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WORKSHOP ON INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS

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INTRODUCTION

Given its mandate to assist developing countries in expanding their industrial base, UNIDO attaches great importance to ensuring that the Organization's technical assistance activities support and foster the complex task of financing industry. With this in view UNIDO maintains close links with national, regional and international Islamic financing institutions.

The contribution of Islamic banks to industrial development and expansion is of particular interest, since these institutions have considerable potential for mobilizing the savings of investors in Muslim countries who have in the past had reservations about entrusting the money to banks which did not respect the precepts of the Shari'ah. The pioneering rôle of the Islamic Development Bank, Jeddah (hereinafter IsDB) since its inception in 1976 and its unique contribution to the economic and infrastructural development of Muslim countries is universally acknowledged. Little is however known at present about the industrial financing operations of national Islamic banks because this sphere of activity is a comparatively recent one for them. In order to gain a better understanding of Islamic banks' industrial financing operations UNIDO recently organized, in close co-operation with the IsDB, a workshop on this topic.

The Workshop, which was held in Vienna from 16 - 20 June 1986, aimed to shed light on the following issues as viewed from the standpoint of banks operating on Islamic principles, the most fundamental of which being the prohibition of lending for interest:

- utilizing short-term financial resources for long-term investment in industry;

- investigating why equity investments - and particularly equity investments in industrial undertakings - still account for a relatively low proportion for Islamic banks total outlays;

- identifying investment mechanisms suited to the operating principles of Islamic banks, such as equity participation, profit-and-loss sharing, leasing, and instalment sale;

- evaluating proposals for new industrial ventures or for the rehabilitation of existing ones;

- co-operation between a technical assistance agency such as UNIDO, NDFIs in Islamic countries and Islamic banks in identifying, evaluating, preparing and implementing industrial projects and in fostering entrepreneurship;

- co-operation between Islamic banks and traditional financing institutions.

In order to obtain up-to-date information on the status of Islamic banks' involvement in industrial financing, UNIDO designed a questionnaire which was sent to all those of them which had been invited to attend the Workshop. Apart from requesting general information on each Islamic bank, such as its size and the type of financing it engaged in, the questionnaire asked for details of exposure to industrial financing, the type of industry preferred, how industrial projects were evaluated for profitability and risk, financing mechanisms utilized, and whether operations in this area had on balance yielded positive results and, if not, what had been the main obstacles.

The workshop was attended by 10 Islamic banks, six traditional banks, five regional and international organizations and observers from the League of Arab States and the International Chamber of Commerce. A full list of participants is attached as Annex 2. The fact that all these participants bore their own travel and accommodation expenses is an indication of the profound interest which problems of industrial financing in an Islamic setting elicit in banking and other circles. 11 papers on industrial financing topics were presented to the Workshop. Details of the participants and of the papers submitted are annexed as attachments 1 and 2, and the ensuing discussion is summarized below.

SUMMARY OF DISCUSSIONS

As regards a definition of industrial financing activities, there was discussion on whether such activities were restricted to the direct financing of industrial inputs, or whether a wider definition should be adopted.

The suggestion by one Workshop participant of a broader definition of industrial financing, one which would include foreign trade financing of capital equipment purchases, aroused some interest. However, for the purposes of most of the discussion, the term industrial financing was assumed to refer primarily to long-term finance for the fixed investment portion of a given project and to short-term finance for working capital.

The participants noted that a wide range of Islamic financial instruments already existed, many of which had been successfully tested by a number of banks, particularly those in Pakistan where the Islamization of the banking system is most advanced. However, it was acknowledged that problems were still being encountered in matching the generally short-term structure of Islamic banks' deposits to the longer term requirements of industrial projects, with their relatively long gestation period. The need for an Islamic equivalent to the overdraft facility widely used in traditional banking to finance working capital and temporary cash needs was also emphasized. The proposal to adopt "value-added" as an alternative yardstick of entrepreneurial success was given a favorable hearing by the participants.

