asset, which makes the daily evaluation of the investment certificate an easy task.

   Such evaluation could easily be performed by a special computer programme. Besides, the actual evaluation by experts and auditors could be carried out every 3 months. This evaluation could be considered temporarily sufficient until the dealings in the secondary market become active and the value is then fixed according to market conditions.

BUY & LEASE BACK

It is possible, according to the leasing mechanism, that the bank buys the asset from the project and leases it back to them.

This mechanism is useful in financing the companies in need of liquidity by selling some of its equipment to the bank for a cash price, agreed upon in advance, but the company, at the same time, does not lose the use of the equipment as it leases it back from the bank at a fixed rental.

The main condition for validation of this mechanism from the Islamic legal point of view is that such a Buy & Lease Back contract should not include a condition to sell back the asset to the original owner as in such a case this transaction will come under the prohibition of "AINA" sales, which are defined by buying a product and selling it back to its original owner. These two sales are therefore considered, in this case, just a ficticious transaction to hide an interest-based loan.

5. HIRE PURCHASE

Hire Purchase (HP) is also called "Decreasing Property" or "Leasing with option to sell."

This mechanism could take one of two forms :

1. To agree upon a rental of the leased asset, paid periodically until the end of the contract, at which time the price is paid in a lump sum and the ownership title is transferred from owner to lessee.

2. The second form is to have the sales price paid by instalments and each time, the title partially passes to the lessee in proportion to the instalment paid. Besides, the rent is also paid from the beginning to the end of the contract, but such rent is decreasing in proportion to the part of ownership which passed to the lessee as a result of payment of sales instalments.

In this second form it is necessary that the payments table, agreed upon, should clarify which part of the instalment is considered decreasing rent. It is of importance from the Islamic law point of view to have such a contract drafted in a clear and precise way in order to have the equity of both parties - seller and lessor on the one hand, buyer and lessee on the other - to avoid mixing consequences of sales and leasing, and losing the basic distinction between them as far as the transfer of ownership and the capital risk appreciation and depreciation are concerned.

From the above one could demonstrate the following positive aspects of these mechanisms :

1. The yield of investment is pre-fixed and known as in the case of leasing.

2. The bank reserves the title of ownership of the leased asset to the unpaid proportion of its value, which is considered enough security for the unpaid balance of the finance advanced by the bank.

3. The bank - unlike in the case of leasing, is bound in advance to sell the asset to the lessee and consequently is not exposed to the risk of having the asset unleased.

However, the negative aspects of this mechanism are :

1. As owner of the asset to the extent of the unpaid part of its value, the bank is exposed to the damage risk of the asset as well as risk of appreciation or depreciation in its value.

2. This mechanism is like a leasing mechanism, ie for a medium or long-term period and the two ways of remedying this, as explained before, could be used in this case also.

6. MURABAHA (Or Cost + Mark-up)

Murabaha is the sales contract in which the seller declares the cost of the goods and agrees with the buyer on the profit margin to be added to the cost.

It could be applied in both cases of cash payment or deferred payment. Islamic banks usually use Murabaha sales on deferred payment basis by buying from a Third Party, on a cash basis, the goods required by its client and then sells them to the client for a deferred payment period and at an agreed price.

In industrial finance such a mechanism could be used to finance fixed assets, such as land, buildings and equipment and also to finance working capital in the case of raw materials and spare parts.

The positive aspects of this mechanism are :

1. The risk is limited as the profit margin is pre-agreed and the relation between the bank providing the finance and the company is of a creditor/debtor nature.

2. As the relationship is of a creditor/debtor nature, and not on a partnership basis, it is possible to take the necessary securities for both capital and profit.

3. It is a flexible mechanism, period wise as it could be used for short, medium or long-term finance.

However, the negative aspects are :

1. It is only possible to be used where goods are involved, which could be bought and sold. Consequently, it could not be used to finance running expenses such as salaries, rent, cost of transport, propaganda, distribution, taxes and services such as water, electricity, telephone, telex, etc.

2. The profit margin is cost on production as it is pre-fixed. As such, Murabaha is similar in this respect to financing through lending and different from PLS financing, where the cost of finance is not added to the production costs and also different from Mudaraba, where neither the cost of finance nor management is added to the production costs.

7. FINANCE OF WORKING CAPITAL THROUGH MUDARABA OR PLS

Some Islamic banks are financing working capital of projects by means of Mudaraba or PLS. Pakistan developed the mechanism of PLS as defined in the "Mudaraba" section, in order to avoid being subject to the provisions of Mudaraba contracts in its traditional form, especially in its negative aspects of non-limitation of period and non-interference of the financing party in the management.

In the new, developed form of PLS, the financing bank has the necessary flexibility to perform its function. However, the two forms of Mudaraba and PLS are basically similar in that in case of loss, this is shared amongst the financing Parties in proportion to the finance advanced by each of them and the working partner (manager) wastes only his time and effort, while in case of profit, it could be distributed according to the pre-fixed ratios, even if it is different from the financial ratios.
Detailed ordinance and instructions have been issued by the Central State Bank of Pakistan to the commercial banks, clarifying the terms and conditions of the PLS financing mechanism.

The Banking and Financial Services Ordinance, issued in Pakistan on 31 December 1984 stipulates the possibility of using investment terms certificates and redeemable participating capital as a part of the redeemable capital of companies in which banks and financial institutions could participate.

