

5. Islamic banks

5.1 INTRODUCTION

In this chapter we analyse how banks have incorporated Islamic principles. There is ample evidence that these principles may lead to serious moral-hazard and information problems and we show how the banks deal with those problems. We start with a survey of the financial instruments offered by the banks, that is, the liabilities side of the bank's balance sheet. Next we discuss the specific problems thrown up by some of these liabilities. Then we discuss the problems associated with typically Islamic bank assets. Agency problems figure prominently, but that's not all. We continue with a quick overview of the practice of Islamic banking. The chapter ends with a few conclusions.

5.2 THE LIABILITIES OF ISLAMIC BANKS

5.2.1 Financial Instruments Offered by Banks

If we discuss the financial instruments offered by banks, we deal with their funding, their sources of funds. Islamic banks of course have to follow the precepts of Islamic finance. This implies that not only their lending but also their funding should make use of halal financial instruments. Islamic banks are thus free to issue shares, but not conventional interest-bearing debt. In principle they offer instruments that pay a variable return, depending on the return on their assets. In this respect deposits with Islamic banks would resemble investment funds. We shall see that, in actual practice, deposits usually offer a much more stable return. We start with an enumeration of the different financial instruments offered by Islamic banks in order to fund themselves and follow this up with a brief discussion of the various instruments.

Apart from share capital, Islamic banks attract funds by issuing or selling the following instruments:

- investment or PLS (profit-and-loss sharing) accounts
- savings accounts

- transaction accounts, or current accounts
- *quard hasan* accounts
- borrowings.

Investment or PLS accounts

Investment or PLS accounts are in principle meant as *mudaraba* funds, with the depositor acting as *rabb al-mal*, or financier, and the bank as *mudarib*.¹ If losses occur, these should be borne by the depositors. In practice, however, clients are not expected to share in any losses of the bank; in general there is a *de facto* guarantee on the capital sum of deposits. This of course is at variance with the principle that the *mudarib*, in this case the bank, should not shoulder any losses, but the forces of competition do not leave the banks much choice. A common practice is the smoothing of profit disbursements over time through a profit equalization reserve into which a part of a bank's profits is paid. This enables the bank to avoid low profit disbursements to its depositors in lean years, or to increase profit disbursements in order to stay competitive if conventional banks increase interest rates on deposits (Wilson 2007).

For all that, investment account holders nominally share in the losses and profits of the bank and are in that respect similar to shareholders, without the rights of shareholders. This creates a corporate-governance problem that the Islamic Financial Standards Board (IFSB) has addressed in its *Guiding Principles on Corporate Governance* (IFSB 2006; see Section 5.4.4). The guidelines aim at providing investment account holders with all relevant information. Unrestricted account holders, for instance, whose deposits are pooled with other deposits and used by the bank for investments without any prior restriction, should receive all necessary information on the calculation and allocation of profits and on the investment policies of the bank. The underlying idea is that investment account holders should be able to monitor the bank's management in order to be able to check whether the risk–return profile of the bank's investments agrees with their own preferences. Not all potential problems have been addressed by these guidelines. In particular, there are still question marks over the seniority of investment account holders' claims in case of bankruptcy (El-Gamal 2005a).

The fact that account holders do not formally have the nominal value of their deposits guaranteed may bring banks planning to offer such banking facilities in Western countries into conflict with the supervisory authorities, as the basic idea of banking regulation is that the capital sum of deposits should be guaranteed. If investment accounts could be structured as participations in an investment fund, such problems could be avoided.

Savings accounts

Islamic banks can offer savings accounts guaranteeing the nominal value of the savings deposits and even providing a return. The guarantee can be given because of the legal fiction that the client's money is placed with the bank in custody, *amanah*, or safekeeping, *wadia* (Errico and Farahbaksh 1998; Sundararajan et al. 1998). Ideally, the money should be held by the bank in the form of cash and not be re-lent, but that does not seem to be the way the banks handle these accounts. The banks of course are not allowed to pay interest on these deposits, but anybody is free to bestow gifts on anybody else, and banks are no exception. They thus may pay depositors a gift, *hiba*, depending on their profitability. This is not a form of interest, or *riba*, because there is no promise of a predetermined payment. The Bahrain Islamic Bank, for example, offers savings account holders 'an annual rate of return based on what Allah has granted in the form of profits' (Raphaeli 2006).

In Iran even less effort is made to hide the similarity to conventional interest. The central bank requires the banks to pay their depositors a certain minimum 'profit' rate. It publishes provisional deposit rates for time deposits up until five-year deposits with public banks, either one rate or a range (for instance, 13–17 per cent). Depositors have near-certainty that their share in realized profits will not substantially differ from these provisional rates. The measure was taken for government-owned banks, not private banks and non-bank credit institutions, apparently in order to ensure the attractiveness of deposits held in state banks. The rate on foreign deposits in the domestic banking system, moreover, is LIBOR, which is openly and unashamedly an interest rate (Kia 2006).