The lack of a "lender of the last resort" for the Islamic banks meant that they had to maintain higher liquidity ratios than traditional banks which, in case of need could turn to their central bank for call money. Being a comparatively recent phenomenon, Islamic banks had not yet built up the expertise needed to convert short-term deposits into long-term investments in line with the needs of industry. It was suggested that deposits from pension funds might offer Islamic banks a source of long-term finance which could be used for such investment.

Islamic banks, it was pointed out, do not necessarily regard themselves as having any particular mandate to invest in industrial projects. Their main objective is to achieve a return on investment for their depositors and protect their capital. They must therefore be convinced that industry offers opportunities for profitable investment.

Some participants felt however that the complexity and risk attaching to equity participation in industrial projects, and particularly in new ones, demanded a degree of skill and sophistication in project appraisal and monitoring which exceeded the expertise available within most Islamic banks, presently operating mainly along commercial lines. It was pointed out that in some cases it might even be necessary for a bank to take over the management of an ailing company, a task requiring highly specialized staff few banks were likely to possess.

The possibility of creating a specialized institution on the lines of the All-India Reconstruction Co. to undertake this task was mentioned, as was the possibility of setting up an Islamic Industrial Development Bank. However, most delegates felt that it would be hard at this juncture to create new institutions. Rather, fuller use should be made of the existing institutions such as the Islamic Development Bank where there is still scope for increasing the proportion of its total outlays committed to equity participations.

In this connection the need for improving the level of co-operation between Islamic banks and national development finance institutions was emphasized, in view of the latters' specific mandate to promote industrial projects. Such co-operation might take the form of Islamic banks purchasing equity in mature industrial projects financed by NDFIs, thereby enabling the latter to recycle their funds for new ventures.

There was general agreement that the obstacles to industrial financing by Islamic banks lay in the lack of suitable projects and the low absorptive capacity of many OIC member countries, rather than in any lack of funds. Thus a substantial proportion of the US$84 million which the IsDB had made available to a number of NDFIs to acquire equity in industrial undertakings, had not yet been taken up.

Some speakers stressed the need for closer attention to be paid to the rehabilitation of existing industrial projects rather than looking only at new ones. Industrial facilities which were no longer operating effectively owing to a shortage of skilled personnel and working capital were characteristic of developing countries, and this was an area where UNIDO could provide technical assistance to ensure that any fresh injection of funds would result in a profitable enterprise.

The slow progress in OIC member countries towards creating effective supranational mechanisms for investment protection on the lines of the Inter-Arab Investment Guarantee Corporation, and for the harmonization of commercial and fiscal law were among the reasons adduced to explain the cautious approach of Islamic banks to cross-border industrial financing activities. Islamic banks were also faced by the need to match deposits in a given currency with investments in the same currency to avoid exposure to exchange losses.

There was general agreement that one of the main obstacles to creating a climate more conducive to investment in industrial projects was the slow pace of progress towards co-ordinating and integrating their economic development, notwithstanding the declared political will of OIC member states to achieve this aim.

After hearing presentations on UNIDO's technical assistance activities and programmes, a number of participants expressed the view that the organization should expand the support it was already giving to Islamic banks by such measures as periodic workshops on selected aspects of project identification, appraisal, promotion and financing, field trips to study specific areas of Islamic banks' operations, ascertain their specific needs and explore opportunities for co-operation with other financing institutions such as NDFIs. UNIDO could also assist in project monitoring and/or supervision and in organizing industrial joint ventures.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

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 foreign trade financing and for investment in activities with a fixed return, such as leasing, hire purchase and arrangements involving purchase of industrial inputs and their resale to the user at a profit. The reasons for this reluctance to invest in industrial projects appear to lie in the view that equity investments offer uncertain returns, both as regards amount and time-frame of receipt. The case study presented by the representative of the IsDB revealed a further hazard: unforeseeable adverse developments may face a bank with the option of increasing substantially the amount of the planned outlay in order to rescue a project encountering difficulties, or of writing off the entire investment.

