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15534

Distr.
LIMITED

ID/WG.465/7(SPEC.)
6 March 1987

ENGLISH

United Nations Industrial Development Organization

Workshop on Industrial Financing Activities
of Islamic Banks

Vienna, Austria, 16-20 June 1986

INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS-
CONCEPTS AND PROSPECTS*

Prepared by

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V.87-82710

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OVERVIEW OF ISLAMIC BANKS

BASIC FEATURES

The early 1970's witnessed the emergence of Islamic banks in an ambitious attempt to forestall what is now commonly known as Islamic finance. This concept of finance is based on two distinct features: (i) the prohibition of riba (usury) including simple interest, and (ii) the mirage between capital and labour as a better alternative to the somewhat passive approach inherent in the Western conventional system of interest-based economy.

The fact is that interest on money lent is due exante regardless of the use for which this money is put, nor does it relate to the outcome of the business whether profitable or not, whilst the financier in a profit and loss sharing system earns an expost reward very much related to the outcome of the business[1]. However, the prohibition of interest in money lending does not necessarily mean that profit and loss sharing is the only means available to the Islamic financial system.

As the abolition of riba is not meant to circumvent business or put an end to a thriving trade and financial activities in the Moslem world, therefore, "God has permitted trade" (surat al-Baqarat) and the Sharia

1. Rafic al-Masri, Masraf al-Tanmieh al-Islami, (Beirut: Muassaset al-Resaleh, 1976), pp 13-21.

has formulated and instigated a host of contractual devices to facilitate and regulate business deals and financial transactions. While sharing a common objective, namely fairness and justice, the accepted norms of business consist primarily of two types: (a) those based on profit and loss sharing arrangements including partnerships (Musharakat) and trust capital (Mudarabat), and (b) those based, in the main, on a fixed yield or return[1]. In this category one could mention: Murabaha (cost-plus), ijara (leasing), wakala (agency), ijara waktina (lease and buy back), bai al-ajal (credit sales), and salam sales as will be explained in the following passages.

It goes without saying that the profit or loss in PLS financing mentioned above cannot be determined with certainty. On the other hand, the fixed yield instruments (type (b) above) are highly predictable and less risky than PLS schemes.

DEPOSIT TAKING

In an Islamic bank, as in a conventional bank, shareholders equity and depositors monies are the main sources of funds. The primary difference is a conceptual one. In essence the shareholders and depositors in an Islamic bank are, to some extent, partners sharing in the profit and loss of the bank at an agreed upon ratio.

1. I would like to ackowledge my gratitude to Prof Anas al-Zarqa for an enlightening discussion on this issue

The operating revenues in a conventional bank are the difference between interest earned and interest received during the financial year. In an Islamic bank the operating revenues are the bank's share in the profits of the entrepreneurs. However, the operating revenues have to be adjusted to account for the share of the depositors as shown in the table below:[1]

	Islamic Banks	Conventional Banks
Gross Income	Operating Expenses	Operating Expenses
	Alms tax 2.5%	Interest paid to depositors
	Net profits paid to depositors	
	Netprofits due to shareholders	Netprofits due to shareholders

However not all deposits share in the profits nor each type of deposit yield an equal profit rate to the account holder. This is explained by the fact that, as in a conventional bank, there are different kinds of deposits that could be grouped into three main headings:

1. demand deposits or current accounts
2. savings accounts
3. Mudaraba accounts.

Generally speaking, demand deposits, by definition, yield no return and the bank provides the service of clearing customers' cheques and withdrawals are normally rendered free of charge.

[1] this table is a modified version of similar one presented by V. Nienhaus , see BRI conference on Islamic Banking & Finance October 31, 1985, London.

Savings accounts are opened upon the issuance of a savings book (pass book). No restrictions are cited on the number of withdrawals or encashments. However, for the sake of profit distribution a minimum balance is required to be maintained for a certain specified period which varies from one bank to another.

Mudaraba accounts are trust accounts and if held for a specific period or specific objective they are called specific or restricted mudaraba accounts. Infinite or unrestricted mudaraba accounts empower the bank to use its judgement and expertise in the deployment of funds in order to maximise the return for the depositors within the constraints of Sharia.

Profits are a fraction of the entrepreneur's net income. The ratio is negotiated between the bank and the customer, whereas in Pakistan the Central Bank normally fix the maximum ratio allowable for the bank.

OBJECTIVES REGARDING INDUSTRIAL FINANCE

Most of the Islamic banks have cited among their main objectives such themes as economic development and fostering of industrial activities in their countries of domicile and in Ummat al-Islam (Islamic nation) as shown below.

The Islamic Development Bank (IDB) aims at fostering economic development and social progress in member countries (article 1).

Faisal Islamic Bank, Egypt, endeavours to comply in its financing strategy with the country's national development plans. Accordingly the allocation of the bank's resources to various sectors of the economy including industry follows, to some extent the priorities set up by the State.

Apart from its religious, social and economic goals, Dar Al-maal Al-Islami Trust aims at assisting Muslims "in the development of their commercial and industrial potential".[1]

Masraf Qater al-Islami is authorised to finance all investment activities in the construction sector and all related engineering industry as well as to engage in direct investments in various projects (articles 1-5, 1982).

1. See Objectives of DMI Trust n.d. brochure p.8.

The main objectives of the Jordan Finance House (JFH) is to invest and share in the development of agricultural, industrial, mining, construction, tourism and commercial projects.

