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Workshop on Industrial Financing Activities
of Islamic Banks
Vienna, 16-20 June 1986

SUMMARY OF PROCEEDINGS OF WORKSHOP

AND PAPERS PRESENTED*

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PROCEEDINGS OF WORKSHOP ON INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS

Executive Summary

In co-operation with the Islamic Development Bank, UNIDO recently (16-20 June 1986) held a workshop on the industrial financing activities of Islamic banks which was attended by 36 representatives of Islamic and non-Islamic banks, international and regional development agencies and a representative of the Organization of the Islamic Conference. Nine staff members of UNIDO participated. The aim of the workshop was to determine the nature and scope of Islamic banks' current engagement in industrial financing, the types of financing mechanisms they are currently using to promote industrial development, what obstacles hamper the expansion of their activities in this field, and what measures could be adopted to overcome such obstacles.

16 papers on a wide range of topics were presented at the workshop. The principal issues discussed concerned existing Islamic financing instruments and the extent to which they are adequate for the financing problems of industry, the reasons why equity investments - and particularly equity investments in industrial undertakings - still account for a relatively low proportion for Islamic banks total outlays and the technical problems of providing short-term facilities and finance for working capital on a profit-sharing rather than interest-charging basis.

Several authors and many speakers stressed the progress that had been achieved in Pakistan towards Islamising the banking system and hailed the emergence of the Participation Term Certificate, recently enshrined in that country's commercial law, as a viable alternative to the interest-bearing corporate bond so widely used in non-Islamic financial markets.

Both the papers presented and the ensuing discussion showed that the provision of risk capital for industrial development still accounts for only a very small part of Islamic banks' outlays, the greater part being for financing foreign trade and for investment in activities with a fixed return, such as leasing, hire purchase and arrangements involving purchase of industrial inputs and their resale at a mark-up. The reasons for this reluctance to invest in industrial projects appear to lie in the uncertainties which surround the return on equity investments, both as regards amount and time-frame of receipt. The case study presented by the representative of the Islamic Develpment Bank revealed a further hazard: Unforeseeable adverse developments may compel a bank to increase substantially the amount of the planned investment in order rescue a project that has run into difficulties.

In contrast to types of financing which offer a fixed return, the choice of equity investments requires a degree of project analysis and appraisal in terms of its technical, financial and marketing viability which few Islamic banks have the capacity to execute. Moreover, the real problems commence only after implementation: in order to safeguard their interests, banks may have to exercise a degree of monitoring and active participation in the management for which they lack the necessary expertise. Even the IsDB with a large professional staff of economists, financial analysts and engineers has experienced considerable problems in obtaining a satisfactory return on its equity investments.

The view of many participants was that the Islamic banks urgently require UNIDO's continuing and increased assistance in a number of areas, such as guidance in how to evaluate the viability of industrial project proposals submitted to them, or management training to enable the banks' staff to help operate a project that has got into difficulties.

However, further research is also needed to refine the existing Islamic financing mechanisms, and particularly to find ways of satisfying the long-term financing requirements of industrial projects given a deposit base which is essentially short-term.

The lack of a legal and fiscal framework specifically tailored to the needs of Islamic banking was also considered a serious obstacle. Thus some Islamic countries continue to discriminate against profit and loss sharing: any distribution to investors is treated as an appropriation of profit and not as a deduction from profit for the purpose of arriving at taxable income. This contrasts with interest payments, which are tax-deductible.

One innovative paper proposed a form of yield to investors based on the value added (defined for these purposes as the excess of the selling price of goods over the cost of their constituent raw and other materials) generated by an enterprise, rather than the profit. This type of return on investment would have the advantage of being less susceptible to manipulation and less subject to short-term fluctuations than net profit. Although discussed only briefly, it appears that a yield based on value-added would be permissible under Islamic banking rules, and concept therefore deserves further study and research.

The workshop produced little in the way of case studies on industrial projects financed by Islamic banks. The case study presented by the IsDB mentioned above indicated that the Bank was called upon to increase its initial investment by a factor of five, but did not indicate whether the project ultimately yielded a satisfactory return. And yet a collection of case studies on industrial projects financed by Islamic banks would be of considerable value in bringing the specific problems of this type of financing out into the open, thereby allowing a frank discussion of the problems. An analysis of the causes of success or failure in this activity would do much to remove the present uncertainty and would show that there is no mystery about successful industrial financing. The techniques are known and have been used with great success and resultant profit in a number of countries, including developing ones.