Besides this form, regulated by Pakistani Law, other Islamic banks which are using this mechanism in financing working capital, are accounting for the volume of variable finance advanced by each party (on the basis of Points Product System), and account a share of the profit to the company for management. The balance is then distributed among the financing parties, according to their ratio of finance.

The agreement provides clearly what could and what could not be deducted from the gross income of the company in order to reach the net profit for distribution (such as reserves, taxes, provisions for amortisation and bad debts, etc).

This mechanism has positive aspects, which are as follows :

1. It covers the company's needs for working capital, regardless of the way they use it. In this it is different from the Murabaha mechanism, which only covers the needs for raw material and spare parts, and cannot be used to finance salaries, rent and general expenses.

2. It is limited in period, usually linked to the financial year of the company and renewable. It enables the bank to supervise the company's activities through its account, kept with the bank (it is usually stipulated that all receivables of the company are credited to this account), through the follow-up of its activities at Board level (if the bank chooses to have a member on the Board) and also at a daily working level through continuous contacts between the company and bank.

However, the negative aspects are :

1. It could only be possible with large companies with efficient administrative, financial and accounting organisation, enabling the bank to deal at a technical and professional level.

PART II

THE NEED OF ISLAMIC BANKS FOR ADDITIONAL MECHANISMS IN INDUSTRIAL FINANCING

It is clear from the previous exposé of the differenct industrial financial mechanisms available to Islamic banks and which is summarised in the attached schedule*, that there are some shortcomings in the available mechanisms which impede the progress of Islamic banks in the field of industrial financing.

The present Paper aims to study such shortcomings and show different gaps which still exist and need solution and some proposals in this respect.

We can treat this under the following headings :

1. Loss Making Risks
2. Foreign Exchange Risks
3. Matching Maturities Problem
4. Conventional Banking Laws Limitations
5. Procedure for Developing Finance Mechanisms

* ANNEX 1

1. LOSS MAKING RISKS

Islamic banking is basically different from conventional banking in that the former is exposed to risk while the risks are almost totally absent in the latter case, due to the lending at interest system.

We do not intend to discuss, here, this basic difference between the two systems. However, what is necessary to clarify is that it is not true that investment cannot be permissible under Islamic law unless the capital is exposed 100% to risk. There are, of course, different degrees of risk and it is wise that the investor, whether individual or institutional, follows a policy of caution in his investments which is reflected in the mechanisms such investments follow.

The need for caution is more in the case of banks whose success largely depends on the degree of confidence depositors have in them and consequently on the degree to which these banks are keen to secure their depositors' funds.

We saw that financing through Equity Participation, Mudaraba and PLS suffers a high degree of capital risk, while this risk is reduced to a great extent through mechanisms of Murabaha, Leasing and HP. That is what led Islamic banks to focus on the mechanism of Murabaha in its investments.

In the following we will analyse some of the reasons for these risks, built in the mechanisms of Equity Participation, Mudaraba and PLS.

FIRST

The first difficulty in using these mechanisms is that you need to make an evaluation of the project before taking the decision of financing it, and in the need to follow it up very closely until the final liquidation of the project. Both evaluation and follow-up need experienced staff, specialised in the branch of the project and in the financial, accounting, administrative and marketing fields as well.

It is not enough to depend on routine office experience which is content to refuse the financing of a project or to classify it within the list of bad debts. Besides this, practical field experience is needed in order to find solutions to problems and lead the investor to safety. Such experienced people are hard to find and very costly, making it difficult for Islamic banks to invest at large on the basis of Equity Participation, Mudaraba and PLS mechanisms.

Small companies and individual establishments, which are not usually keeping legal accounts and organised administration and which are more exposed to dishonest and irregular accounting are too risky to deal with on this basis.

2. It is necessary, in drafting the agreement, to be more precise in defining clearly the accounting method and the different elements to be deducted from the gross income before reaching the distributable net profit.

   Such drafting needs the cooperation between legal, financial and accounting experts from both parties in order to avoid any litigation.

3. This is a risk capital mechanism as it is based on PLS and as such, before adoption, needs a thorough study of the economic, financial and commercial conditions of the project in order to avoid the bank's involvement in the financing during a period when the income of the project is not satisfactory for the bank.

* * *

The solutions to this problem could be found as follows :

1. To establish a pool of project evaluation within an international organisation such as the Islamic Development Bank or UNIDO, the Islamic banks having to share in the cost of such services.

2. To organise concentrated training programmes for officers of Islamic banks working in investment fields in order to aquire experience and dexterity which raises the performance level of the existing investment organs in banks.

3. To encourage the establishment of independant follow-up practices, or developing some of the offices of auditors and lawyers to perform the follow-up function on behalf of Islamic banks for pre-agreed fees.

SECOND

Another problem is represented in the dependance of success of the project under investment on the experience and honesty of the project's manage- ment. Such risk increases in small and individual projects where financial or administrative organisation is absent and supervision by the bank on the progress of the project and its accounts is difficult.

Therefore, it was not by chance, nor meaningless that the legislators in Pakistan and Jordan limited the Mudaraba activity to companies of reasonable capital. The Jordanian legislator even limited it to public companies.

It is evident that the rarity of the capable, honest management, referrred to by the Quran ("the best you employ is the capable and honest") leads some of them to prefer working for themselves,those left being "head hunted" by large institutions.