Transaction accounts, or current accounts

Transaction or current accounts pay no interest, but the nominal value of deposits is officially guaranteed. Again, this is under the flag of *amanah* or *wadia*. In cases where conventional banks might pay interest, Islamic banks can offer free services. HSBC Amanah, for instance, offers depositors free payment services, provided their total deposits exceed some minimal value. In that case, clients also receive discounts on such things as the hire of a safe deposit box. Lloyds TSB assures its Muslim clients in the UK that the money they hold in their current account or in their so-called Islamic business account will be used by the bank in a sharia-compliant way. Overdrafts are not allowed, and if it proves impossible to intercept an electronic payment and a negative balance ensues, the bank will not demand interest but charge a fixed fee. On Lloyds TSB's Islamic student account overdrafts are allowed, but no interest is charged. Presumably a fixed fee does the trick.

Quard hasan accounts

Quard hasan accounts pay no interest and are meant to provide funds that the bank in its turn uses to grant quard hasan loans.

Borrowings

Conventional banks hardly ever do without fixed-income liabilities. The closest Islamic equivalents are surely sukuk and Islamic banks are starting to use these for their own funding. The pioneer was Malaysian Banking Berhad (Maybank), which issued a \$300 million (RM 1.03 billion) subordinated Sukuk in 2006 in order to strengthen the tier 2 capital of the bank.²

5.2.2 Problems of PLS Funding

Profit-and-loss-sharing arrangements throw up problems in the relationship between a bank and its depositors. A bank's assets are not quoted on stock exchanges and its profits and losses are consequently difficult to ascertain. It is well-nigh impossible for depositors to assess the quality of a bank's outstanding loans. A predetermined rate of interest on deposits saves on information costs in such circumstances. For its part, it gives the bank, like its clients, a stronger incentive to try and allocate funds in the most profitable way (see Goodhart 1995). There is a moral-hazard problem. PLS modes of finance may offer the banks an incentive for risk taking, and for operating with very little own funds. Depositors will have to take the brunt if investments go sour, just like equity investors in a conventional investment company, only they have no say in the appointment of the managers. The only thing they can do is shift their funds to other banks, but they may not always have sufficient information to do so in time. Indeed, this moral-hazard problem was cited as one reason by the Rector of Al-Azhar University in Cairo in his 2002 fatwa for declaring interest-bearing bank deposits *halal* (see Section 3.3.1). It does not come as a surprise, then, that depositors appear to find PLS accounts less attractive than conventional time and savings deposits, and often prefer to hold their money in (guaranteed) transaction accounts if those conventional instruments are not available.

5.3 PROBLEMS WITH ISLAMIC ASSETS**5.3.1 Capital Adequacy Standards**

Islamic banks may invest their funds in any of the *halal* instruments. These have been discussed in Chapter 4. An Islamic bank's balance sheet would

Table 5.1 Balance sheet of an Islamic bank

Assets	Liabilities
cash	investment accounts
mudaraba participations	savings accounts
musharaka participations	transaction accounts
murabaha advances	quard hasan accounts
investments (ijara, sukuk)	borrowings (sukuk)
	own funds

mainly look as depicted in Table 5.1. Islamic banks face problems that their conventional competitors do not have to cope with. One thing is that specifically Islamic financial assets, first of all PLS participations, but also murabaha credit, do not always sit easily with the norms imposed by bank supervisors or recommended by international agencies. Capital adequacy standards in particular do not favour PLS participations.

The Basel Committee of Banking Supervision (BCBS) takes the stand that banks should not hold significant equity positions in companies that are also their counterparties. This is based on the idea that a bank faces increased risk when ownership and the provision of debt funding are in the same hands. Mudaraba and musharaka participations are, from a risk perspective, similar to equity holdings. They are not held in a bank's trade book, that is, they are not held with the intent of trading and under both the Basel II and the IFSB norms, which generally follow Basel II, this means they carry a 400 per cent risk weight (Schoon 2007). PLS arrangements thus are expensive for the banks. They will try to get compensated by demanding a relatively high share of any profits earned with the money they make available to clients. This in turn makes PLS funding unattractive to the banks' clients as well.

With murabaha, there is a related problem. A bank offering murabaha finance becomes owner of the assets it finances, however briefly. Some countries prohibit banks investing in moveable or immovable assets for business purposes (Grais and Pellegrini 2006b, p. 13). If it is allowed, the required capital–asset ratio will be very high again.

5.3.2 Agency Problems

PLS arrangements bring specific agency problems with them. Any financing activity may run into agency problems, but in mudaraba and musharaka finance they are particularly prominent. This will become clear if we look more closely at what bankers actually do during a loan cycle. They go through three stages: screening, monitoring and enforcement.

1. **Screening.** Banks have to closely screen potential borrowers in order to find out whether they are trustworthy and their projects are promising. Fantasizers and swindlers should be kept at a distance. This screening serves to mitigate the problem of asymmetric information and in that way to avoid adverse selection, that is, a poor choice of borrowers and projects. There is asymmetric information in that the prospective client has information about his own person or firm and on the projects to be financed that they are not always willing to share with the financier. The financier thus has to spend time and money to find out whether the potential borrower can reasonably be expected to be as good as his word and his projects are not pipe dreams.
2. **Monitoring.** After a loan contract has been concluded, the bank has to monitor the borrower in order to make sure that the funds provided are used for the ends for which they have been made available. This monitoring serves to minimize moral hazard, that is, behaviour by the borrower, once he has received the funds, that is detrimental to the interests of the financier.
3. **Enforcement.** If things go awry and the borrower defaults, or if there is serious danger that he will do so, the financier will try to force the counterparty to observe the terms of the contract. This enforcement may ultimately lead to the bankruptcy of the borrower. That can be prevented to a large extent if the borrower provides security. Some projects are less risky than others in this respect. Trade finance, for instance, is relatively risk free, as the lender can obtain title to the goods financed and sell them if the borrower defaults. In other cases the borrower may provide collateral or conclude a covenant with the lender to lower the risks. Penalty clauses may also act as an incentive to make the borrower observe the terms of the contract.