As a next stage in its co-operation with the OIC and the IsDB, UNIDO could endeavour to obtain from Islamic banks which have experience in this field, details of both successful and less successful industrial projects they have financed, the problems encountered, how these were resolved, and the ultimate results of the investment in terms of yield. Such case studies would help to eliminate the aura of mystery and uncertainty which surrounds industrial financing at the present time and encourage more Islamic banks to initiate operations in this activity.

The workshop concluded that UNIDO's wealth of expertise in industrial financing should be made available to Islamic banks on an on-going basis. Training of bank officials in project preparation and monitoring techniques, workshops on the use of UNIDO software offering sensitivity analysis and scenario-building options for project evaluation, assistance with the legal, financial and organizational aspects of joint ventures, technical documentation on establishing new industries in developing countries, clearing-house activities to match industrial investment projects with appropriate sources of finance, and the exchange of information between Islamic banks on their experience in the field of industrial financing - these are the main areas where further support from UNIDO is urgently required.

THE ROLE OF THE ISLAMIC DEVELOPMENT BANK IN FINANCING INDUSTRIAL PROJECTS

by A.R. Youssef

In his paper on the rôle of the IsDB in financing industrial projects (33 pages, plus four appendices covering a further 28 pages) Mr. A.R. Yousef gives valuable insights into the operations of this leading Islamic finance institution, together with statistical material on how the total engagements are distributed over the various types of economic activity. The value of the material is enhanced by the annexure of a case study on a clinker grinding plant in which the IsDB took an equity participation.

The salient features of the paper may be summarized as follows:

Since its foundation in 1977, the IsDB has provided financing for industry (manufacturing and agro) totalling at least US$963 million in the form of equity participations (US$169 million or just under 3% of the total outlays of US$5,897 million) and lines of equity to NDFIs (US$84 million), leasing (US$489 being 9% of the total) plus lines of leasing (US$52 million), instalment sales (US$131 million) and technical assistance amounting to US$38 million. This means that the bank's total engagement in finance for industry to date is of the order of only 16% of its total outlays. Equity participation was heavily biased towards chemicals and petrochemicals (60% of the total), followed by textiles (6%). Participation in agro-industries accounted for under 4% of the total.

According to the author, the performance of the equity projects has not, in the main, been satisfactory. Delays in implementation and start-up, the absence of essential infrastructural facilities, inadequate marketing arrangments, human resource gaps and, above all, the depreciation of local currencies vis-à-vis the Islamic dinar (which enjoys parity with the SDR) have all contributed to the poor results and have led the Bank to reappraise its equity participation policies. As the author points out, depreciation of local currency can make a project that is successful in terms of its contribution to the host country's economy unsatisfactory from the bank's viewpoint, because of the reduced value to the bank both of the investment and of the profit distributions it generates.

While the paper does not quantify the outcome of the Bank's equity exposure, either in terms of the current value of investments versus their historical cost or in terms of their yield, the case study on the clinker grinding plant gives some indication of the magnitude of the problem. Here, a planned equity participation of US$4.68 million escalated into an exposure of US$20 million because the government of the country concerned, which was the only other shareholder in the venture, was unable to meet its commitment to provide electric power for the plant and clinker handling facilities at the port, and because owing to cost overruns the project, when the point of start-up was reached, had insufficient working capital to purchase raw materials.

The experience of a decade in equity financing has led the IsDB to "reformulate its strategy to face the challenge of industrial development in the coming years." While the paper does not give any details of what changes in its investment policies and practices will emerge from the reformulation, it may be expected that more attention will be paid in the future to the impact on projects of currency depreciation by investigating whether the forecast return will be sufficient to offset the effects of such depreciation, after taking into account the state of the economy and its balance of payments and external debt ratios. Projects in countries with a chronic shortage of convertible currency should also be evaluated from the standpoint of their ability to generate the foreign currency needed for their operations, i.e. by exports. Industrial projects dependent on imported inputs which are oriented primarily towards the domestic market are clearly vulnerable on two counts: depreciation of the local currency will increase their operating costs and the shortage of foreign exchange may prevent them from purchasing sufficient raw materials, with adverse effects on capacity utilization and sales revenues.