The first kind are often too greedy to share with the financing party in the profits of the project, since they believe - and maybe rightly so - that the basis of success or the main element of it is due to management more than capital.

In any case, dealing of Islamic banks on the basis of PLS or Mudaraba with this kind of person is risky and can only be tolerated within the framework of local banks or branches of large banks, where the personal relations and trust between the management of the bank and the client plays an essential rôle in the success of this kind of transaction.

The solution to this situation could be found in the following :

1. To encourage promulgation of legislation, creating a legal framework for the Mudaraba activities, conditions for its establishment, management, supervision and control in a way to give the Islamic bank more security to finance on Mudaraba basis.

2. To limit financing on the basis of Equity Participation and PLS to large companies, where financial and administrative organisation and supervised staff can be trusted to manage the project well.

3. To take securities from managers, wherever possible. Security is not meant here to secure the capital and the profits as this is against the nature of PLS and Mudaraba, but in the sense that it is limited to the performance of the management obligations in a way that in case of non-compliance, it could be possible to revert to securities whether personal or real without wasting time and effort, and risk ruing the defaulting management.

THIRD

The third difficulty is the importance of product marketing in the project and its impact on profitability. No doubt this problem could be covered by the evaluation of the project and by the organisation of the management giving due attention to marketing.

However, the sensitive relationship between marketing and profitability, and the possibility of reduced demand for the product for reasons beyond the manager's reach, make it necessary to carry out a thorough marketing study.

The rôle of Islamic banks in development is basically played by participating in the promotion and financing of new projects until the start of production and success is attained by opening markets and realising profits. Then the bank can choose a suitable moment to sell its shares in the project in order to obtain the liquidity necessary to enter into other new projects.

Therefore, the bank realises the annual dividends - after a few initial years where the new project is not giving dividend at all- as well as capital gains from the sale of its shares in the project.

This means the bank does not contribute to the development by having shares in running projects, nor by continuing to keep its shares in the project after its success, but in the continuous promotion and financing for the creation of new projects and then by selling them when fruitful.

This pilot positive rôle needs to receive special attention in marketing the project's product so as to share in its success, and then focuses its attention on the shares of the project itself in order to sell them off at a profit, high enough to compensate for the risk, time, effort and expense afforded during the establishment period.

All this means that the bank needs to establish a strong department for venture capital, depending on a group of experts in industrial engineering and economics. Such experts are rare and costly and it is therefore suggested that such a department be established as a joint venture between Islamic banks within a pool. It has been suggested that such a pool could be set up within IDB or UNIDO.

FOURTH

The last remedy for capital risks - which does not exclude the previous proposals but has to be added to them - is the establishment of an investment guarantee institution, commonly owned by Islamic banks.

The principle in Islamic law is that the management in Mudaraba contracts is only responsible in case of mis-management and negligence, eg, by investing in a project which is not allowed or by not taking the necessary precautions in the management of Mudaraba funds.

It is also agreed that guarantee in cases other than the previous ones is possible if this is offered by a Third Party. Hence, the idea of establishing an institution for guarantee of investment risks, to be financed by Islamic banks through a percentage of their profits, and those of depositors, considered as a donation,and the proceeds of these contributions, be paid to cover the loss of capital in case of Mudaraba, Equity Participation and PLS according to a system to be set up in the form of a mutual insurance company, which is allowed from the Islamic point of view.

2. FOREIGN EXCHANGE RISKS

The risks of Foreign Exchange in industrial financing of Islamic banks could be studied in two aspects :

1. Limitations on movement of funds to and from the host country

2. Devaluation or decrease in the local currency rate

FIRST

The ideal investment environment, among others, is expressed in the freedom of capital movement to and from the host country. There are some limitations on this freedom, which differ from country to country, and which are completely absent from others. The most severe of these limitations is the non-allowance of refund of foreign capital after allowing it in the host country.

Next is the non-allowance for a fixed period, (several years) to get the foreign capital out, after which it is allowed to be transferred in a lump sum or in tranches.

Some host countries do not allow the transfer of capital but do permit the annual transfer of profit within a certain percentage of the capital.

Wherever such limitations on the movement of foreign currency exist, a black market develops, allowing at least two rates or sometimes up to five or six different foreign exchange rates.

Sometimes, the law of the host country allows the entry of foreign capital at one rate (official or incentive) and allows its exit at another rate (incentive or free). It could also have different rates for exit of capital than for exit of profit.

Islamic banks and their "foreign shareholders" have suffered from these limitations as is expressed in different banks' reports. What applies to the "foreign shareholders" in Islamic banks applies in one way or another to the investments in Islamic banks outside their own countries, if they decide to finance in countries subject to these limitations.

Naturally, such limitations in certain countries do not encourage investments. Therefore, the idea of exempting capital coming from a specific country or for a specific project from these limitations in order to encourage foreign capital needed badly by such countries.

Such exemptions are contained in laws which also give guarantees to foreign investors. Taking seriously such guarantees and laws, foreign capital is flowing in the hope that the host country is respecting its official promises, expressed in these laws.

To the surprise of the foreign investor such laws are being amended and such exemptions cancelled resulting in a drastic change in the results of the investments in a way which was never predictable to the foreign investor and which has totally changed, in most cases, the results from expected profit to a realised loss.