The Jordan Islamic Bank (JIB) was more implicit as regards industrial financing by declaring that the bank's objective is to provide riba-free financing to various sectors without spelling out these sectors. Undoubtedly the industrial sector is included within its range of activities (article 2g).

ARE ISLAMIC BANKS EQUIPPED TO FINANCE INDUSTRY?

In the preceding paragraph we have incorporated the industrially-related objectives of some Islamic banks, though the empirical evidence suggests that a great number of the existing Islamic banks devote a high proportion of their resources towards commercial banking activities although they are empowered by their charters to foster the economic development at home as well as in other Islamic countries, as outlined earlier. However this attitude towards long term finance is not without reasons as outlined below.

The above cited observations, however, do not apply to countries like Pakistan and Iran where the banking systems are nationalised and transformed into Islamic financing. Furthermore the well established specialised banks in Pakistan have stepped up their industrial financing activities after Islamization. In the four years preceding Islamization, industrial term financing to the private sector was doubled from rs 1.5 bn to rs 3 bn whereas it surged up to rs 4.2 bn in 1984/85.[1]

On the other hand there are efforts by Islamic bankers to establish long-term investment institutions like Albaraka Islamic Investment Bank in Bahrain, Dar al-Maal al-Islami Trust, Islamic Cooperative Development Bank - Sudan.

There are also a few non-bank investment companies whose main objective is to invest and promote various commercial and industrial

1. M. Aftal "Pakistan Move to Islamic Banking", The Banker, June 1986, pp. 57-60

projects that were established recently in Jordan and Sudan.

IMPEDIMENTS TO INDUSTRIAL FINANCING BY ISLAMIC BANKS

Most, if not all, the Islamic banks maintain a small staff of financial analysts and economists, although the great majority have investment departments. The responsibilities and duties of this department usually range from equity and direct investments in some Islamic banks and/or financial institutions to medium overseas financing of international trade and trilateral transactions. Nonetheless, they rarely engage in long-term financing of industrial projects and seem to concentrate on short-term finance to various sectors including industry. For this reason only a few Islamic banks have gained industrial expertise and found the establishment of a team of experts rather costly. However it must be borne in mind that the Islamic banks' deposit base is mostly short term. Moreover, the absence of an Islamic Central bank that can act as a lender of last resort has compelled them rather reluctantly to maintain a self-imposed liquidity ratio which is, by and large, higher than common norms and ranges from 50% on savings accounts to 90% on infinite mudaraba accounts.

It takes time and effort to build up professionalism in liquidity transformations, particularly if someone would suggest the abandoning of the "golden rule of banking" or the real bills doctrine that calls for matching short-term deposits with short-term lending and long term deposits with long term lending. According to Khatkhat and Villaneuva (1980) the "sediment theory" has proved that in developing economies "a certain core of funds always remain with banks over longer periods of time".[1] I believe further research is needed to test this hypothesis in IDB member countries. A great deal could be expected if the results of these researches were proved to be positive. For not only the Islamic banks would be more equipped to finance industry but a wide range of long term finance may be launched as happened in West Germany. Our friends from the specialised and universal banks in Germany could assist us in this respect.

1. See IMF Staff Paper, Sept 1980, Vol. 23, p 488

THE METHODS USED BY ISLAMIC BANKS TO FINANCE INDUSTRY

As explained earlier the Islamic methods of finance are either profit related or fixed yield instruments. Based on maturity classification the methods of finance may be grouped as follows:

i) Short term: trade financing, bridging finance,

ii) Medium term: leasing, hire purchase, business development, finance

iii) Long term: equity finance, redeemable participation, building construction finance, investment auctioning.

TRADE FINANCING

Murabaha is an Islamic method for financing the purchasing or importation of capital goods, consumable goods and raw materials. Under the Murabaha agreement the customer provides the bank with the specifications and quotations of the goods to be purchased. The Islamic bank study the documents with reference to the price, the specification and conditions for payment. In many instances the bank would be able to obtain the same goods from a different supplier at more favourable conditions than those obtained by the customer. When the bank and its customer agree on the terms of the deal, the former purchases the goods or commodities and later on passes the title to the customer. The profit accrued to the bank is a mutually agreed upon mark-up on the cost of purchase. Repayment could be stretched over 6 or 12 months on instalments or on a lump sum basis.

BRIDGING FINANCE

Bridging finance in the conventional banking system may take the form of an underwriting agreement whereby the investment bank as underwriter undertakes the flotation of equity shares in the market and to carry on its books any unsubscribed shares. In Pakistan this method is developed slightly to eliminate the interest factor. Thus the investment bankers purchases some of the shares to be issued at a discount with a condition i.e. a firm commitment that the bank will sell the rest of the shares to the investors at par.

IJARA (LEASE FINANCING)

The exact meaning of the Arabic word Ijara is reward or recompense. The use of ijara started before Islam and was regularised during the early zenith of Islam and has now been adapted to modern needs. A business or individual client may request the IB to purchase machinery or equipment with the intention of renting it to the client. Ijara financing is based upon valuing the financial position of the client and the expected direct cash flow of the lease contract in the same manner as in ordinary lease financing decisions in a conventional bank though without taking interest into consideration.