Some comments on the internal project appraisal guidelines developed by the Bank may be apposite at this juncture:

1. While the industrial project appraisal guidelines developed by the bank require a breakdown of the capital cost between foreign and local currency, no such breakdown is specified for the flow of revenues to be generated by the project. Such a breakdown is however of considerable

value in determining the extent to which the foreign currency earnings of a project are sufficient to meet the foreign exchange component of its operating costs. Clearly, freeing project managers from dependence on (frequently arbitrary) allocation of scarce foreign exchange will contribute to the project's viability.

2. Certain key variables, such as annual profit and net assets would be best expressed in the bank's currency, based on conservative assumptions of likely exchange rate trends, in order to evaluate profit distributions and the project's residual value in the investor's currency.

3. While the guidelines make provision for sensitivity analysis of the effects on the project of changes in vital parameters such as sales and raw material prices, they do not mention the design of scenarios to reflect the effects of different visions of the future. The presentation of varying scenarios based on more or less optimistic predictions of future economic development is a valuable forecasting tool, particularly when linked to probability analysis of likely trends.

The volume of equity participations by the IsDB does not as yet match the importance which the bank attaches to this activity and, as noted above, is outweighed by involvement in other financing mechanisms such as leasing and instalment sale. These, while adhering to the letter of the Shari'ah are less close to its spirit, since the return to the bank is fixed in the initial contract (apart from some flexibility regarding the date payments commence) and in no way dependent on the overall results of the venture.

The IsDB's continued commitment to equity participation may be therefore ascribed more to the requirements of its Articles than to any enthusiasm generated by successes achieved in this type of venture.

VALUE ADDED PARTICIPATION - A NEW FINANCING INSTRUMENT FOR ISLAMIC BANKS

by Prof. V. Nienhaus

Prof. Nienhaus's paper (40 pages) is concerned with what is perhaps the major unresolved problem of Islamic banking: the fact that given the conditions prevailing in many Islamic countries the uncertain outcome of profit-and-loss sharing ventures, although favoured by the Shari'ah, makes them somewhat hazardous, so that the major part of Islamic banks' earnings "originate from leasing, mark-up trade and similar forms of financing which...carry virtually no risk for the bank and come economically very close to conventional interest loans".

As a result many Islamic banks are unable to provide their clients with "circulating" i.e. working capital, the purpose of which is to increase the value of <u>all</u> the project's assets, but can only finance transactions clearly identified with <u>specific</u> assets such as raw materials, machines or buildings. Other papers presented during the workshop indicate that some Islamic banks regard equity participation in new industrial ventures as a loss-making activity which can only be undertaken with profits earned in more conventional fields such as foreign trade financing, leasing and instalment sales.

Prof. Nienhaus's researches into forms of business partnership permissible under the Shari'ah have led him to the conclusion that the prohibition of 'riba' applies only to situations where the rate of return is fixed, regardless of the venture's outcome, as is the case with a loan bearing a fixed rate of interest. A business partnership where one of the partners sustains a loss while the other receives a profit may be permissible, provided such profit is not <u>unconditional</u>.

Prof. Nienhaus points out that in early Islamic times there were no banks and that all the parties to a venture who had contributed capital were entitled to participate in managing the venture. All capital invested conferred equal rights and obligations. Today enterprises are not normally formed ad hoc merely to carry out individual commercial ventures but are established for an unlimited period and for the continuous creation of wealth.

In Prof. Nienhaus's view, modern enterprises use two kinds of capital: the inside or equity capital, provided by the proprietors of the enterprise, and the outside or loan capital, provided by financial intermediaries such as banks which in normal circumstances do not wish to participate in the management of the enterprise nor commit their capital for an indefinite period. The goal of such intermediaries may be primarily to earn profits for themselves and their depositors (commercial banks) or they may perceive their principal rôle as that of promoting the wealth and prosperity of the community as a whole (national development finance institutions).