By repetition of such situations in more than one country and under different political and economic systems the foreign investor lost confidence in the foreign investment laws with all their incentives, exemptions (and guarantees).

To meet this confidence crisis, a special treaty was concluded to establish the Inter-Arab Investment Guarantees Corporation to which 22 Arab countries adhered. Under its scheme the Corporation provides compensation for losses emanating from the following non-commercial risks :

a) Expropriation and Nationalisation :

This includes measures taken by public authorities in the host country whereby the investor is deprived of his rights with respect to his investment and in particular measures relating to confiscation, nationalisation, sequestration, expropriation, compulsory seizure or deprivation of a creditor of his rights including the right of assignment and the imposition of moratoria of unreasonable length.

b) Inconvertibility :

This includes introduction by the public authorities in the host country of new measures which prevent the investor from repatriating the principal of his investment or the remission of his earnings therefrom or the investment amortisation instalments. This also includes delay for an unreasonable period in approving the transfer, or the imposition by the public authorities of a rate of exchange which clearly discriminates against the investor at the time of the transfer. This does not include the measures existing at the conclusion of the guarantee contract, nor does it include the general measures of devaluation of currency or its decrease.

c) Wars :

This includes any armed foreign intervention or local civil disturbances in a host country, ie revolutions, coups d'etats, insurrections and other acts of violence which have a direct detrimental impact on the assets of the guaranteed project.

It is suggested that the possibility be studied to enlarge this treaty to include all Islamic countries, and to amend the way of investment of the Corporation's funds in order to avoid interest based investments and consequently to be acceptable to the Islamic investor.

However, a pressing question is whether the Inter-Arab Investment Guarantee Corporation has succeeded in solving the confidence crisis of the investment environment in the Arab world since Arab capital is continuously moving outside the Arab world and it is becoming necessary to thoroughly study the reasons for this situation and the solutions to it.

It may be that among these reasons is the exception at the end of Paragraph b) of the general measures of currency devaluation or the decrease in its value from the risks covered by the Corporation on the basis that these risks are normal ones, to which any country is exposed and which the investor should expect a nominal commercial risk. This is what we are now going to discuss.

SECOND : DEVALUATION OF LOCAL CURRENCY OR DECREASE IN ITS VALUE

The devaluation of the local currency or the decrease in its value represents a real obstacle to the foreign investor, especially on a medium or long-term basis, due to the fact that until the investment proceeds yield in the local currency the investor finds that the value of his investment in its original currency has decreased in a way so as to absorb the yield and even produce a loss in most cases.

We must define, here, between two cases :

1. Cases of countries which have not put limitations on the movement of foreign currencies, in or out, and which allow at the same time, for non-residents to deal in its local currency.

2. Cases of countries in which limitations are set on both movement of foreign currency and dealing by foreigners in its local currency.

1. <u>First Case</u>

We take Germany as an example, where a Kuwaiti or Saudi investor could convert any convertible currency to Deutschemark (DM) and where he can deal in DM, then convert them back to the convertible currency again.

Here, the risk of dealing in DM lies only in the possible decrease in its value and, consequently, in the decrease in value of the investment itself denominated in DM and therefore realising a loss when the investment proceeds are converted again to the foreign currency.

The measure taken in this case by conventional banks is to conclude a forward purchase contract of the foreign currency matching the maturity date of the DM investment, thus allowing the con- version from DM to the foreign currency at the agreed rate.

The fixation of the forward foreign exchange is accounted for on the basis of the spot rate plus or minus the difference between the interest rate of both currencies.

EXAMPLE : If the spot rate for $ is 2 DM and the interest on $ is 10% and on DM is 5%, the forward rate for $ would be 1.9 DM (2 minus 5%). If the spot rate of $ is 2 DM and the interest on $ is 5% and on DM is 10%, then the forward rate for $ would be 2.1 DM (2 plus 5%).

In both cases the foreign exchange risk is limited to 5% plus or minus, which is the difference of interest rates of both currencies and this difference is known in advance when the investment starts and could, therefore, be taken into consideration when examining the feasibility study of the project, for instance if the expected return of the investment project is 15% then it becomes 10% or 20% according to the circumstances.

At the end of the investment transaction (say, 1 year) the $ is purchased at the rate pre-agreed upon at the beginning of the transaction, even if the actual rate at the end of the transaction differs. (eg, if it became $1.00 = 2 DM or 1 1/2 DM.) This change has no impact on the execution of the transaction at the pre-agreed forward rate and this is the protection which this transaction gives. Without such cover the increase of $ from 2 DM to 2 1/2 DM exposes the foreign investor in Germany to a loss of 25% when re-converting the DM to $ and vice-versa, a decrease of $ from 2 DM to 1.5 DM results in a profit of 25% when re-converting the DM to $.

Consequently, both cases will affect the investment yield, which is assumed here to be 15% to become 40% in one case or to become a loss of 10% in the other.

As the forward contract in foreign exchange is not allowed in Islamic law according to the prevailing opinion of Islamic jurists, due to the opinion that there should be time matching between the agreement on the rate of exchange and the actual execution of the transaction, some Islamic banks have developed as an alternative to the spot purchase of local currency and the forward purchase of the foreign currency, another arrangement called "Reciprocal Interest-Free Deposits" in different currencies without actual spot or forward purchase. The arrangement could be summarised in a deposit - interest free - from one Party to another, guaranteed by a deposit from the other Party in another currency, also interest free. When both deposits mature (say, after 1 year), each Party gets his deposit refunded in its original currency. This arrangement enables them to each use the currency of the other Party for the agreed period without facing foreign exchange risks.