LEASE PURCHASE FINANCING (IJARA WA IKATINA)

Under this method, equipment or buildings may be rented to the client on a straightforward rental basis, while the client undertakes to effect payments in instalments over an agreed time period. A savings account may be held with the same financial institution, permitting, through the re-investment of accumulating rental payments the eventual purchase by the client, of equipment or buildings.

The transfer of title depends on the nature of the deal. If a lump sum payment is agreed upon, the title will be transferred to the customer upon exercising his option and paying the agreed price. While if the payment was made by tranches and spread over a period of time, the transfer of title in this case will be gradual and the bank's title to the property decreases proportionally, as well as the rental fees, with the sucessive payments of the tranches.

ADVANTAGES OF LEASING

Companies that resort to leasing would benefit from its inherent advantages. By leasing these companies would be able to rent warehouses, heavy equipment, machinery and even factory buildings instead of freezing assets. Another consideration relates to the relative stability of rental fees which, even if they were adjusted for inflation, still remain highly predictable and within the market range, they have an added advantage of being off-balance sheet items.[1]

As for the lessors (Islamic institutions) they would receive a continuous income stream as long as the property is occupied and the lessee a prime industrial corporation. Leasing could also be applied in building construction and business expansion.

1. See the Wilson Report, Committee to Review the Functions of Financial Institutions (London: Her Majesty's Stationery Office, 1980), pp 223-5.

EQUITY FINANCE BY ISLAMIC BANKS

Equity finance by Islamic Banks (IBs) to industrial companies is performed through Mudaraba (trust capital) and Musharaka equity participation. The foundations and operations of these methods are in order.

DEFINITION OF MUDARABA

The jurists define Mudaraba as "a contract of profit sharing, with one party providing funds and the other his work". In other words, Mudaraba (or qirad) is a contract between two parties, e.g. an Islamic bank acting as financier (Rab al mal) who provides a second party, the industrial company (Mudareb) with capital to finance a particular project. Profits are shared between the two partners according to a negotiated percentage. Losses, if any, are borne by the Islamic bank, and the Mudareb only loses his efforts and his expected share in the profits.

MUDARABA APPLICATIONS

Mudaraba or qirad is best adopted in project financing, and trade financing. Some Hanbali jurists (fuqaha) allow its usage in financing agriculture and in financing small businesses or workmanships.

In pursuing this type of financing an IB may use its own funds, its depositors' funds or both. The contractual relationship between the IB and depositors or between the former and entrepreneurs varies with respect to the source of funds utilised.

If the IB utilises a mixture of its own funds and that of the depositors, the bank would act as an agent for the depositors, whereas between the IB and the entrepreneur the former acts as a financier.

Contrary to the widespread conviction the application of Mudaraba in financing industry is very limited owing to Sharia restrictions on Mudaraba transactions, not to mention the risks (supra). These restrictions inhibit its wider application to cover many sectors in the economy. For instance, the majority of Islamic scholars argued that Mudaraba should be limited to self-liquidating transactions like trading in commodities that involves outright buying and selling. By self-liquidating transactions, the assets of the Mudaraba must be easily recognisable, realisable and may be liquidated before any proceeds are distributed between the partners at the termination of operations, completion of deal, or achieving the Mudaraba objectives. If the partners, however, wanted to renew the Mudaraba, a new contract must be negotiated, but only after the old one has been terminated and the rights and liabilities of the parties concerned have been recognised and settled.

Actually before liquidation and distribution of profits, the Mudareb possesses an uncontested right, not only to his share in the profits but also to any gains or appreciation in the value of output or assets of the joint venture that might occur during the life of the Mudaraba contract. Furthermore the determination of the partners rights require detailed calculation which is time consuming, especially if such an exercise has to be done several times a year. However, this is not, in itself, an obstacle when computerisation is sought.

The Mudaraba accounts must be recorded properly and audited independently, a rather dubious task especially for small businesses when the cost involved is not justifiable.

However, a broader definition of Mudaraba so that it may be applied to the financing of industrial projects, needs further research and thorough analysis.

MUDARABA FINANCING

Musharaka financing is a well established partnership contract in Islamic law and used to be operative in the early Islamic era. It is also currently one of the popular means of financing outside banking systems, among commercial or small industrial sectors in the Arabic and Islamic cities.

In the context of Islamic banking, Musharaka is described as a joint venture between an Islamic bank and a customer or industrial entity geared for certain operations and may terminate within a specified period of time, or when certain conditions are met as will be explained later.

The Islamic bank may finance industry, trade, real estate, building construction and almost all legal enterprises through equity or direct participation. Musharaka is well suited for financing private or public companies and particularly in project financing for short, medium and long term periods. The Faisal Islamic Bank, Sudan, for example, finances selected projects and assists in the procurement of production equipment on Musharaka basis for periods up to 3 years. In all cases projects are evaluated, and if they are economically feasible, and expected to be profitable, and if the would be partner has adequate experience, and his references are satisfactory, the extent of the Bank's participation could be negotiated.

Musharaka consists of two types, mainly (a) Musharaka related to certain projects or deals and terminating with the project's completion, and (b) redeemable Musharaka.