The "continuous creation of wealth" which Prof. Nienhaus perceives as the objective of modern enterprises manifests itself in the "value added" resulting from the traditional combination of capital and labour. This may be defined as the difference between the value of sales on the one hand and the cost of bought-in materials and services on the other, and is represented by the total incomes paid to an enterprise's workforce, interest on loans and the net profit, part of which is distributed to the shareholders, part paid to the government in the form of taxes and part retained in the business to strengthen its capital base.

Prof. Nienhaus's central argument is that it is this value added which embodies the wealth created by an enterprise and which must be shared in equitable proportions between those who have contributed to its creation. The proportion due to the workforce is normally fixed by tariff agreements and individual employment contracts and does not depend directly on the results of the enterprise's operations (for the sake of simplicity profit-sharing arrangements with the workforce are ignored) so that defining labour costs as a percentage of value added (which cannot be determined in advance) is not feasible.

This means that only one of the two classes of capital contributors can receive a pre-determined proportion of the value; the other can receive only the residue. Prof. Nienhaus suggests that it is the providers of outside capital who should be entitled to a fixed proportion of the value added.

The arguments he adduces elsewhere: that the outside capital providers do not participate in the management of the enterprise and cannot influence the outcome of its operations; that the figure of net profit is much more susceptible to manipulation and short-term fluctuations than the value added figure, so that outside capital contributors with their relatively short-term commitment to the enterprise might, if entitled only to a share of the net profit, sustain a substantial loss in an atypical year without being able to recoup it with the profits of following years.

The value added is also easier to ascertain with accuracy than the profit, since it is largely accounted for by the salaries and wages paid, the profit element being a relatively small proportion.

According to Prof. Nienhaus, offering the providers of outside capital a fixed percentage of the value added does not violate the Shari'ah because the value added is not a predetermined figure, nor is it even of necessity a positive one: a negative value added is a possible, even if an extreme outcome. As previously stated, the fact that a provider of internal capital can sustain a loss while a provider of outside capital receives a profit does not in itself contravene the Shari'ah, only the predetermined profit, regardless of the results of the enterprise constitutes such a violation.

The following simple examples (based on Prof. Nienhaus' work) provide an illustration of positive and negative value added.

(1)

Sales		220
less bought in materials	120	
" labour costs	50	
		170
net profit		50
value added (220 - 120)		100

If the outside capital receives an agreed 20% of value added, its share will be 20, leaving 30 (50 - 20) as net profit for the inside capital.

The following example demonstrates a profit situation for the outside capital and a loss situation for the inside capital:

Sales		220
less bought in materials	120	
" labour costs	90	
		210
net profit		10
		===
value added unchanged at		100

If the outside capital receives an agreed 20% of value added, its share will be 20, leaving -10 (10 - 20) as net profit for the inside capital.

The following example demonstrates a loss situation for both outside and inside capital:

Sales		220
less bought in materials	230	
" labour costs	50	
		280
net loss		- 60
		===
value added (220 - 230)		-10

If the outside capital receives an agreed 20% of value added, their share of the loss will be 2, leaving 8 (10 - 2) as the loss for the inside capital.

According to Prof. Nienhaus, the exceptional nature of negative value added does not vitiate the argument that a positive outcome is not unconditional. Therefore the prohibition of "riba" does not apply to a participation based on a percentage of value added.

Value added participation, as Prof. Nienhauss indicates, has advantages vis-à-vis profit and loss participation for both the entrepreneur and the investor. The advantage from the entrepreneur's point of view is that the cost of the funds follows the trend of profits and losses so that in years with meagre or negative results the charge is less than in successful ones, in contrast to a conventional interest-based loan.

The attraction for the investor is that reduced profits, and even losses, do not deprive him of some return (unless of course the value added is negative, an extreme case), and that the value added figure can less easily be manipulated and artificially depressed than the figure of net profit. That also means he can reckon with a shorter term commitment with less danger of selecting a period in which a loss is incurred. Thus in view of Prof. Nienhaus value added participation (VAP) is superior to profit-and-loss sharing (PLS) in terms of fairness.