In contrast to types of financing offering 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 monitor and even participate actively in the management - for which they lack both the staff and the expertise. Even the IsDB with a large professional staff of economists, financial analysts and engineers has experienced 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 increasing assistance in a number of areas, such as guidance in how to assess the viability of industrial project proposals submitted to them, or management training to enable the banks' staff to intervene where 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, although several authors and many speakers stressed the progress that had been achieved in Pakistan towards Islamizing 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.

Some Islamic countries continue to discriminate against profit and loss sharing: any distribution to investors is treated as an appropriation <u>of</u> profit and not as a deduction <u>from</u> profit for the purpose of arriving at taxable income. This contrasts with interest payments, which are tax-deductible. Moreover in certain OIC member states Islamic banks are not permitted to take deposits because of their inability to guarantee a fixed return.

One paper proposed an innovative type 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 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; the concept therefore deserves further study and research.

With regard to case studies on industrial projects financed by Islamic banks, only one was presented - by the IsDB. The study revealed that the Bank, owing to unforeseen events which occurred during project implementation, decided to increase its initial investment by a factor of five in order to ensure the project's successful conclusion. The availability of further 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 more informed discussion of the specific 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 success and financial benefit 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 engage 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 required.

Recommendations

1. UNIDO should continue to gather information on the industrial financing activities of Islamic banks

Most Islamic banks are young institutions. Not only is their number growing, but the scope of their activities is undergoing constant change. The Workshop therefore needs follow-up in the shape of ongoing contacts with Islamic banks to monitor the development and growth of their industrial financing activities. Judging by comments received, many such institutions are only at the initial stages of developing industrial financing operations. A shorter version of the industrial financing questionnaire should therefore be prepared, tailored to a more modest level of activity in this area.

2. UNIDO should endeavour to foster co-operation between Islamic banks and NDFIs in OIC member countries

The main areas of concern are:

- Identification, appraisal and joint financing of bankable industrial undertakings - both new projects and rehabilitations of existing projects;

- The acquisition by Islamic banks from NDFIs of equity in mature industrial investments;

- Training staff of Islamic banks in techniques of project appraisal and preparation, implementation and monitoring;

- Facilities for rescuing a project which is in difficulties. This might involve the creation of a specialized organization or of a task force within a given bank or group of banks.

3. IsDB and UNIDO should continue their co-operation by organizing workshops on related topics in the near future, preferably in an Islamic country, and in particular one covering a specific priority industrial subsector such as food processing.

Such a workshop could result in the identification of specific projects in the sub-sector which could then be promoted by UNIDO using the resources of its Industrial Investment Division.

4. IsDB and UNIDO should publish a collection of case studies on industrial financing activities of Islamic banks and NDFIs in OIC member states

The case studies would demonstrate the problems that have been encountered and how they were tackled. Case studies of successful industrial projects should be emphasized with an analysis of the factors to which success was due.

5. Co-ordination meetings should be held between the top management of Islamic banks and other financing institutions (national, regional and international)

Such meetings should be held from time to time to discuss problems of industrial financing in an Islamic context and develop strategies to bring about a broader engagement in industry by Islamic banks. The meetings would also provide a forum where structural problems of specific industry sectors in OIC member countries could be discussed with UNIDO experts, and proposals for appropriate technical assistance programmes drafted. Each such meeting should centre on a specific topic, of which the following are examples:

Case studies on existing industrial investments in Islamic countries;

Techniques for evaluating the profitability of industrial investment project proposals in an Islamic context

Preparation of industrial investment projects using specialized software for sensitivity analysis and scenario building

Using Islamic financing mechanisms in industrial financing

The principle of "value-added participation" as an alternative to profit-sharing

Monitoring the implementation of industrial investment projects. "Early warning" systems to detect ailing projects

6. Technical Assistance Resources available from UNIDO and other UN agencies

Many participants in the workshop only became aware of the full range of technical assistance resources available after hearing presentations by UNIDO staff. There is therefore a need for more intensive dissemination of information on the range of help available, since this could play an important role in encouraging Islamic banks to engage in industrial financing activities.