The interesting question now is whether the agency problems facing Islamic banks differ from those facing conventional banks, and if so, what the implications are for screening, monitoring and enforcement. It seems that Islamic finance, especially under *mudaraba* and *musharaka* contracts, but to a lesser degree also under other contracts, indeed differs substantially from conventional banking in this respect. The problems peculiar to *musharaka* and *mudaraba* will be discussed in fuller detail, but there are also some general problems. As we saw in Section 4.4, an efficient and reliable sharia litigation system is wanting, guarantees cannot always be demanded and penalty clauses will be of limited value to creditors. As enforcement thus is appreciably more difficult under Islamic banking than under conventional banking, screening becomes doubly important. It must be said that with *murabaha* and *ijara* the risks for the financier are

lower than with *mudaraba* and *musharaka*. Under an *ijara* contract, the financier retains title to the goods and with *murabaha* he may retain title to the goods, though transfer of ownership may also take place before the loan has been repaid.

5.3.3 More on Monitoring under PLS

PLS financing, or *mudaraba* and *musharaka*, creates particular information and moral-hazard problems that require intensive monitoring. First, there is an information problem. The bank or financier needs more information than under conventional banking. Under conventional bank lending, the borrower pays a predetermined interest rate. Under *musharaka* and *mudaraba* contracts, profits are shared between borrower and lender, and the financier also shoulders part or all of the losses. Thus the lender and the borrower first have to agree on the accounting system to be adopted, in order to avoid quarrels on the determination of profits, and in addition the lender has to monitor the borrower in order to avoid being cheated. The borrower, after all, has an interest in reporting low profits. The financier must keep close tabs on the borrower in order to receive the required information, but borrowers are often reluctant to open their books to the banks, not only in order to minimize the sums to be paid to the bank but also for fear that information will be leaked to the tax collector. In some countries smaller businesses don't even have any books to open. The economic anthropologist Professor Willem Wolters mentions an Islamic bank in Yogyakarta, Java, that lent money to small traders under *mudaraba* contracts. As those traders kept no books at all, finding out how large profits were was a cumbersome and time-consuming process. The bank had to send surveyors to the market to make an estimated guess of the traders' sales and profit margins (Wolters 2005).

Monitoring under PLS finance has to deal with a second problem that figures much less prominently in conventional banking. This is the moral-hazard problem. Under a *mudaraba* contract, the financier alone bears any losses. This makes *mudaraba* financing especially attractive for all kinds of visionaries and gamblers. As the more average type of borrower is concerned, they will hardly feel tempted to pull out all stops. Why toil from dawn to dusk or burn the midnight oil if in case of failure the loss is borne by others? This is peculiar to the *mudaraba* contract. Another factor that serves to reduce the drive of the borrower to do his utmost to make a success of a project and to maximize profits is the sharing of profits between the borrower or entrepreneur and the financier. This regards both *mudaraba* and *musharaka*. What is the mechanism? Under conventional banking, the borrower pays a predetermined rate of interest and all returns

Table 5.2 Yields for the debtor and the bank under conventional banking with a 10 per cent interest rate and Islamic banking with 50:50 profit sharing

Return on the project	Yield for the borrower		Yield for the bank	
	conventional banking	Islamic banking	conventional	Islamic
0%	-10	0	10	0
5%	-5	2.5	10	2.5
10%	0	5	10	5
15%	5	7.5	10	7.5
20%	10	10	10	10
25%	15	12.5	10	12.5
30%	20	15	10	15

above that rate, abstracting from taxes, will be retained by the borrower. He thus has an incentive to go for high returns. Under PLS, only part of the profits is for the borrower, but even low returns do leave a positive net result for the borrower. Under conventional banking, by contrast, the yield for the borrower is negative if returns on a project are lower than the interest rate paid to the bank. Table 5.2 gives a numerical example illustrating the difference. We see that with a 50:50 distribution of profits between the borrower and the financier and a 10 per cent interest rate on bank loans, the borrower would earn a yield of 2.5 per cent when the return of a project is 5 per cent, whereas with a conventional bank loan this yield is only earned when the return is 12.5 per cent. The borrower is likely to be content with a lower return than under conventional banking. The upshot is that the financier goes home with a lower yield on his capital and that society is saddled with a less efficient use of its resources and thus with a lower per capita income than would be attained under conventional bank loans.

An additional problem with *mudaraba* that makes monitoring even more difficult is that there is no recognizable default on the part of the agent-entrepreneur until the contract expires, and the financier cannot, as under a *musharaka* contract, himself actively take part in managing the project. Under a *mudaraba* contract, the borrower, or user of funds, does not bring in any funds himself. He need not be an entrepreneur but may be a mere manager. Shirking and spending money on other things than improving efficiency are difficult to prevent and it appears that Presley and Sessions (1994; see also Mills and Presley 1999, ch. 4) are unduly optimistic when they expect *mudaraba* contracts to provide such good incentives to managers as to make monitoring superfluous. They too easily assume that

managerial effort is an increasing function of expected yield, not only at low rates but also at high rates of marginal expected yield. If leisure, honorary positions and spending on luxuries compete in a manager's utility function with income, the principle of utility maximization would predict lower effort than under conventional bank loans, provided relatively low returns go unpunished.