It has been argued that "the implementation of equity financing is conditional upon careful examination of the company's financial performance and in particular on the expected cash flow to be generated". Hence the decision to finance industrial projects "will largely depend upon the project's ability to generate revenues rather than the absolute dependence on the character of the borrowers or their collateral".[1]

1. Haitham S Kabbara, "Banking Crisis in Kuwait", Arab Banker, Lon., Vol. VI, No. 2, March/April 1986, pp 22-5.

INVESTMENT AUCTIONING

This system has been proposed by the Council of Islamic Ideology in Pakistan (CII Report on the elimination of interest in Pakistan). The idea rests on forming a consortium between commercial banks and investment institutions with an objective to initiate and promote industrial projects. The consortium would study the feasibility of a certain project or projects and choose a potentially feasible one. Then after completing the relevant studies, a final report would be prepared. The project would be announced and a bidder would be invited from competent investors for say purchase of the machinery from the consortium. The bid will be awarded to the highest bidder, provided that at all times the bidders are of sound reputation in the industry. The bid price would reflect the cost of machinery plus a small margin (called service charge) to the consortium to the highest bidder. The tenders are awarded providing that the successful bidder would implement the project within a specified time .

Repayments are effected by instalments. The investment auctioning as applied in Pakistan has advantages and disadvantages.

The investor would rely on the expertise of the professional appointed by the consortium to appraise the project. On the other hand, any unexpected technical faults which develop create a problem in deciding who bears the responsibility.

THE EXPERIENCE OF NATIONAL DEVELOPMENT FINANCE INSTITUTIONS IN FINANCING INDUSTRY IN COOPERATION WITH ISLAMIC BANKS*

The avenues of cooperation between NDFIs and Islamic banks are yet to be explored and restlessly sought. Primarily both institutions share common goals and commitments towards the communities development and progress. In fairness one has to draw a distinction between Islamic commercial banks and Islamic development banks as mentioned earlier. This distinction is rather important as it sheds some light over the behaviour of some of the Islamic banks and explains their attitude towards long term industrial finance. Furthermore the extent of cooperation between NDFIs and Islamic banks may vary from country to country and is subject to the following various considerations and constraints:

a) the size, number and types of the Islamic bank in a given country and the objectives of each;

b) the availability of well-organised and adequately-run NDFIs in that particular country, in addition to the availability of competent staff within an NDFI who are at the same time well informed about the activities and methodologies of Islamic banks;

c) the degree of industrial development and the need for continued efforts to promote specific industrial sectors or to concentrate on expanding particular branches within already existing industries;

* Material in this section is based on: (a) the writer's own experience while trying to promote cooperation between NDFI and IBs, and (b) unpublished material in preparation for a Doctorate degree in Islamic Banking at Loughborough University, Banking Centre, UK

d) the management's long-term investment strategy of the Islamic bank(s) and the attention accorded to industrial development within its activities;

e) the availability and dimensions of long-term capital in the Islamic bank(s) that could be directed towards long-term investment in industry;

f) the complexity of industrial financing as opposed to trade or personal financing, coupled with the reluctance to hire industrial specialists and/or economists by the Islamic banks.

Finally, it should be pointed out that NDFIs cooperation with Islamic banks is largely dependent on the nature of operations and functions of an NDFI itself. For instance, the avenues of cooperation are expected to be very fruitful or free from legislative barriers or red tape restrictions in countries where the NDFIs are operating on interest-free basis, e.g. as in Saudi Arabia.

SETTING THE SCENE

Having discussed the limitations and constraints we can turn to describing the steps that ought to be taken in order to develop a meaningful relationship. At the beginning, the relations between NDFIs and the Islamic banks were clouded with passivity and lack of understanding of each other's business and objectives. The same thing is bound to happen again and again whenever a new Islamic bank is to be established in a certain country. The first step towards a long lasting cooperation is to bridge the gap and mend the fences, as they say. This could be easily achieved through personal contacts and direct meetings whereby the two parties share their views and exchange their thoughts. In order for the first conference to be informative and practical, it would be helpful if a brief summary of the objectives and operations of both institutions was distributed at the start of the meeting. This would clarify many points especially if followed by a brief presentation by experts from both sides, and would be kept for future reference and feedback.

Probably the second most significant aspect of this meeting would be the realisation that although the respective articles of association of the NDFIs and that of the Islamic banks may pursue the same objectives, the methods by which they are achieved are different. For example, both can issue LCs, however the methods of operating and financing would be different.

POTENTIAL AREAS OF COOPERATION

An Islamic bank once proposed to an NDFI that they jointly finance the importation of raw materials for industry on the basis of Murabaha. Though the NDFI was interested, it turned out that it could not buy or hold title of commercial goods which is an essential requirement in Murabaha financing. Unfortunately the negotiations were halted in this case. Nonetheless these obstacles should not deter us from seeking solutions which are commensurate with Sharia principles and, at the same time, in conformity with the banking laws. For instance, the NDFI could form either independently, or in collaboration with IBs and/or other financial institutions a subsidiary to perform the operations that the

NDFI cannot execute alone. Another solution could be for the NDFI to open a trust account in the IB authorising the latter to invest the funds either in a specific deal (e.g. industrial finance) or in unspecified projects. Mind you this proposal might not (and indeed is not) plausible in some NDFI quarters who would like to see the funds flowing in the opposite direction, i.e. from the IBs to the NDFI vaults.