7. Development of co-operation between Islamic banks and traditional financial institutions

There is considerable scope for co-operation between Islamic banks and non-Islamic financing institutions, in particular venture capital and national development companies which specialize in equity participation rather than loan finance.

8. Investigating ways of establishing secondary markets in Islamic countries to mobilize small investors funds for industrial projects

There are a number of mechanisms in use in industrialized countries to channel small investors' funds into types of financing based on profit-and-loss sharing, rather than fixed-interest loans. That in widest use is the unit trust. An Islamic unit trust is perfectly feasible and the concept should be promoted.

9. Harmonization and integration of systems of fiscal and commercial law in Islamic countries

Most countries which adhere to the OIC have done little, if anything, to modify their legal and fiscal systems accordingly. Only in Pakistan has progress been made in giving legislative force to the main types of Islamic financing mechanisms. There is therefore an urgent need for OIC member states to consider ways of allowing Islamic banks to operate pari passu with non-Islamic institutions. UNIDO could play a valuable role in defining the problem and bringing together experts from OIC member states to study possible solutions.

WORKSHOP ON THE INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS
VIENNA, 16-20 JUNE 1986

Annex I

LIST OF DOCUMENTS

Workshop Paper No		Language
1.	The role of the Islamic Development Bank in financing industrial projects (Mr. Youssef)	E
2.	Islamic financing mechanisms available for Islamic banks and the need for new mechanisms (Mr. Attia)	A & E
3.	Value added participation (VAP) - A new financing instrument for Islamic banks (Mr. Nienhaus)	E
4.	Notes on capital movements, trade liberalization and financing activities of Islamic banks (Mr. Nienhaus)	E
5.	Notes on the background, achievements and problems of Islamic banks (Mr. Nienhaus)	E
6.	UNIDO approved and/or operational technical co-operation projects	E
7.	Working paper on receiver financed UNIDO technical assistance to industrial capacity utilization, industrial in-depth surveys and rehabilitation	E
8	Working paper on UNIDO technical assistance to industrial check-up and rehabilitation	E
9.	Computer printout of investment projects being actively promoted in Egypt, Malaysia, Mauritania and Sudan	E
10.	The evolution of Islamic industrial financing: constraints, potentialities and prospects for industrial development (Mr. Selby)	E
11.	Overview of Islamic banking and finance (redeemable participation) (Mr. Attia)	E
12.	Investment mechanisms and joint ventures: the promotion of industrial co-operation between member countries of the OIC (Mr. Abdelmoneim)	E
13.	The Islamic Development Bank: Investment profile and its efforts in developing financial instruments in accordance with shariah (Mr. El Hennawi)	E

14. Halal - leasing: finacial leasing complying with the Islamic sharia'
(Mr. Trolle-Schultz) E

14. A. Halal financing instruments for overnight investments
(Mr. Trolle-Schutlz) E

15. Industrial financing activities of Islamic banks, concepts
(Mr. Kabbara) E

16. Industrial financing techniques of Islamic Banks
(Mr. Ahmad) E

WORKSHOP ON THE INDUSTRIAL FINANCING ACTIVITIES OF ISLAMIC BANKS
(Vienna, 16-19 June 1986)
UNIDO, Vienna International Centre
Conference Room C-II
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ANNEX III

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) Mr. A.R. Youssef gives valuable insights into the operations of this leading Islamic finance institution, together with statistical material on how its total outlays 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 US$963 million in financial resources for industry (manufacturing and agro) 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 (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 is 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.

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 of currency depreciation on projects by investigating whether the forecast return will be sufficient to offset the effects of such depreciation, after taking into account the state of the domestic economy and its balance of payments and external debt ratios. Projects in countries with a chronic shortage of convertible currency will 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. The guidelines require a breakdown of the capital cost between foreign and local currency, but 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) allocations 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 is not 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 all the project's assets, but can only finance transactions clearly identified with specific 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 unconditional.