Close monitoring thus is required under PLS forms of finance. This can become quite expensive, like in the case of the surveyors sent into the field by the Yogyakarta bank mentioned above. Monitoring under PLS can hardly be done by simply looking at some balance sheet ratios. Clients will have to be visited on the spot. Standardizing the monitoring process consequently is hardly possible, which puts larger banks in particular at a disadvantage (Čihák and Hesse 2008).

The danger of moral hazard can be mitigated by demanding collateral or security. This would protect the bank against losses. We have seen that sharia law does not allow collateral or security in the case of PLS modes of finance, as the financier should participate in the risk of the business he finances (Saleh 1986, p. 106). Under PLS, any loss is to be borne partly or wholly by the provider of funds, except if the loss is due to misconduct, negligence or violation of the conditions of the contract. However, loan covenants and other such constraints on the behaviour of borrowers are allowed (Suleiman 2005). The rules are not always strictly applied. Indonesia's Bank Muamalat, for instance, includes collateral data in its list of requirements for a musharaka or mudaraba application and Sadr and Iqbal (2002) report that the Agricultural Bank of Iran routinely asks for a third-party guarantee in the case of smaller musharaka participations, and for real estate as collateral in the case of larger musharaka participations. It thus seems that in the case of musharaka and mudaraba, collateral is sometimes allowed by the fuqaha in order to protect the Islamic bank from any misconduct by its clients (Karim 2002, p. 98).

5.3.4 More on the Downside of Islamic Forms of Finance

It has been noted that PLS banking calls for careful screening because of the danger of adverse selection, and careful monitoring because of the dangers of asymmetric information and moral hazard. One factor contributing to adverse selection is that in a mixed financial system with both Islamic and conventional banks, entrepreneurs may not like the idea of profit sharing if they have rosy expectations of the success of their ventures whereas they may prefer profit-sharing finance from Islamic banks if they are less sure of a positive outcome. This might burden Islamic banks with a disproportional share of bad debts, which can only reinforce their preference for

other forms than PLS. Empirical research provides support for this idea. In a survey among 385 small business firms in Sydney it was found that they were more likely to apply for PLS methods of finance with Islamic banks the higher the levels of business risk. Not unnaturally, high interest rates also made them more inclined to ask for PLS funds. Less understandably, high expected rates of return had similar effects. Perhaps these were positively correlated with business risks. What the entrepreneurs did not like was the close monitoring, which could result in management intervention on a day-to-day basis, that went with PLS finance.³

It is not only potential clients, but also the banks that have reservations about PLS finance. One contributing factor is of course the fact that a disproportionately high share of applicants may turn out high-risk debtors, translating into uncertain and variable returns. Another is the fear of incomplete information, or even deliberate misreporting. All this adds to the need for close, and consequently expensive, monitoring. Not surprisingly, then, it was found in a survey among Islamic banks that reputation and the experience of the entrepreneur (*mudarib*) were the most important factors for financiers in deciding whether or not to enter into a *mudaraba* contract (Khalil et al. 2002).

Banks and the authorities have sought ways to mitigate the moral-hazard problem. The line followed in Iran is that the entrepreneur entering into a *musharaka* contract is to a great extent treated as a borrower who must repay his debt, even if he suffers losses (Yasseri 2002). The central bank publishes 'expected rates of return on facilities', that is, for loans, differentiated over industries. These rates of return apparently have to function as benchmarks for the profit rates that a competent entrepreneur should be able to make. The Iranian approach of course is totally at odds with the basic idea of the financier participating in the risks of the business it finances. Apparently, the more Islamic a government claims to be, the more it can take liberties with the fundamental tenets of Islamic finance.

All this does not mean that *murabaha* or *ijara* are free from moral hazard. In so far as ownership remains with the financier, this provides some security. Possession, however, is with the borrower, and there is a risk that he will not treat the good in question with the utmost care. This, though, is a universal agency problem that conventional bankers also have to face. Peculiar to Islamic finance is that the financier, if formally the owner, is vulnerable because he may be liable for any damage from the use of the asset financed, such as injury caused by equipment or environmental damage caused by oil spillage. It is, consequently, the formal owner that has to take care of insurance. We have, furthermore, seen in Section 4.4 that late payments pose special problems, as the scope for applying penalty clauses is rather limited. Banks may therefore be inclined to find

compensation in higher mark-ups and ijara rates. There are, indeed, strong indications that murabaha finance is more expensive than comparable conventional loans (Dar 2007). Other forms of Islamic finance are probably little better in this respect (see Sections 6.3.6 and 8.2.2).

5.3.5 Potential Benefits for Banks of PLS Finance

We have been discussing all kinds of problems associated with the assets of Islamic banks. There are also potential benefits for the banks, however. If Islamic banking is confronted with higher screening and especially higher monitoring costs than conventional banking, the danger of insolvency is lower, provided PLS principles are applied rigorously. Conventional banks run an interest risk. If interest rates fall and debit rates are adjusted faster than credit rates, or if interest rates rise and banks borrow short but lend long, profits are squeezed. Also cyclical downturns may hit them hard. Borrowers default and income on loans falls, but interest on deposits and bonds must continue to be paid. If PLS principles are applied, a lower income on outstanding loans and participations goes hand in hand with lower payments to depositors and the bank's solvency is not endangered. In practice, however, the losses of Islamic banks are not shared with depositors and often a minimum yield on deposits is guaranteed. As a result, the potential benefits of PLS finance cannot be realized.