Disposal of Mature Investments

An increasing number of NDFIs would like to dispose partially or totally of mature industrial projects in order to recycle funds for new ventures. On the other hand the IBs seem to be good candidates for buying on going profitable industrial enterprises. Apparently, little has been achieved in this direction due to the absence of fresh initiatives and weak contacts on both sides. Even when contacts are established and the IB expresses initial interest to buy, another obstacle may stand in the way towards a meaningful cooperation. This is due to the requisite by some Islamic banks that the industrial company should not carry interest-bearing debts in its balance sheet. This poses another problem to the NDFI and other commercial banks who might have lent heavily to the same industrial corporation. A solution to this would be to buy the company and restructure the debt into equity.

Joint Financing of Venture Capital

Another area of potential benefit for both institutions is to jointly finance new industrial projects.

In the past the NDFI has tended to take the initiative. It is suggested that the IBs should take a pro-active stance by seeking out potential projects and then approaching NDFI either for technical assistance e.g. project appraisal, or co-financing. I personally believe that this is possible given the opportunities that are available to the IBs through their contacts with the entrepreneurs, as many of these Islamic entrepreneurs usually prefer to approach an IB with requests for finance.

SUMMARY AND RECOMMENDATIONS

The mutual cooperation between NDFIs and Islamic banks could be achieved within the framework prescribed earlier. However an acceleration of this process is very much within our reach if all parties concerned could undertake to implement a well-designed plan of action and according to a reasonable timetable. Such a plan may call for actions in a widespread area of concern including, but not restricted, to the following:

1. Identifying the common goals and objectives of NDFI(s) and Islamic bank(s). These goals and aspirations might include the need for:
    i) simplifying the official rules and regulations pertaining to industrial licencing as well as the implementation stages of industrial projects;
    ii) coordination in several areas such as identification of feasible industrial projects;
    iii) conducting pre-feasibility and feasibility studies of industrial projects and sharing the cost thereof;

iv) identification of competent entrepreneurs within and outside the national boundaries;

v) exchanging of information pertaining to new industrial opportunities, syndicated loans, unpackaging of technology, and technical assistance from the UN system or the regional and international organisations and financial institutions.

2. Underlying the limitations imposed by the laws and regulations of each institution. Then studying the possibility of cooperation either (i) through the existing laws, or (ii) by seeking creative financing mediums that comply with both Sharia and the civil or company laws.

3. Stemming from the above it is imperative to develop Islamic financial mechanisms and instruments that could be adapted to the needs of a modern financial environment, and could foster the mutual cooperation between NDFIs and Islamic banks.

RISKS IN INDUSTRIAL FINANCING[1.]

The financing of industrial, commercial and other sectors in the economy by Murabaha or Musharak methods ties up the Islamic banks' return on investment with the results of operations of these businesses. In case of dwindling returns, the Islamic banks' profits may be affected proportionally with the ratio of its equity participation or profit and loss sharing schemes in the overall financing operations. In addition, the degree of risk is normally associated with the type of financing instrument employed by the banks. In Mudaraba finance, the Islamic banks assume more risk than in Musharaka, provided everything else remains the same. The high degree of risk associated with the former type of finance stems from the fact that the Islamic bank provides one hundred per cent of the Mudaraba capital and is totally liable for losses incurred. Unless, of course, in cases of fraud, mismanagement or negligence whereby the managing partner becomes fully accountable for his conduct and the bank would be entitled to fair compensation. Another consideration of risk is related to the inadmissibility of collaterals in Mudaraba contracts, on the grounds that the Mudaraba is based on trust and confidence between the two partners. This stance is based on Islamic jurists contention that Mudaraba is a fiduciary contract and the capital entrusted to the Mudareb is a 'trust money' entailing that any request for a coallateral or guarantee renders the contract void. However the Hanbali school (a

1. This topic is based on unpublished material by the author for a doctorate degree, see op cit.

branch of Hanafis), ruled that the stipulation of a guarantee would only constitute a breach of the terms of the contract which could be rectified without the need to nullify the contract itself which remains valid. Nevertheless, it is permissible to request a collateral to compensate the bank for damages resulting solely from the negligence and misconduct of the managing partner. This entails that in the absence of fraud or negligence, the losses, if occurred, are an outcome of adverse business conditions and uncontrollable circumstances which have nothing to do with the managing partner nor the bank for that matter. Thus it would be unjust if the entrepreneur would have to lose his time and effort and at the same time has to protect the bank against business losses.

Although by Musharaka the bank is offered the opportunity to share in the equity ownership, there are certain risks inherent in this type of financing. These involve potential losses of limited liability that may include both the loss of the expected return and a loss of part or the full amount of the capital invested in the joint venture. To minimise the risks, the Islamic banks try to be cautious and selective in their financing operations through Musharaka or Mudaraba. This explains why these two forms of financing do not account for more than 15 per cent of financing operations of the Islamic banks. Alternatively the degree of risk in a conventional bank seems to be less than in an Islamic bank as far as Mudaraba or Musharaka are concerned. This might be true in normal circumstances where the payment of interest in a conventional bank is almost guaranteed regardless of the results of operations of the customers. As for an Islamic bank, the return or yield is directly linked with the results of operations of the customers' business. The yield could be positive or negative depending on whether the partner's business has been profitable or not. Nevertheless, it ought to be mentioned that net profit to be shared between the bank and the entrepreneur is defined as net income before depreciation and financial charges. This method renders the occurrence of a negative yield very remote given the other precautions mentioned above. However if adverse business conditions prevail (e.g. bankruptcy of a customer financed by a conventional bank and another financed by an Islamic bank) the picture would be slightly different.[1] In case of unsecured loans, both banks would not be able to recover the loans or equity capital, whilst the conventional bank would be able to recapture part, or a sizeable propoprtion, of the secured loan. Alternatively the Islamic bank would not be able to recover the capital. As Mudaraba or Musharaka loans are, by their very nature, not secured.