In the second part of his paper Prof. Nienhaus examines some accounting problems raised by the concept of VAP:

(1) How should stocks of unsold goods be treated for the purpose of computing value added ? Should they be valued at selling price and added to actual sales, or should they be ignored and their cost of production eliminated from the cost of bought-in material ? Prof. Nienhaus concludes that in general the latter treatment is more appropriate, except in cases where sales fluctuate widely within a short period of time, while production continues at a consistent level.

(2) Is depreciation an appropriation of value added for the maintenance and renewal of fixed assets or is it an item of bought-in goods and services to be deducted from sales in arriving at value added ?

Prof. Nienhaus does not opt for either of these alternatives, leaving the question open. Since, however, the purpose of depreciation is not primarily to provide funds for asset replacement but to spread their cost over the period in which they are used by the enterprise for the purpose of earning profits, the treatment of depreciation as an item of bought-in goods and services would appear more appropriate.

(3) Should extraordinary items be included for the purposes of calculating value added ? It is somewhat difficult to follow Prof. Nienhaus arguments, since he does not provide a clear definition of extraordinary items. Generally accepted accounting principles would indicate that extraordinary items which result from the normal operations of the enterprise, e.g. the recovery of a debt previously written off as non-recoverable, might be included. "Windfall" items, such as a huge profit by a manufacturing concern on selling land surplus to requirements should on the other hand probably not be included, except to the extent the capital profit is attributable to the period under consideration.

(4) Manipulation of the value added

As Prof. Nienhaus correctly points out, manipulation of value added is much less simple than manipulation of profit. For example inflating management salaries will reduce the profit, so there is no effect on value added. Inflating the cost of bought in materials or concealing sales would reduce value added, but involve deliberate and possibly criminal manipulation and are relatively easily detected. The danger is certainly much smaller than in the case of conventional profit and loss sharing.

Determining the rate of VAP

Since the value added cannot be determined precisely in advance, it is necessary to arrive at a forecast of it in order to determine an appropriate return on the investor's capital contribution. If the bank's forecast of value added is more optimistic than the entrepreneur's, it will be prepared to accept a lower percentage than the entrepreneur is willing to pay.

Thus if the bank is prepared to invest 10,000 at an assumed return of 10% it will expect to receive 1,000 as its VAP. If its forecast of the value added is 100,000 it will be prepared to accept a 1% rate of VAP. Meanwhile the entrepreneur estimates value added at 90,000. If his estimate is true he will pay the bank only 900. Had the bank known his estimate and adopted it, the bank would have required a participation percentage of 11.11% in order to achieve its desired return of 1,000.

It appears from the above that in negotiations between providers of outside capital and users of outside capital, the providers will take as pessimistic a view as possible of the value added to be generated in order to raise the rate of the participation, while users of capital will for converse reasons take as optimistic a view as possible. This conflicts with Prof. Nienhaus statement that entrepreneurs may take a pessimistic view of future value added owing to their aversion to the risk of overstating profits, and may be prepared to accept higher rates of VAP in return for the "cushion" against the effects of losses which this type of financing offers as contrasted with fixed interest loans.

The problem of forecasting value added applies mainly to new projects. Where a participation in an existing enterprise is being negotiated there will be past figures on value added generated which will simplify the task of forecasting the future.

Conclusions

Prof. Nienhaus proposal for a new type of financing mechanism for Islamic banks is worthy of further investigation and analysis. As he himself indicates, a number of questions of detail remain to be answered. One of the most important concerns tax: is a distribution based on a percentage of value added a <u>charge against</u> or a <u>distribution of</u> profit ? The question is an important one because in many countries distributions of profit are effectively taxed twice - the first time as part of the taxes assessed on the enterprise and the second time in the hands upon distribution. Clearly, the VAP concept would be much more attractive to entrepreneurs if tax authorities accepted the VAP as a deduction to be made in arriving at profits.

Some of the components of value added will need further refinement: depreciation, for example, should be defined only as the amounts required to write fixed assets off over the estimated useful lives. Special fiscal depreciation granted to encourage investment in plant and machinery should be disregarded, since it could seriously distort value-added calculations in the short term.

However the concept is one which, suitable refined, may provide a solution to one of the main problems of Islamic banks: designing a mechanism to free funds for investment in industrial and other enterprises while avoiding the risks (particularly in the short term) of pure profit-and-loss sharing arrangements.