Still, if Islamic banks rise to the challenge of an increased degree of moral hazard, PLS finance may play a useful role. If they not only monitor financial transactions, but also cooperate closely with their clients in their daily activities, including the timing of purchases of raw materials, keeping an eye on prices and quantities, a reduction of bad debts may be the result. This is claimed to have been the case in Sudan, where Faisal Islamic Bank and Sudanese Islamic Bank, the latter with farmers as its partners, entered into musharaka contracts and essentially acted as venture capitalists, providing not only financial assistance but also expertise in a broad field of business management (Van Dooren and Kerkhoven 1987; Lewis and Algaoud 2001, p. 105). Later studies, however, give the impression that it was not an overall success and Elhiraika (2003) paints a much less rosy picture of Sudanese agricultural finance during the 1990s. Nevertheless, it seems that the natural role of PLS finance, in particular musharaka, is to provide venture capital.

An additional plus of Islamic banking, much trumpeted by its advocates, is that it is less likely to suffer from banking crises such as the 2007–08 credit crisis. As Islamic banks are not allowed to invest in financial instruments that are not asset-backed, problems with esoteric collateralized debt products, for instance, will not directly hurt them. Note, however, that this

is no guarantee that they won't burn their fingers on real-estate finance, as they are free to invest in shares or certificates of property developers and lease firms (provided these are sharia-compliant, of course). Further, if they do not share in the downside of trade in all kinds of credit instruments, the benefits pass them by as well. Occasional excesses should not mask the fact that many economic agents can only hedge risks thanks to the availability of a rich menu of interest-based instruments. It's like flying. Revealed preference shows that the occasional crash does not outweigh the great benefits fast air travel brings. It must be conceded, however, that Islamic banks are less likely to succumb to the usual herd instinct of bankers when some debt-based bubble promises high profits and the eventual crash lies outside their horizon.

5.3.6 Liquidity and Risk Management

Islamic banks labour under a number of handicaps. The ban on *riba* makes liquidity management difficult, as it precludes Islamic banks operating in the conventional money market. Investing in time deposits and certificates of deposit is not acceptable, and floating-rate notes, even though not offering a fixed interest rate, are not usually seen as sharia-compatible either. Borrowing on the money market is likewise not acceptable. One solution found by Islamic banks is to invest liquid funds in the London Metal Exchange, which ensures that the investments are backed by real assets (*Euromoney* 2001). New asset-backed money-market instruments may further ease the plight of Islamic banks' CFOs in the future (see Section 7.3).

Risk management is also much more difficult than under conventional banking. Even if the industry is extremely ingenious in devising new products that succeed in receiving the stamp of approval of sharia boards, opportunities to hedge against all kinds of market risks are still restricted, as derivatives are much less widely available to Islamic banks than to their conventional competitors.

5.4 THE PRACTICE OF ISLAMIC BANKING

5.4.1 Introduction

We first look at the uses of funds of Islamic banks, or, what kinds of credit they actually provide, and then provide a sketch of the development of Islamic banking and of issues associated with the Islamic character of those banks. We also point to financing needs that are not satisfactorily met by Islamic financial institutions, in particular the need for working capital,

especially in small- and medium-sized enterprises (SMEs), touch on the efficiency of Islamic banks and conclude with a summary of the positive and negative contributions of Islamic banking.

5.4.2 Uses of Funds

What kinds of financing do Islamic banks offer in practice? It has been suggested that genuine profit-sharing forms, with their informational and moral-hazard problems, generally are less attractive to the banks than financial products that more closely resemble conventional interest-bearing debt. The empirical evidence confirms this conjecture; the available figures show that profit-sharing and profit-and-loss-sharing arrangements are far from dominant. Iqbal (1997, p. 40) estimated that in the mid-1990s *murabaha* contracts made up some three-quarters of Islamic bank financing and *ijara* contracts some 10 per cent. These two categories averaged 95.3 per cent of new financing by Bank Islam Malaysia over the 1983–94 period (Aggarwal and Yousef 2000, p. 103). In Iran instalment sales, the Iranian version of *murabaha*, rose from 34 per cent of the outstanding facilities of Islamic banks extended to the non-public sector in 1984–85 to 49 per cent in 1990–91, falling to 43.4 per cent in 1996–97. *Mudaraba* financing steadily declined from 18.5 per cent in 1984–85 to 6.7 per cent in 1996–97 but *musharaka* participations started at 18.6 per cent and ended up at 23.4 per cent (Sadr and Iqbal 2002; Yasserli 2002). Even the IDB, set up by governments to promote the use of Islamic financial instruments, saw the share of *musharaka* and *mudaraba* financing in its asset portfolio fall from 55 per cent in 1975 to a very meagre 1 per cent in 1986, whereas *murabaha* rose from nil to over 80 per cent, the rest largely taken up by *ijara* (Kuran 2006, p. 11). The Indonesian Bank Muamalat reported that 39 per cent of finance was provided in PLS forms and 56 per cent as *murabaha* loans in 2003 (Wolters 2005, p. 13). In Sudan *musharaka* took up between 23 and 32 per cent of banks' financing in 2002–04 and *mudaraba* between 4.6 and 5.7 per cent (El-Hawary et al. 2007). The figures may even paint too rosy a picture of the share of PLS arrangements. It has been documented, for instance, that state banks in Pakistan have set target returns on *musharaka* and *mudaraba* credit, promising to return any 'excess profit' to the entrepreneur (Kuran 2006, p. 9). Arrangements parading as *musharaka* and *mudaraba* in the statistics thus were in fact based on a fixed rate of interest.