The risk in Murabaha finance is considerably reduced since the Islamic bank is permitted to secure the deal either through cash deposits, mortagages or third party guarantee. However, as outlined earlier, the customer is not bound to accept the goods purchased by the bank. This overburdens the credit department who must exert all efforts and must seek the advice of the trading department in the bank before it decides to go ahead and order the goods. In other words, the bank must ensure the marketability of the goods before opening the letter of credit, simply because the goods might end up in the bank's warehouse, if at a later stage, the client chooses not to proceed with the transaction. This applies, however, in some banks such as the Kuwait Finance House,

1. For an outline of safeguards and control measures, see Adnan Abdein and Dales N Shook, The Saudi Financial System (Oxford: John Wiley and Sons, 1984) p 192-7.

whereas in other banks like DMI, for example, the promise to buy is not binding as long as the bank has not purchased the goods. The deal becomes enforceable as from the purchase date, thus reducing the exposure of risk. However in both cases the liability for perished or damaged goods is borne by the Islamic bank until such time when the title is passed on to the client since the IB opens the LC in its capacity as importer.

Nevertheless the Murabaha contract creates an interesting situation where the non-binding promise by the client to purchase the goods, is legally binding in countries where civil law is different from Islamic law.

Leasing is not immune from risk. The risk in leasing stems from the fact that the rental payment is linked with the expected profitability and cash flow of the rented assets which might be volatile at times. The determination of the rental charges and the restoration of asset in good working conditions require careful planning and adequate supervision by the bank, for it might happen that the hirer, in hire purchase finance, becomes insolvent or unable to purchase the asset. In this case the bank may be compelled to sell the asset at its market worth if it has no rental value any more.

Liability for loss or equipment damages is borne by the client from the possession date. Consequently, the client's obligations cover the contract period, although the rental charges are paid by instalment. This type of lease is similar to a 'net lease' contract in the conventional system.

The Inter-Arab Investment Guarantee Corporation (AIGC) provide insurance coverage against political risks such as nationalisation and expropriation, non-remittances of capital and dividends or losses caused by acts or war or riots.

I wonder whether the restrictions imposed by Sharia on insurance could be solved when a third party, independent of the borrower or lender, proposes voluntarily to secure the project against non-commercial losses through an insurance company such as AIGC. This notion however, raises a question concerning the insurance premium, as it is unacceptable according to Islamic law, for a partner in a Musharakat to guarantee the financier against adverse business conditions.

However, it is not illegal, to my knowledge, if the host government with the donor government share the insurance premium. Alternatively the international organisations could pay the premium as part of its promotional expenses or grant. According to Sami Homoudi "The government as walial-amr can give incentives in the form of a guartantee to the cpaital investment, as it happened in Jordan for Al-Muqarada Bond".[1]

1. See "Utilization of funds generated through Islamic financial institutions, IDB-Islamic Research and Training Institute, Kuala Lumpur Seminar, April-May 1986.

ISLAMIC FINANCIAL MARKETS AND INSTRUMENTS

MONEY MARKETS

Money market transactions are confined and restricted in the Islamic financial system. Call money or overnight money is not available unless it is obtained free of interest. Money market instruments in the CBS such as: banker's acceptances and letters of guarantee are issued basically, on gratis except for a service charge regardless of the amount of the guarantee.

CAPITAL MARKETS

Background

In principle, an Islamic bank is able to underwrite securities and to be active in trading and selling. Portfolio selection or equity paticipation is governed by certain rules and regulations that should be strictly adhered to, e.g. (a) the company issuing the shares should not deal or trade in banned operations and should not be a financial institution whose main activities are directly related to trading in interest-based securities, or syndication, underwriting and management of interest-bearing bonds; (b) dividends or yields must not be guaranteed or stated in advance, and (c) dealings in preference shares are not allowed on the grounds that they entitle the holder to preferential rights as to dividends and they bear a fixed rate of return.

On the other hand, while trading on the margin is not allowed due to the involvement of interest, purchase of securities could be fulfilled on the basis of bai al-jal i.e. buying on credit.

DEVELOPMENT OF THE CAPITAL MARKET

The evolution of an orderly Islamic financial market is dependent upon the development of Islamic financial structure in a certain country or region. Fortunately, a number of features for such development in the Islamic countries are currently available.

Firstly,
In almost all economies of the IDB member countries there are surplus units looking for investment opportunities. Conversely, there are deficit units looking for funds. Secondly, the Islamic banks issue financial claims i.e. deposits to surplus units. These deposits become available to corporate or individual entities through the process of intermediation. Thirdly, the corporations issue shares that could be sold to the public or to the Islamic financial institutions.

Nevertheless the process of equity participation through shares is very limited in scope and magnitude in many IDB member countries. Fourthly, there are virtually no restictions on buying or selling company shares in the secondary market in almost all IDB member countries.

What is missing, however, are two important segments of the market namely trading in government securities and trading in corporate debt certificates[1]. It is worthy to note that the Islamization of the banking system in Pakistan has permitted the floatation of some PLS certificates. This development was aided by the already existing financial infra-structure including market makers and investment funds, and a set of rules and pertaining laws and regulations such as the Mudaraba ordinances[2].