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 an infringement.

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 <u>unconditional</u>. Therefore the prohibition of <u>riba</u> does not apply to a participation based on a percentage of value-added.

Value added participation, as Prof. Nienhaus 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 the 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 materials ? 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's 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's 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.

In conclusion, Prof. Nienhaus's 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 charge against or a distribution of 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 of the paper (34 pages) 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 ban 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.

In short, 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 remove some of the uncertainty from 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's paper (41 pages) 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 mudaraba 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 from 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 responsible 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 mudaraba 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" (murabaha), leasing (ijara), and purchase and lease-back (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 "Mudaraba Companies and Mudaraba (Floatation and Control) Ordinance" was enacted in 1980 to establish the conditions on which mudaraba 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 was enacted under which the courts can impose penalties on debtors who fail to meet their obligations towards the banks.

However, as Dr. Ahmad points out, much remains to be done: mudaraba is so far the only interest-free mode of financing used by banks and other financing 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 (38 pages), 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 <u>mudaraba</u> 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 benefits of removing 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 may be unable to survive the intra-group competition resulting from 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.

Pending the entry into force of 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, in 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 insignificant in quantity, is mainly in raw materials, and 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, 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.

THE ISLAMIC DEVELOPMENT BANK: INVESTMENT PROFILE AND ITS EFFORTS IN DEVELOPING FINANCIAL INSTRUMENTS IN ACCORDANCE WITH SHARIAH

by Dr. Mohamed El-Hennawi

The Islamic Development Bank (IsDB), which commenced operations in 1975, was created to foster the economic and social development of OIC member states which are also its members and of Muslim communities throughout the world. The Bank is authorized to accept deposits and to raise funds in any other manner compatible with the Shariah. The main functions of the IsDB, which has a subscribed capital of 1,952 million Islamic Dinars (ID 1 = SDR 1), are to assist productive enterprises in member states by means of equity participations and loans, to promote trade among OIC countries, provide them with technical assistance, and conduct research into how the Shariah should be applied to banking and financial operations.

The IsDB's Ordinary Operations - project financing and technical assistance - account for 27% of its total outlays since inception, of which more than 97% or some US$1.44 billion* were devoted to project financing. Technical assistance totalling US$37 million was provided during the same period, mainly for pre-investment studies and R&D equipment. While during the first five years loans predominated, as of 1981 leasing and instalment sales took the lead. Equity participation has shown a declining trend.

Of the total project outlays, 41.6% went to the industrial sector (including mining) and 14% to agriculture. The remainder was shared between transport and communications, public utilities and the social services.

Foreign trade financing commenced in 1977 to utilize funds temporarily surplus to other needs and with a view to assisting member countries with the import of essential commodities, and promote trade among them. Foreign trade has so far accounted for some US$3.8 billion, being about 70% of the Bank's total

*billion is used here in the sense of one thousand million.

outlays.

By the end of 1985 expansion of training facilities, promotion of Islamic causes, and social and economic support for Muslim countries in non-member countries have been financed in the amount of US$164 million from the Special Assistance Account, established 1979.

Over the past year the Bank has undertaken activities leading to a "Scheme for Financial Instruments based on the Shariah", presented to and endorsed by the 7th meeting of Islamic banks held in Amman in March 1986.

At their May 1986 meeting in Jeddah, the Heads of the Islamic banks decided to implement the Scheme by establishing an investment portfolio jointly owned by the IsDB and other Islamic banks to finance trade operations among Islamic countries.

The Islamic Certificate of Deposit proposed under the Scheme represents an investment in and financial claim against the assets of a specific project group of projects, taking the form of

i) permanent equity participations;

ii) declining participations;

iii) Purchase/leasing of material and equipment etc. for subsequent leasing; and

iv) short, medium or long-term financing of trade (based on the Murabaha concept).