There is a further dimension to VAP not mentioned by Prof. Nienhaus: negotiable VAP certificates could be issued which might contribute to the creation of a secondary capital market which on the one hand would provide a attractive haven for individual savings, and on the other enable Islamic banks to recycle their funds more rapidly as new opportunities for investment in Islamic countries arise.

INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS - CONCEPTS AND PROSPECTS

by A. Kabbara

The author identifies a number of Islamic banks which are active in financing industrial projects. Apart from the IsDB, he mentions the Faisal Islamic bank, the Dar Al-maal As-Islami Trust, Masraf Qater al-Islami and the Jordan Finance House. Among the obstacles to long-term industrial financing he highlights the characteristic short-term deposit structure of Islamic banks and the fact that the principal long-term mechanisms currently available are of the PLS type, with all the risks and uncertainties that these entail, particularly in the case of new projects. The Shari'ah does not permit the taking of collateral in cases of PLS types of association. This combined with the lack of an Islamic central bank to act as lender of the last resort means that Islamic banks have to maintain much higher liquidity ratios (50-90% of deposits) than interest-based banks.

Fixed return techniques such as leasing are less risky, since the leasing charge will normally be financed by the cash flow generated by the leased assets. However, in case of default the bank's only recourse is to repossess and dispose of the leased assets. Since leased plant is normally tailored to the needs of the lessee, this may be difficult and involve considerable loss. The bank's image may also suffer if it adopts harsh measures against clients whose problems are not necessarily of their own making. It is for this reason that in Western countries banks rarely engage in leasing, but establish specialized companies for this purpose. The development of leasing in Islamic countries is impeded by the lack of experts in the field.

While the scope for equity participation through shares is limited for legal reasons in most IsDB member countries, the introduction of "Participation Term Certificates" (PTC), a type of redeemable share certificate, has had considerable success in Pakistan. The novelty of PTCs is that distributions to their holders are treated by the authorities as <u>deductions</u> from profits, thus giving such payments the same tax status as interest payments in the traditional banking system.

To summarize, the reservations shown by Islamic banks towards financing fixed investment and working capital of industrial projects, as opposed to financing specific transactions, are due to the lack of experts able to evaluate and monitor such projects and, in case of need, to take an active role in project management.

The author's proposal to establish an Islamic industrial bank to promote co-operation between NDFIs and Islamic banks, to raise long-term funds for industrial development and to develop an Islamic capital market seems premature in view of the many unresolved problems, theoretical and practical, of Islamic banks' industrial financing activities, and given the existence of an Islamic financing institution, the IsDB, which has already gained considerable experience in this field. Instead, the need is for a series of measures to take some of the mystery out of setting up and operating successful industrial projects in order that those Islamic banks which have not ventured into this field may be encouraged to do so, starting in a small way and increasing the scope of their activities as their experience and confidence grow.

INDUSTRIAL FINANCING TECHNIQUES OF ISLAMIC BANKS

by Dr. Z. Ahmad.

Dr. Ahmad provides valuable insights into the industrial financing activities of the Massraf Faysal Al-Islami (MFI) group of banks which operate under the umbrella of Daral Maal Al-Islami. MFI has devised a standard form of contract for its mudarabah investments under which the bank provides all the capital, while the client is responsible for production and sales. The finance is provided on the basis of detailed projections of cash flow and distributable revenue prepared by the client, continuously monitored by the bank. The client is also required to report quarterly any divergences of actual results over those budgeted. Depending on the terms of the agreement, the client is entitled to a share of the profits only, or may receive a fixed management fee and a correspondingly smaller share of profit. MFI's participation is restricted to recouping its investment plus a predetermined rate of return, the aim being to withdraw from the project when these targets have been met. MFI is entitled to step in and manage the project itself, should there be any breach of contract or should the operating results fail to attain the projected cash flow and/or distributable revenue.

A second variant is the shirkah contract, whereby capital is provided by both MFI and the client, who continues to be resposible for supplying management and other services.

In order to limit its investment in the riskier type of equity participation, MFI makes interest-free loans to mudarabah and shirkah clients which can be secured by promissory notes. One assumes that MFI includes the cost of such interest-free loans in its computation of the profitability of a given project, although the author does not specifically mention this aspect.