In such an arrangement between an Islamic bank and, say, a German bank, the latter makes its calculation on the same basis of difference between the interest rates of the two currencies. Taking the previous example, if the interest on $ is double that of DM, the German bank will offer, against a deposit of $ 1 mn, a deposit of 4 mn DM, while if the interest on $ is half the interest on DM the German bank will offer a deposit of 1 mn DM against a deposit of $ 1 mn and this in both cases in order to have equal interest proceeds between the two currencies.

This will have its impact on the investment yield for which the DM is needed. If the project requiring finance in DM needs 2 mn DM and the assumed yield is 15% (300,000 DM) this yield will be accounted in one case in relation to the $ investment of 1/2 mn which results in a yield of 30%, while in the other case will be related to the $ deposit of 2 mn, resulting in a yield of 7.5%

The following table shows a comparison of these results :

	In case of Investment without cover	In case of cover by forward contract	In case of cover by reciprocal deposits
Maximum Profit	Profit 40%	Profit 20%	Profit 30%
Minimum Profit (or Maximum Loss)	Loss 10%	Profit 10%	Profit 7.5%
Elements influencing the Final Yield	Investment Yield + FX Rates	Investment Yield + FX Rates + interest rate	Investment Yield + FX Rates + interest rate

FX = Foreign Exchange

The previous table shows that the use of the reciprocal deposits mechanism is not very useful from the economic point of view, besides involving the interest element, which is similar in this case to the cover by forward contract from the Islamic point of view.

Therefore, there is a clear need to find other solutions to this problem.

2. <u>Second Case</u>

If we take as an example Egypt or Sudan as a host country for this case the use of either the forward contract mechanism for the foreign currency (which is excluded, anyhow, from Islamic banks) and the reciprocal deposits mechanism, as cover for risks of depreciation or decrease of the local currency, we will meet some problems :

Assuming that a Kuwaiti or Saudi investor makes an arrangement with an Egyptian or Sudanese bank for a reciprocal deposit :

The first question will be the possibility of opening an account in the local currency (Egyptian or Sudanese Pounds) in the name of the foreign investor. If this is possible :

Then we meet the problem of direct investment in real estate, for example, where the foreign investor needs - besides the permission from the Authorities to have title to real estate - to convert the foreign currency at the rate fixed for such investment by the Authorities and the equivalent in Foreign currency goes to the State. The local bank cannot use it as a reciprocal deposit, however, according to the arrangement referred to above.

If the investment subject was to buy shares in a local company, such a purchase should take place in the foreign currency whether the company is covered by the special law for foreign investments, allowing the foreign investor to repatriate the capital and profits abroad, or whether it is a local company (according the Law No 159/81 in Egypt, for instance) where the law does not guarantee the repatriation of the capital and yield abroad.

This means that in all cases the payment at the beginning of the investment should be in a foreign currency and therefore the mechanism of reciprocal deposits cannot be implemented.

A solution for possible further consideration is to use local intermediaries (for instance a local Islamic bank in Egypt or Sudan), in whose name the investment takes place and who consequently pays in local currency on account of the foreign investor, besides using the mechanism of reciprocal deposits to cover the foreign exchange risks.

THIRD : MATCHING MATURITIES PROBLEM

Industrial finance needs different kinds of resources, on long, medium or short-term basis. As most of the resources of Islamic banks come from short-term deposits and on-call (current and savings) accounts, short-term finance in the Industrial Sector does not pose any problem.

It usually takes the form of financing working capital, either on Murabaha basis, when buying raw materials and spare parts (usually for periods between 1 and 6 months), or in the form of PLS (usually for 1 year) as explained previously.

However, the problem arises concerning the medium and long-term finance, due to the principle of matching maturities, ie the non-use of short-term resources in long-term investments, otherwise the bank gets into liquidity trouble if depositors withdraw their short-term deposits.

Islamic banks are no exception, in principle, in this respect. However, in practice they have more surplus liquidity than available investments to absorb it. This fact should not force them to invest long-term on a non-calculated risk basis as in extraordinary public circumstances (political or economic) or private ones (non-distribution of profits to depositors), the picture could change and lead depositors to withdraw their deposits, whether on-call or short-term, upon maturity.

Therefore, the problem should be studied in its right framework without being influenced by temporary circumstances. We will discuss the problem at 3 levels :

A. Resources matching the needs of medium and long-term finance.

B. Resources, not matching the needs of medium and long-term finance.

C. Non banking resources

A. Resources matching the needs of Medium and Long-term Finance

These resources are of 3 kinds :

(i) Equity capital of the bank
(ii) Subordinate capital of the bank
(iii) Specified deposits

(i) Equity capital of the bank

Equity capital of the bank is available for investment for an unlimited period. However, normally the volume of the capital is limited in relation to the volume of deposits and is also usually used to acquire fixed assets of the bank, such as the premises of Headquarters of branches, or furniture and equipment,necessary for the bank to function.

In case these uses do not absorb the whole of the paid-up capital, the balance could be used for long-term investments. The best investments in this case are Equity Participation in subsidiary companies as such Equity Participations are permanent investments which should only be financed from permanent resources.