PARTICIPATION TERM CERTIFICATES

Participation Term Certificates (PTC) were first introduced in Pakistan by the Panel of Economists and Bankers. The PTC may be issued by companies seeking medium long-term finance directly to the public by prime borrowers or may be underwritten by an Islamic merchant bank. As the PTCs are not interest bearing certificates, their floatation would not be possible unless the company law is changed to the country of issue. This is in fact a stumbling block to the efforts of Islamic banks to facilitate the negotiability of profit-related certificates in IDB member countries.

1. As the development of these two instruments is the cornerstone towards the evolution of the financial markets. For more details, see Jack Revel, The British Financial System, (London: Macmillan Press 1973) pp 20-71.

2. For more details see D M Quereshi, "The Role of Sharia Based Financial Instruments in a Muslim Country". Seminar on development a system of Islamic financial insstruments, Kuala Lumpur, 1986

THE ROLE OF INTERNATIONAL ORGANISATIONS AND NATIONAL DEVELOPMENT FINANCE INSTITUTIONS IN PROMOTING AND FACILITATING COOPERATION WITH ISLAMIC BANKS IN FINANCING INDUSTRY IN ISLAMIC DEVELOPMENT BANK MEMBER COUNTRIES

A few years ago the Islamic banking experiment was filled with doubt and its objectives were misunderstood by the international financial community. It was looked at, in some financial circles as a backward movement aiming at instigating the bazaar (market) philosophy of ancient Arabia into our modern and sophisticated environment. Other commentators have blown their whistles trying to alarm the West about the dangers of the petro-dollar money that aims at competing with the Western banking system through the promotion of Islamic banking. Fortunately these misnomers have faded away and our meeting today to discuss the avenues of cooperation between the two banking systems is more than sufficient proof.

The international organisations may be classified, for the sake of simplicity of exposition into three categories:

a) private international organisations
b) government sponsored organisations
c) specialised agencies.

Practically, all these institutions may operate either separately or jointly to promote or implement mutual collaboration with Islamic banks in IDB member countries. Proposals to facilitate and enhance cooperation and mutual understanding; exchanging technical information and training of manpower.

The Islamic banks have grown rapidly and expanded vertically without proper planning and effective organisational structure. In order for the international organisations to understand and grasp the intricacies of this phenomena (a) yearly or semi-annual seminars or workshops could be held, and (b) field trips may be organised under the auspices of UNIDO to visit some of the Islamic banks as a fact finding mission to study specific areas like equity finance, murabaha or international finance.

These visits serve many purposes and have the following advantages:

a) it familiarises the visiting bankers with the operations of the Islamic banks;
b) it helps to explore potential areas of cooperation
c) it sheds some light on the particular needs of the host bank. This would pave the way for a fruitful and lasting relationship among the parties concerned.

In order to facilitate contacts with the Islamic banks, the International Financial Institution (IFI) would be advised to approach the NDFI with whom prior contacts had been established. The NDFI on its part would introduce the IFI to the Islamic bank in its country.

The range of activities in industrial finance and the lack of trained manpower in the Islamic banks calls for immediate action by top management to secure training in the several equity areas like project financed leasing. Though leasing could be an important part of Islamic financing instruments, it is noted that not only Islamic banks but also old and well established conventional banks in the Arab and Islamic world lack adequate trainees in this complicated area of finance.

Another potential area for training IBs personnel is in project supervision and monitoring, a field very familiar to the French Banque des Affaires and the German Universal banks.

JOINT VENTURES

Probably the low turnover of industrial finance in some countries in the Gulf have precluded the need for hiring industrial specialists. A frequently occurring scenario was one where Islamic banks have conceded their willingness to finance industry but they cannot find industrial experts to evaluate and monitor industrial projects. A joint venture is a sensible approach in these circumstances.

The Islamic banks including IDB and NDFI provide finance, along with interested international financial institutions (IFI). The UNIDO or the IFC may provide technical assistance and financial advisory services. Also IFI can provide legal services in connection with importation of machinery and equipment and drafting purchase contracts. Apart from project evaluation, technical assistance might involve identification of profitable enterprises, prefeasibility study of projects in the IDB member countries. The assistance may include also a package for financing small industries.

INTERBANK OPERATIONS

The Islamic banks have experienced difficulties in short term and overnight investments. It was thought that trading in commodities would secure liquidity when needed. This method, as it turned out, was very risky. I am sure that the Western financial institutions could assist the Islamic banks in finding a solution that complies with Sharia principles to facilitate short term investment of excess liquidity.

A host of other ordinary banking business may develop as a result of cooperation in industrial finance, like correspondent services, confirmation of LCs, financing the export of raw materials and intermediate goods by IFI to Islamic banks' customers.

RESEARCH AND DEVELOPMENT OF NEW INSTRUMENTS

Other potential areas of cooperation might include undertaking resarch to promote and issue and sell Islamic certificates of deposit and participation term certificates for and on behalf of the Islamic banks.

IBs are not unique in this. Currently banks in Europe are experiencing difficulty in developing appropriate mechanisms for the assessment of Hi-Tech ventures. To overcome this a network is developing between the Hi-Tech entrepreneur and financier. The objective being to update and acquaint themselves of the current 'state of the art'. An example of this is the 'Forum' organised annually by the Financial Times.