MFI also utilizes the other instruments of Islamic banking: "cost-plus financing" (murabahah), leasing (ijara), and instalment purchase (ijara wa iqtina).

Turning to the Islamization of the banking system in Pakistan, Dr. Ahmad stresses that the government has taken steps to institutionalize Islamic banking by embarking on the creation of a suitable legal and administrative framework. Thus a "Mudarabaha Companies and Mudarabah (Floatation and Control) Ordinance" was enacted in 1980 to establish the conditions on which mudarabah operations can be carried on. And to "safeguard the banks against undue delays and defaults in repayment by parties obtaining finance from them", in 1984 the Banking Tribunals Ordinance under which the courts can impose penalties on debtors who fail to meet their obligations towards the banking system.

However, as Dr. Ahmad points out, much remains to be done: mudarabaha is so far the only interest-free mode of financing used by banks and other financial institutions in Pakistan to have been regularized and standardized.

In his concluding remarks, Dr. Ahmad stresses the need for training programmes, not only to provide detailed guidance on implementing the various modes of financing permissible under the Shari'ah, but also to equip the staff of Islamic banks with expertise in techniques of project appraisal, profit forecasting, sensitivity analysis, and the application of the various methods of computing return on investment. Islamic banks must also be able to evaluate the success of industrial projects by the use of monitoring systems which will provide early warning of any problems.

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

by D. Mohamad Gamal Attia.

In the author's discussion of leasing, he indicates that this mechanism is able to provide a reliable return to short-term depositors by linking their return to the income earned from an individual leasing transaction or from the bank's leasing business in general. In his view it would even be feasible for banks to issue investment certificates representing the leased assets denominated in units of an appropriate size and sell them in a secondary market, thereby replenishing the bank's liquidity. The certificate's value at any given time would presumably be the relevant proportion of the outstanding leasing payments, discounted to its present value at the appropriate rate.

Mr. Attia does not however explain what recourse the holder of such a certificate would have against the lessee if for any reason he ceased to make the rental payments. Neither repossession nor legal action would appear realistic alternatives for a small investor. It might be possible for the bank which issued the certificates to act as trustee ("mudarib") on behalf of all the holders. This aspect needs clarification before the issue of "leasing certificates" can be considered a viable financing instrument.

According to Mr. Attia, some Islamic banks finance the working capital of industrial enterprises by means of mudaraba and PLS. Pakistan has regulated this type of financing by means of the 1984 Banking and Financial Services Ordinance previously mentioned which provide for the use of fixed-term investment certificates and a class of redeemable participating capital. Outside Pakistan, Islamic banks provide working capital on a consortium basis and, at the end of a given accounting period, split the profit in proportion to the amount they have advanced, an appropriate share being attributed to the enterprise. However, this mechanism is only feasible in the case of relatively large companies with well organized and reliable financial accounting functions. It also requires very careful study of the project's strengths and weaknesses to avoid the bank becoming involved during a period when profits are low or losses are being incurred.

As regards the risks of PLS type investments, Mr Attia stresses the need for careful evaluation of projects before a financing decision is taken. The shortage of staff skilled in such work leads him to propose a "pool of project evaluation within an international organization such as the IsDB or UNIDO" and "concentrated training programmes for officers of Islamic banks working in investment fields in order to acquire experience and dexterity". He also suggests the creation of an investment guarantee corporation, jointly owned by Islamic banks and financed by a contribution from their profits, to make good losses incurred in unsuccessful investments. The weakness of this proposal appears to lie in the danger that Islamic banks would be less likely to develop the project evaluation and monitoring skills they need, if a safety net existed to rescue them from the effects of ill-considered investments.

NOTES ON CAPITAL MOVEMENTS, TRADE LIBERALIZATION AND FINANCING ACTIVITIES OF ISLAMIC BANKS

by Prof. V. Nienhaus

This paper provides some useful background on the political and economic backdrop against which the industrial financing activities of Islamic banks should be viewed, at least to the extent that these activities concern OIC countries. He points out that attempts at economic integration by developing countries have been, in the main, disappointing, and that the OIC is no exception. The costs and benefits of the removal of restrictions on trade and factor movements can turn out to be detrimental to the industrial development of the least advanced member countries, since industries in these countries are often too inefficient to survive when exposed to intra-group competition upon elimination of tariff protection. Furthermore, if left to their own devices, new industries will tend to locate in those intra-group countries which offer a higher level of development in terms of labour force and infrastructure.