The bank, in this case gives priority to Equity Participation in the subsidiaries complementing its financial function such as companies for finance, investment or insurance.

As for producing companies, whether industrial, agricultural, commercial or services companies, they come in order of priority after the first group of companies and therefore the participation of the bank in these companies is usually symbolic.

(ii) Subordinate Capital of the bank

Subordinate capital of the bank in countries where laws permit acceptance of such resources is usually of a long-term nature (5 years minimum) and is usually called to fill the financial gap in the bank's capital structure in case any obstacle impedes raising Equity capital (such as currency risks, taxes, temporary need, statutory ratios between capital and investments). If such are usually the reasons for calling subordinate capital, one could consider the possibility of classifying long-term investments (industrial and others) among these reasons, which allows the bank to raise subordinate capital and to treat it on PLS basis (as participating bonds and participating debentures are treated in some countries.)

(iii) Specified Deposits

Specified Deposits are the most appropriate resources in Islamic banks for medium and long-term industrial finance, as they are not limited in period but linked to the period of the project for which it is ear-marked. A Specified Deposit could be ear-marked to a specific project, it could also be destined for a specific sector (industrial, agricultural, trade, housing, etc) or for investment in a specific country.

The depositor in the specified deposit does not share in the results of the general pool of investments of the bank, but his deposit is connected PLS-wise to the results of the specific pool (Project, Sector or Country) to which his deposit is ear-marked.

In case of deposits linked to a specific project (but not those linked to a specific sector or country), the depositor's authorisation to the bank for management of the project is rather of a proxy nature than of "Mudareb" nature as the depositor clearly accepts the risks of a specific project. On the basis of the proxy, the fees of the bank could be a percentage of the deposit or a lump sum, while in case of the general investment the bank's fees should be a percentage of the profit, as is the case of a "Mudareb" in the Mudaraba contract.

If the specified deposit is, in principle, linked to the period of the project, there should be no problem to apply the idea of consecutive partnership to this specified pool and allow new depositors to come in after the start of the project or to pull out before its liquidation, but still sharing in the final result of the project, whether profit or loss.

The rôle of the Islamic bank in this kind of deposit is very similar to the fiduciary function of conventional banks. Islamic banks (specially in Pakistan), took a further step in this respesct by issuing investment certificates representing the assets invested by Islamic banks or by "Mudaraba" companies in Pakistan.

The most suitable assets for this purpose are leased assets as they can be evaluated periodically and their yield (rental) pre-fixed. Consequently, the certificates representing these assets could easily be assessed and dealt with and the profit realised includes 2 elements, one being the monthly or yearly income divided by days and the other being the appreciation or depreciation in the value of the asset itself.

If a secondary market could be organised, where such certificates are negotiated then it would be easy for banks and individuals to invest on short-term by buying these certificates to absorb their surplus funds or by selling them when liquidty is needed. The more widespread this secondary market, the more effective it becomes as a channel for regulating the liquidity of Islamic banks.

Such diversity and flexibility in using the mechanism of specified deposits and investment certificates make it possible for Islamic banks to advance industrial finance, whether in the form of equity capital or by leasing plant machinery and equipment on long and medium-term basis.

We should take into consideration, finally, that in this kind of finance, not depending on the private resources of the bank, it is important to give more attention to marketing the industrial project among depositors in order to convince them and attract their deposits. Such effort should be carried out jointly by the bank and the management of the project as the flow of finance needed by the project depends on the success of such marketing.

B. Resources not Matching the needs of Medium & Long-term Finance.

We intend to discuss here the possibility of using the on-call deposits (current and savings accounts) and the short-term general deposits (1 month to 1 year) in a medium and long-term financing as well as the question of transformation of maturities :

1. Islamic banks could - as conventional banks do - analyse the average withdrawal of its on-call deposits and the average of renewal of short-term general deposits in such a way as to forecast the liquidity possibilities available from these resources over the next 2 or 3 years and in the light of such analyses, up-dated regularly (monthly for instance), Islamic banks could fix percentages of these resources and direct them to medium-term investments. Such possibility is subject, of course, to regulations and ratios fixed by the banking laws in each country.

2. Islamic banks could also choose among its long-term investments, suitable assets to be represented by investment certificates, negotiable within a secondary market and thus allow banks to transfer these long-term assets into liquidity when needed, by selling the certificates representing them.

Such arrangement could take into consideration :

a) In case of Equity Participation in the capital of the projects, the shares should be quoted in the stock exchange at the first possible date and dealing in them should be activated.

b) Finance of subordinate capital of projects should take the form of redeemable shares and also be quoted in the stock exchange as early as possible and dealing in them activated.

c) Finance on Mudaraba basis should take the developed form as in Pakistan and Jordan, where negotiable certificates are issued and dealing in them activated.

d) Also in the case of leasing and HP it is preferable to take the form of certificates representing the leased assets to be negotiated and dealing in such certificates activated.

This means in all cases it is necessary to activate a secondary market to deal in these instruments in order to make them easily liquidated, which is necessary for success. Needless to say, it is necessary to widen the possibility of the secondary market through cooperation between Islamic banks in this respect

C. <u>Non-Banking Resources</u>

Industrial finance should not be limited to the bank's resources. Investment and insurance companies have long-term funds available for this kind of finance. Many Islamic investment and insurance companies have been established and their resources should be taken into consideration in this respect. This requires :

1. Coordination with these companies whether directly or through Islamic banks, to which they belong or through the pool which has been suggested to be established within IDB or UNIDO.