All records of transactions relating to a project financed by such certificates, and of the resulting assets and liabilities, will be kept separate from the records of the Bank, which will act solely as trustee of the project on behalf of the investors.

The IsDB may be willing to repurchase the certificates - at their face value up to the start of operations and thereafter at a price based on the project's financial position and on the demand for the certificates - until such time as a market for the certificates may exist in Islamic countries.

The Bank's liability would be limited to issuing a prospectus on the project containing full and reliable information and to ensuring that prospective investors had access to the relevant pre-investment studies.

The Bank may also establish a "Co-operative Insurance Fund" to cover all non-commercial risks of such a project funded by income of the project and donations by the Bank.

The profits earned by the project would shared between the IsDB as trustee, the certificate holders as investors and the Co-operative Insurance Fund. In the case of "declining participation" projects, part of the profits would be utilized to repay a portion of the par value of each investment certificate - determining certificates to be repaid by a draw would not be permissible, owing to the Shariah prohibition of lotteries.

To ensure the success of the scheme for mobilizing funds IDM would also need to:

- Encourage other Islamic banks to engage in Shariah-based financial instruments, e.g. underwriting, brokerage, etc.,

- Secure the co-operation of other financial institutions in implementing the Scheme,

- Contact financial markets in member countries to enlist their co-operation and establish a "Consultation Group" of Islamic financial and related institutions, government representatives and companies who would provide needed guidance.

- Establish a "Shariah Control Board" to monitor financial transactions.

To mobilize additional resources, the Bank has issued marketable securities in respect of a number of its profit-yielding portfolio equity projects and is working with other Islamic banks to implement the proposed intra-OIC trade promotion Scheme.

Among the options under consideration by IsDB are the establishment of a unit or investment trust or mutual fund:

Pakistan currently leads the field in mobilizing the savings of small investors and channelling them into suitable investments. Its two major investment trust companies - the National Investment Trust and the Investment Corporation of Pakistan - are therefore being studied by the IsDB, together with leading unit trusts in Malaysia. The Bank is also evaluating a study on the Al-Baraka Group as a possible model for a limited liability company with opne-ended capital.

In addition, the IsDB is considering the issue of an Islamic Certificate of Deposit. This could be used where - unlike the proposed Scheme - a separate legal and financial entity is not feasible. Such certificates would not relate to a specific investment, but would be invested by the Bank as general trustee in whatever instruments it deemed appropriate. The periodic distributions of profit would depend on the earnings of the underlying enterprises. The Bank is currently studying aspects of the liquidity ratios, pricing, maturity, tradeability etc. of such certificates.

IsDB has taken a leading role in developing financial instruments which conform to the Shariah and in creating a market for such instruments. Together with other Islamic banks, it is seeking to design an appropriate scheme to mobilize domestic savings and facilitate co-operation, both among Islamic financial institutions and between these and conventional financial institutions.

Annex 4

Glossary of Islamic Banking Terms used in the Report

Ijara-wa-Iqtina	Purchase and Lease-back. The bank purchases assets such as machinery and equipment from a client enterprise and leases it back to them. The mechanism is a useful way of providing liquidity, e.g. for working capital.
Ijara	Leasing. The mechanism is similar to the leasing concept used in non-Islamic environments.
Mudareb	An entrepreneur who has the experience and reputation to be entrusted with and to manage the funds of a Mudaraba project (q.v.).
Mudaraba	A joint enterprise whereby one party provides the capital and the other provides the entrepreneurial skill and effort
Murabaha	A mechanism for financing the acquisition of goods, and particularly imports, whereby the bank buys the goods and resells them to the enterprise at a later date at an agreed mark-up.
Riba	Interest. Any return on money lent or invested which is a function of the amount and the period for which it is made available.
Shari'ah	Islamic law.
Shirkah	A mechanism similar to Mudaraba, except that both partners supply capital while one of them only supplies management skill and effort.