5.4.3 The Development of Islamic Banks

We now give a short history of Islamic banking. Interest-free banking seems to have been tried first in the 1930s in India, but those attempts

came to nought (Kuran 2006, p. 14). In 1956 Tabung Hajji, or the Pilgrims' Administration and Fund, was set up in Kuala Lumpur on the initiative of the Malaysian government. It collects savings for hajj, the pilgrimage to Mecca, and invests its funds in real estate, manufacturing industry and agriculture in sharia-compliant ways. Tabung Hajji had little impact on the discussion and development elsewhere in the Islamic world. It seems to have been unknown to Islamic bankers and economists, at least in the Middle East, until it came up in discussions at the IDB in 1981 (Kahf 2004). Another isolated initiative was the Mit Ghamr Savings Bank, established by Ahmad al-Najjar in 1963 at Mit-Ghamr in Egypt and based on profit sharing. Initially, it did well. Mr al-Najjar set up a number of similar institutions in other small towns. They were, however, closed down in 1967. This was for political reasons, as the banks had become associated with the Muslim Brotherhood, even if Ahmad al-Najjar himself was not affiliated with them. It has been suggested that the government cracked down on the banks because Muslim Brotherhood members had infiltrated as clients, depositors and employees, though the official reasons given were of a technical nature, such as non-observance of regulations (*ibid.*).⁴ In the 1970s the climate in Egypt and the Islamic world at large changed and banks could openly label themselves as Islamic (Ariff 2001). Private banking following Islamic principles started in 1975 with the foundation of the Dubai Islamic Bank, followed by the Faisal Islamic Bank in Egypt and the Sudan in 1977.

Islamic banking really got on the agenda after the Third Islamic Conference of Foreign Ministers, held in Jeddah in 1972. The finance ministers of 18 countries presented a plan to introduce sharia principles in the financial and banking system and in the wake of the conference several countries took steps in this direction (Lewis and Algaoud 2001, p. 120). Then in December 1973 the Conference of Finance Ministers of Muslim Countries, again held in Jeddah, issued a Declaration of Intent to establish an IDB, which duly started operations in 1975. The purpose of the bank is to foster economic development and social progress of member countries and Muslim communities in accordance with sharia principles, through participation in equity capital and providing loans. More recently, the IDB launched a venture capital fund targeting high-tech ventures in Muslim countries (Al-Rifai and Khan 2000).

The first oil crisis in 1973–74 suddenly provided the Middle Eastern world, Arab countries in particular, with enormous amounts of money, which gave a strong impetus to the development of Islamic financial institutions. Increased self-confidence in the aftermath of the oil crisis among Arabs may have helped in their efforts to develop a financial system of their own invention.

Iran and Sudan claim to have fully Islamized banking systems.⁵ Pakistan has a long history of attempts and setbacks (see Section 1.3), but also has a largely Islamized financial system. Other countries, such as Malaysia, Egypt, Jordan, Turkey, Bahrain and Indonesia, operate mixed systems, with both Islamic and conventional banks. Islamic banking made a start in Morocco in 2007. Islamic banks also operate in Western countries. In Europe such banks have been, or were, found in Denmark, Luxembourg and Switzerland, but the UK is the only European country where Islamic banking has really taken off. It is hardly possible for Islamic banks to operate as fully-fledged commercial banks in Western countries without making some concessions to the prevailing monetary system. Interest-based operations cannot be fully avoided, as central banks require commercial banks to deposit or borrow funds against interest. Setting up as a secondary bank instead of as a clearing bank would be a way to circumvent this problem.

Islamic banking products are not only offered by fully Islamic firms, but also by non-Islamic banks. Western banks, such as HSBC, Citibank, Deutsche Bank, Standard Chartered and BNP Paribas, are among the many institutions active in this field. In Muslim countries they cater for both the wholesale and the retail markets, but elsewhere they tend to restrict themselves to the wholesale market. HSBC and Lloyds TSB, however, also tap the retail market in the UK, along with specialized Islamic firms. Penetration is increasing in other parts of the world as well. In South Africa, for instance, one of the leading banks, ABSA, offers Islamic banking facilities to both business firms and consumers. Usually a separate legal entity is set up for this purpose. However, this does not seem strictly necessary, as long as all money streams, including the funding of Islamic activities, is strictly separated from the bank's conventional business (Yaqubi 2000).