2. Development of instruments and mechanisms, suitable to the nature of these companies, whose requirements are, in principle, simpler than banks - which are subject by nature to restricted banking regulations.

3. To consider specialisation and distribution of functions in the field of industrial finance so that each Islamic investment company specialises in a different type of industrial finance, thus facilitating coordination and supervision of finance management.

Some could specialise in leasing, some in stocks and others in Mudaraba. Specialisation could also be according to the kind of industry. Some could specialise in heavy industry, some in semi-product industry and others in final product industry.

Specialisation could also be according to countries where an Islamic investment company could specialise in industrial financing in each country.

Such specialisation will help to concentrate expertise in each field, save a lot of effort and expense and give Islamic banks more chance to concentrate on their other banking activities.

FOURTH : CONVENTIONAL BANKING LAWS LIMITATIONS

To allow the establishment of Islamic banks in non-Islamic countries, using mechanisms of finance and treatment of deposits different from those used by the conventional banks, it was necessary to exempt such banks from the conventional banking laws and regulations until suitable rules could be applied to this new set of banks.

Consequently, banking law regulations in Islamic countries are no problem for the activities of these banks. However, the problem arises when establishing Islamic banks without such exemptions, which happens outside the Islamic world, where they are not expected to receive such special treatment.

This issue is important when discussing the possibility of cooperation between Western banks and Islamic banks in financing industrial projects as the finance mechanisms, as explained before, which are valid in Islamic banking, are not possible under Western banking laws. Therefore, it is necessary to discuss the issue and find a solution allowing such cooperation.

The basic problem is that the mechanism of conventional banking is based on lending and allows capital risk investments within a very limited area, where for instance it is limited to a small percentage of the bank's capital (in order to spare the depositors any risk) and takes the form of acquiring shares in public companies as opposed to private ones. It is also required that such shares are negotiable on the stock exchange so as to facilitate transforming them into liquidity and other such measures which exclude the use of Mudaraba and PLS mechanisms by conventional banks, besides making use of Equity Participation very limited.

As for the mechanism of leasing and HP, some banking laws allow their use either by banks directly or by specialised leasing companies which obtain the finance from banks within allowed ratios.

Therefore, the mechanism of Murabaha is the only possibility available - within the normal credit ceilings - for conventional Western banks to finance projects, as in Murabaha transactions the relationship ends immediately after its start to a creditor/debtor relationship between bank and customer, which is similar to Western banking mechanisms.

Assuming an Islamic bank and a Western bank would share equally in the finance of an industrial project, the following table shows the possibility and conditions of distributing such finance among different mechanisms available to both kinds of banks :

FINANCE MECHANISM	ISLAMIC BANK	WESTERN BANK	TOTAL AVERAGE
Equity	10	1	5.5
Subordinate Capital	15	1	8
Conventional Mudaraba	-	-	-
New Mudaraba Form	15	-	7.5
Leasing	5	5	5
Leasing with Certificates	10	19	14.5
Hire Purchase (HP)	5	5	5
HP with Certificates	10	19	14.5
Murabaha	15	50	32.5
Finance of Working Capital on PLS	15	-	7.5
TOTAL	100	100	100

The previous table took into consideration the following assumptions :

1. Participation of Western banks in the equity of the project or in its subordinate capital is symbolic (1%), while participation of Islamic banks could be 10% in the equity and 15% in the subordinate capital.

2. Western banks do not participate in Mudaraba, either in its conventional or its new form, nor do they finance working capital on PLS basis, in order to avoid breaking Western banking laws.

Finance by Islamic banks could reach 15% in the new Mudaraba form (we excluded the conventional form due to its negative aspects) and to 15% in financing working capital on PLS basis.

3. Finance by Western banks through the Murabaha mechanism could be 50% as it is suitable for Western banking laws, while Islamic banks were limited to 15% in order to distribute their finance to different available mechanisms.

4. Finance by Western banks through leasing and HP took the balance left with preference given to the certificates form in both cases, in order to facilitate investment liquidity.

5. These percentages include the total finance advanced by Islamic and Western banks to the project, whether equity capital or short-term finance (Murabaha and working capital on PLS basis), medium-termfinance (Murabaha, leasing, HP and Mudaraba), or long-term finance (Murabaha, leasing, HP and subordinate capital).

FIFTH : PROCEDURE FOR DEVELOPING FINANCE MECHANISMS

It is clear from the previous exposé and the comparitive summary on the attached schedule that there are some gaps in the mechanisms available to Islamic banks.

This does not mean that the basic concept of Islamic banking is unable to remedy such shortcomings but this is due mainly to quick expansion in the establishment of Islamic banks and the increase in their deposits to an extent never imagined by those who planned the Islamic Banking Movement.

Such expansion resulted in focusing on the daily business of these banks rather than planning activities, which include among other things, the development of financing mechanisms.

The chance of Islamic banks in developing their mechanisms is much greater than for conventional banks due to the fact that the latter are limited to one formula which is creditor/debtor, whether with their depositors or users of their funds.