The threshold in the above cited examples has been to enhance mutual cooperation and to create better understanding between the Islamic and international and regional financial institutions. As for the specific roles of specialised agencies, I trust that the UNIDO pamphlet in this regard will fulfil your needs.

CONCLUSIONS AND RECOMMENDATIONS

PROPOSAL FOR ESTABLISHING AN ISLAMIC INDUSTRIAL BANK

The financing of industry is an essential element in socio-economic development. The recently evolving Islamic banks are overburdened with operational problems and are facing growing pressures from their communities to assist in the development of productive enterprises. Given the adverse business conditions that are facing the Islamic banks from their conventional rivals and from the regulatory agencies, I believe the time is ripe for us to study the feasibility of establishing an Industrial Islamic Bank to perform the following main objectives:

1. To serve as a specialist niche in Islamic industrial financing in IDB member countries

2. To facilitate, promote and coordinate the cooperation between NDFI and Islamic banks

3. To facilitate, integrate and coordinate the cooperation between international organisations and Islamic banks in a wide range of industrial financing activities including technical assistance, joint ventures and research and development

4. To raise long-term funds for industrial development in IDB member countries

5. To develop an Islamic capital makret through the establishment of Islamic industrial papers and certificates

PROPOSAL TO SOLVE THE SHORT-TERM LIQUIDITY SHORTAGES

The inaccessibility of short term money to alleviate chronic liquidity shortages in the Islamic banks could be partially resolved through inter-banking operation within the existing Islamic banking structure as follows:

A cash surplus bank would furnish the cash-deficit bank with fresh money in the form of sight or short-term deposits. Several deposits or withdrawals might occur during the year. At the end of the year, the donor bank could share in the profits of the recipient bank on the basis of daily products along with the banks' saving or term deposits account.

The training and research institute of the Islamic Development Bank is currently providing a valuable service to practitioners/candidates in Islamic banking. Its efforts should be strengthened and enhanced to cope with the growing demand for innovation and evolution in the Islamic financial instruments related methodology. Another area of paramount importance is project control and follow up. The IDB could obtain the experiences of the Islamic banks for further evaluations and improvement in the methods employed.

LIST OF ABBREVIATIONS

CBS	Conventional Banking System
CBs	Conventional Banks
IBS	Islamic Banking System
IDB	Islamic Development Bank
IBs	Islamic Banks
NDFI	National Development Financial Institutions
IFI	International Financial Institutions
PTC	Participation Term Certificates
PLS	Profit and Loss Sharing Schemes
Lcs	Letters of Credit

GLOSSARY OF RELIGIOUS TERMS
IN ISLAMIC BANKING

Ayat, verses of a chapter in the Quran.

Beit Al - Mal, Finance House that was established in the early zenith of Islamic rule and was performing the duty of a Central Treasury.

Bai Al-Ajal, credit sales

Fugaha, Scholars in Islamic Laws (Jurisprudence).

Furu , Secondary sources of Islamic Laws.

Hadith, Narrative relating deeds and utterances of the Prophet.

Hajj, Pilgrimage to Mekkah

International Murabaha, Islamic Method of financing international trade.

Istihsan, Justice based on intuition.

Istislah, Social utility prevailing over the existing rule.

Ijara Wa Iktina', Lease and purchase back.

Ijma, consensus reached after intensive deliberations (consultations) among religious scholars on points or issues facing the nation and not envisaged in the Quran or Sunna.

Quran, Book of revelations made to Prophet Mohammad by God.

Mudaraba, contract whereby one party provides capital and the second his work (effort).

Mudareb, an entrepreneur who has the experience and can manage and invest the funds of a Mudaraba project (s).

Musharaka, A partnership based on equity participation.

Murabaha, the Islamic method for financing the pruchasing or importation of goods, whereby an Islamic Bank buys goods and sells them to a borrower at cost-plus basis rather than lending the borrower directly.

Murabaha Letter of Credits, the Islamic substitute of a letter of credits in a CB.

Qard Hasan, interest- free loan from a lender to a borrower.

Qiyas, deduction by analogy, i.e. to give an opinion on a case (not referred to in the Quran or Sunna) in terms of another case (referred to in the Quran or Sunna) by analogy if the two cases were sufficiently similar.

Rab Al-Mal, an investor who provides funds to a second patry in a Mudaraba Conract.

Riba Al-Nas'ia, the charging of additional interest on or after the due date to allow for the re-scheduling of the debt.

Riba Al-Fad'le, excess interest or the increase in value accrueing to one party resulting from exchanging two currencies and two commodities of the same kind or gendre.

Rok'n, pillars or main principles of Islam.

Sawm, fasting imposed on Muslims for one month per year from dust to dawn and is considered the 4th pillar of Islam.

Salawat, prayers that are practised five times a day.

Sadaqat, charity imposed, once a year at least on every adult individual or household on behalf of his (her) family.

Shahadah, the first pillar of Islam, and means to profess that God is one and Mohammad his messenger.

Sunna, habitual practice and behaviour of the Prophet Mohammad during his life.

Sura, a chapter in the Quran.

Salam, forward buying i.e. cash is paid for goods that will be delivered in future.

Tawliya, to sell at break-even

Wadi'a, to sell at a discount

Zakat, alms tax on property, money and savings accounts, cattle, corn and merchandise.