5.4.4 Standard-setting Organizations

Islamic banks, being a comparatively recent invention, saw themselves confronted with a host of problems which are easier to solve with the help of collective action. The information problems that are typical of Islamic banking, for instance, call for uniform norms for financial accounting. The AAOIFI, the Accounting and Auditing Organization for Islamic Financial Institutions, which was established in Algiers in 1990 (initially called Financial Accounting Organization for Islamic Banks and Financial Institutions) and later moved to Bahrain, tries to fill the gap. It has been publishing norms for accounting, auditing and solvability since 1993 and, more recently, also for the application of the sharia. The need for

such norms, to a great deal consisting of adjustments of the IAS, became especially pressing after the collapse of the Bank of Credit and Commerce International (BCCI) from Abu Dhabi in 1991. The failure of BCCI led to substantial losses for a number of Islamic banks and undermined trust in them. AAOIFI standards are, however, not universally applied. Still, they have been made mandatory in Bahrain, Sudan and Jordan and are being implemented as guidelines by the Saudi Arabian Monetary Agency (SAMA). They underlie accounting standards in Indonesia and Qatar, and Malaysia seeks to harmonize banking supervision across countries on the base of these standards (Sundararajan and Errico 2002, p. 16). The AAOIFI was set up by the industry itself. It has no power of enforcement and it is a very small outfit, with a permanent staff of some 15 persons plus around 40 outside consultants (Khalaf 2007). One of the AAOIFI's directives is that the profits of transactions that conflict with sharia have to be given to charities, but cannot be deducted from zakat obligations.

Another international organization, the Islamic Financial Services Board (IFSB), issues standards for the supervision and regulation of Islamic financial institutions. It was founded in Kuala Lumpur in November 2002 with technical assistance from the IMF and grew out of an initiative by the central bank governors of ten Muslim countries and officials from the IDB and the AAOIFI earlier that year when they met in Washington at the IMF/World Bank spring meeting. It started operations in March 2003. Membership is made up of the supervisory and regulatory authorities of a number of Islamic countries plus Singapore, the IDB, the IMF, the World Bank, the Bank for International Settlements, the Asian Development Bank and over 100 market players and professional firms. It has set itself the task of complementing the work of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors (see www.ifsb.org). It also provides research, training and technical assistance and aims to develop into a kind of Bank for International Settlements for Islamic Banks (Sundararajan and Marston 2002, p. 157; *New Horizon* 2003, pp. 2–5). There is some overlap with the activities of the AAOIFI, as both busy themselves with capital adequacy norms and corporate governance.

Also in 2002 the monetary authorities of Bahrain, Brunei, Indonesia, Malaysia and Sudan, jointly with the IDB based in Saudi Arabia, set up the IIFM in Bahrain in 2002, with an eye to fostering the development and self-regulation of an Islamic capital and money market, among other things through standardization of Islamic financial instruments and the issuance of guidelines (Sundararajan and Errico 2002, p. 15; www.iifm.net/profile.php). In April 2008 they were reported to be in the final stages of

developing the first standardized Master Agreement for Islamic financial products, the Master Agreement for Treasury Placement (www.albawaba.com/en/countries/Bahrain/225108). They are also working on the development of other Master Agreements (see Section 4.3.5).

Finally there is the the Islamic International Rating Agency (IIRA) in Bahrain, which started operations in July 2005. It rates creditworthiness, sharia compliance and corporate governance of financial institutions, and also insurers' financial strength. It has to compete with the large international rating agencies (Haladjian 2006).

5.4.5 Safeguarding the Banks' Islamic Character

The first thing a bank observing Islamic principles has to do is to make sure that their activities are sharia-compliant. Firms offering Islamic financial products therefore have instituted sharia boards. There is nobody in a position to set formal requirements, but a fatwa by a qualified scholar declaring that the products touted as Islamic pass muster is the bare minimum, and a fully-fledged sharia board made up of at least three members is generally deemed desirable. Some of these boards may be composed of people who don't find it below them to receive bribes or favour their connections (Scheepens 1996), but the more serious institutions appoint experts. Still, even without bribes sharia boards tend to be rather liberal in their interpretations of the *fiqh*. Whenever minimum formal requirements are satisfied, they tend to give the seal of approval. Nienhaus (2007) sees two causes of this permissive attitude. First, board members realize that banks have to innovate in order not to be left in the slow lane vis-à-vis their competitors. Second, sharia board members of any particular bank have little reason to be more strict than members of boards of other banks. That would make life for their bank harder and might jeopardize their reappointment.

Religious scholars with expert knowledge of financial markets and products are in short supply and one sees the same names cropping up in different places.⁶ One author estimates that the number of religious experts with sufficient knowledge of finance does not exceed 60 worldwide (Devi 2008). Top scholars are said to receive up to \$250,000 or \$300,000 for a capital-markets deal involving a sizeable amount of paperwork (Tett 2006; Devi 2008). Costs of Islamic finance and uncertainty about what is acceptable where would fall with harmonization or centralization of decision making. Adopting AAOIFI standards would help, but these are not universally welcomed by sharia boards, as they sometimes feel their wings are clipped by these standards. In Malaysia the government has imposed uniformity by setting up a national sharia board overseen by the central bank.

Banks in Iran can do without a sharia board, as haram activities are simply forbidden and it is not deemed necessary for banks to ask Islamic scholars advice over whether some venture by their clients is sharia-compliant.

As the whole idea of Islamic banking was born in the bosom of salafi reformists, it is no surprise that some Islamic banks dislike the idea of men and women rubbing shoulders in their premises, God forbid (and God forbids, they are convinced). This has led to the provision of special desks for women. In Saudi Arabia, of course, this is about the only way to tap the potentially vast female market segment, but in other countries, too, the practice is spreading. The National Bank of Sharjah, UAE, which completed a shift to Islamic banking in July 2002, opened 'Ladies Only' offices, in order to 'provide privacy to women', that is, to separate the sexes. Dubai Islamic Bank did the same in mid-2002, in order to take account of 'the social needs of present-day Islamic culture', and it already has separate for-women-only parts in existing offices. In 2007 the Emirates Islamic Bank launched Al Reem, a women's banking service with an exclusively female staff (Kinninmont 2007).