Islamic banks, however, could use several forms of transactions, reflecting a wide range of economic and financial activities which therefore allow enough flexibility to meet the varied needs of economic life. Realising such a target is a really innovative task, not only from the Islamic law point of view but also from the banking angle as it involves creation of new instruments and mechanisms which were never used before, either by Muslim Jurists or by bankers.

It is clearly a multi-dimensional operation, as innovation of such instruments and mechanisms does not only take into consideration adaptability to Islamic law, but also positive laws which are different from one country to another and consequently it is expected that the same form will be expressed in multiple models according to different requirements of laws in each country.

It is also important to take into consideration that the cost resulting from the use of the new instruments should be to the minimum, whether from viewpoint of tax, commission and fees of intermediaries or from the administrative costs angle.

Therefore, the participation of experts from different disciplines such as Islamic law, contemporary law, banking and taxation, is necessary in this kind of team-work.

As the actual Islamic Banking Movement suffers from certain obstacles, priorities should be given to those fields which need immediate remedy, such as :

1. In the field of financing working capital on PLS basis, it was clear that some negative aspects can impede the implementation of this mechanism. Therefore a new mechanism needs to be found, avoiding such negative points.

   There is a separate Paper including proposals from Professor Dr Volker NIENHAUS in this respect concerning the participation in added value.

2. There are two types of contract under traditional Islamic law which are very suitable to industrial finance ; one is the "SALAM" contract, which is a sales contract in which the price is paid in cash and delivery of the goods deferred. The other is "ISTISNAA" contract, according to which one person requests another to produce a certain product for an agreed price.

   Both these contracts are not yet used by Islamic banks and need modern drafting to make them suitable for banking purposes on the one hand, and the needs of industrial finance on the other.

3. No alternative has yet been found to the overdraft facility, practised by conventional banks, which could be acceptable from the Islamic point of view and could cover practical needs at the same time.

   The uses of Murabaha mechanism, as previously explained does not cover all cases, especially service expenses. The finance of working capital on PLS basis also encounters some problems, therefore the door is open to several alternatives and solutions.

4. The question of the secondary market has been studied enough in principle, but its implementation needs preparatory research covering the choice of the legal framework and the concept of arrangements between the different Parties concerned.

5. The rôle of banking guarantees in financing is still the subject of discussion between Muslim Jurists and bankers alike and needs development to allow Islamic banks to offer such essential services in a form, acceptable from the Islamic point of view.

It is suggested that a team be formed, whose terms of reference would be to develop the financing mechanisms of Islamic banks in cooperation with the different Parties concerned and including experts in the different specialised fields, necessary to perform this function.

* * *

A COMPARATIVE TABLE OF INDUSTRIAL FINANCING MECHANISMS AVAILABLE TO ISLAMIC BANKS

ANNEX 1.

	FINANCE MECHANISM	[illegible]	[illegible]: [illegible]	[illegible]: [illegible]	CAPITAL RISK	IMPACT OF TITLE ON: [illegible]	IMPACT OF TITLE ON: CAPITAL GAINS	IMPACT OF TITLE ON: ASSET RISK	IMPACT OF TITLE ON: [illegible]	FOREIGN EXCHANGE: [illegible]	FOREIGN EXCHANGE: [illegible]	BALANCED TERMS	[illegible]	[illegible]	LIQUIDITY: LIMITED PERIOD	LIQUIDITY: [illegible]	PRODUCTION COST DOES NOT INCLUDE: FINANCE COST	PRODUCTION COST DOES NOT INCLUDE: [illegible] COST
1	Equity	Limited Percentage in quoted Instruments	In all countries	-	x	✓	✓	x	x	x	x	✓	x	✓	x	difficult in initial stages	✓	x
2	Subordinate Capital	Limited Percentage in quoted Instruments	In some countries	needs detailed drafting	x	x	x	x	x	✓	✓	✓	x	x	✓	poss. in some countries	✓	x
3	Conventional Murabaha	Excluded	In some countries (Jordan, Tunis & Sudan)	needs detailed drafting	x	✓	✓	x	x	x	x	x	x	x	x	x	✓	✓
4	New Murabaha Form	Excluded	Pakistan & Jordan	needs development	x	✓	✓	x	x	x	x	x	x	✓	✓	✓	✓	✓
5	Leasing	Allowed directly or through specialised companies financed on normal basis	In some countries	needs detailed drafting	✓	✓	✓	x	x	✓	✓	limited	✓	x		possible by selling asset	x	-
6	Leasing with Certificates	Allowed directly or through specialised companies financed on normal basis	In Pakistan	needs development	✓	✓	✓	x	x	✓	✓	limited	✓	x	✓	✓	x	-
7	Hire Purchase	Allowed directly or through specialised companies financed on normal basis	In some countries	needs detailed drafting	✓	✓	✓	x	✓	✓	✓	limited	✓	x	✓	possible by selling asset	x	-
8	HP with Certificates	Allowed directly or through specialised companies financed on normal basis	In Pakistan	needs development	✓	✓	✓	x	✓	✓	✓	limited	✓	x	✓	✓	x	-
9	[illegible]	Possible provided bank does not keep title	In Pakistan	needs careful drafting	✓	x	x	indicated if purchase & sale simultaneously	indicated if purchase & sale simultaneously	✓	✓	limited	✓	x	✓	x	x	-
10	Finance on Working Capital on PLS	Excluded	In Pakistan	needs detailed drafting	x	x	x	x	x	✓	x	x	x	✓	✓	x	✓	✓