To quote Nienhaus, the OIC "is probably the most heterogenous of all groupings worldwide striving for economic integration":

- the individual share of one quarter of the individual OIC countries in aggregate GDP is near to nil, while the three largest member countries share 43% of the total;

- the share of manufacturing industry in national GDP ranges from 2% to 24%;

- the population of the largest country is 500 times that of the smallest one;

- per capita income of the poorest country is US$ 130, and of the richest US$ 22,870 (the most extreme range of per capita income that can be found in any existing integration grouping).

The above features partially explain the lack of success that the OIC countries have had in pursuing their quest for integration. The only OIC-wide integrative measure since the General Agreement for Economic, Technical and Commercial Co-operation among OIC member states is the Agreement for Promotion, Protection and Guarantee of Investments which was adopted in 1981 but has not yet come into force because the number of ratifying States has not yet reached ten.

As a kind of substitute for the above Investments Agreement, the IsDB and the Islamic Chamber of Commerce, Industry and Commodity Exchange (ICCICE) have concentrated on promoting Islamic joint ventures. At present project partners are being sought for six such projects representing a total investment of US$ 128 million. However, given the absence of any multilateral preferential trade agreement between the OIC countries, the products emanating from Islamic joint ventures are confined to the national markets of the countries where they are located. Exports, if any, will tend to be to the industrialized countries of the North, and not to the other members of the group since trade between Islamic countries tends to be significant in quantity, concerns mainly raw materials, and is growing at a slower rate than the total trade of these countries.

In Nienhaus's view, without trade liberalization measures, implementation of the OIC Investments Agreement and the partial freeing of capital movements it envisages "would operate in favour of the industrially more developed Islamic countries with large national markets, while the least developed and smaller Islamic countries would have even less chance of attracting investment and being chosen as the location for new industries than they would have in a conventional free trade area without free capital movement". In the OIC context, an "appropriate" trade liberalization scheme would allow the smaller, less developed countries access to wider markets, while retaining some form of protection to ensure that the increased efficiency resulting from intra-group competition was not achieved at their domestic industries' expense.

Nienhaus points out that trade promotion without trade liberalization may lead to the continuation ad infinitum of a distorted trade structure based on different national export promotion strategies of the group members, rather than on intra-group comparative advantage. He mentions in this connection the IsDB's recently established long-term trade financing facility of US$ 300 million. According to its Articles of Agreement, the IsDB's funds should be employed primarily in project financing by means of equity participation, profit sharing or leasing. Funds surplus to this purpose may be used for trade financing. However, the share of trade financing in total IsDB outlays increased from 30% in 1977 to 67% in 1985, and nearly two thirds of these were used to finance imports of petroleum and petroleum products. Thus about one half of total IsDB trade financing concerned exports of Islamic oil producers, and especially Saudi Arabia, Iraq and Kuwait while 10% to 15% were used for non-oil imports from Islamic countries. Only this relatively small percentage may have had some impact on the industrial development of the Islamic countries.

Prof. Nienhaus concludes that from the standpoint of the individual and collective development of the Islamic countries, the funds of the IsDB as an inter-governmental development bank would be better employed in setting up an industrial venture financing scheme (which would also bring IsDB activities back in line with what was originally intended), leaving the financing of intra-Islamic trade to Islamic (and non-Islamic) commercial banks.

These should be willing, for profit reasons, to provide the funds needed by mobilizing additional funds from their depositors and by channelling more of the available funds into trade activities. This would however provide only part of the solution. A "real" efficiency-improving re-allocation of industrial activities between the Islamic countries founded on intra-group comparative advantage can only be achieved by means of a liberalization of the movement of goods and/or factors. Therefore the Islamic countries must look for appropriate liberalization strategies and not only concentrate on trade and investment promotion. Entrepreneurs may then find new investment opportunities in the re-structured industrial sectors and Islamic banks may find it attractive to finance the new industrial ventures.