5.4.6 How to Provide Working Capital

There can for all practical purposes be no question of overdraft facilities with an Islamic bank, even if ingenious solutions have been tried.⁷ Business firms, in particular SMEs, consequently may find it difficult to find working capital in an Islamic financial system. The usual PLS forms of finance are often unattractive for both bank and client, and do not meet fluctuating financial needs. Moreover, bai'salam is at best only available for fungible goods. One solution was tried out by Indonesia's Bank Muamalat, namely short-term profit sharing by job order (Karim 2002). This worked as follows. An entrepreneur receives an order for a certain project and the bank provides working capital on a profit-sharing basis (mudaraba or musharaka). The credit risk is borne by the bank. This is possible because it has opportunities to check the financial solidity of the business firm's customer through bank-checking mechanisms provided by the central bank. For terms up to two years, a similar solution was devised for small firms that acted as subcontractors for bigger firms. Profit-sharing financing was offered related to the payment schedule agreed between the bank's client and the big firm. All this was tried out in a pilot project that started in 1998, but ten years later Bank Muamalat's website provided no information on such facilities, other than very brief references to musharaka and mudaraba finance and long lists of requirements that must be met before one is eligible for a profit-sharing participation.

More, though apparently still only limited, success has been shown by another method, Islamic factoring. The factor in this case does not discount its client's receivables, but acts as an intermediary between a firm selling goods and the buyer of the goods. It buys the goods from the firm against immediate payment and resells them on credit. The selling firm will act as the financier's agent in this murabaha transaction. Specialized companies, which may be bank-affiliated, are better placed to provide these services than banks themselves, due to the restrictions placed on trading real goods by banks.

5.4.7 The Efficiency of Islamic Banks

Sharia norms impose costly procedures on banks. First, there is the expense of having to ask a sharia board for a fatwa each time a new product is launched. Next, Islamic banks may be expected to face higher costs of monitoring than conventional banks. Furthermore, more separate contracts are required under sharia law than under conventional legal systems. This leads to higher costs. But that is not all. Other operating costs will be higher as well. In the case of the prevalent murabaha finance, in particular, the bank is required to purchase a good and resell it to its client, which surely takes up more labour time than the equivalent single loan transaction at a conventional bank and requires additional expense on insurance, storage and so on. High required capital–asset ratios further add to the costs.

Conclusive empirical evidence on costs is not yet available (see Brown et al. 2007). One complicating factor is that Islamic banks started on a small scale and may have had fewer opportunities than conventional banks to exploit economies of scale. Research among 18 Islamic banks by Yudistira (2004) supports this conjecture, at least for the smaller banks.

5.5 CONCLUSIONS

Islamic banking works under a number of restrictions to which their conventional competitors are not subject. These give them their special character, but may also act as handicaps. For one thing, Islamic banking products will often be more expensive than conventional products. This is so for several reasons. PLS modes of finance suffer from moral hazard and informational problems that make for substantial costs of monitoring. Murabaha requires more work than conventional credit, and it carries the additional burden for the banks of temporary ownership of the goods financed, however briefly. This implies storage costs, costs of insurance

and relatively high capital–asset ratios, which all eat into a bank’s profits. Further, Islamic contract law says that each transaction requires a separate contract, which is costly. If shareholders and depositors then want a similar return on their money as conventional banks provide, Islamic banks will have to demand high profit shares, charge higher fees or work with higher margins, to the extent that market conditions allow them to do so, that is, to such an extent that clients just do not yet run away to the Islamic banks’ conventional competitors.

Another point is that the range of products and services offered by Islamic banks is narrower. It is especially difficult for them to meet SMEs’ need for working capital. They also have less opportunity than conventional banks to meet their clients’ need for hedging facilities.

It is not only the banks’ clients that have to cope with various restrictions, the banks themselves have less scope for hedging their risks and managing their liquidity as well. A factor directly adding to the cost of doing business the Islamic way is the need to have a sharia board, made more expensive as the scarcity of sharia scholars with enough knowledge of finance to serve on such boards drives their price up.

Against these minus points, there are a few pluses. First, if PLS principles are strictly applied, the solvability of banks is insulated from interest rate risk, and also from credit risk, as poor performance of borrowers is compensated by low profit disbursements to depositors. This would be fine for the banks, but only shifts business risks to their customers. In actual practice, PLS principles are hardly strictly applied. Depositors often receive a guaranteed minimum return. Another potential plus is the fact that Islamic finance is bound to restrict itself to asset-backed operations may help Islamic banks escape credit crises. By the same token, however, this makes them miss out on the benefits of pure interest-based instruments.

One is led to the conclusion that Islamic banks and their clients have to pay a price for their principles. Probably this price is higher in the retail sector than in wholesale activities. The additional costs involved in a murabaha transaction of a couple of thousand euros, dollars or ringits will weigh more heavily as a percentage of the value of the transaction than the extra expense of ijara or murabaha financing of, say, the purchase of airliners for a few hundred or thousand millions.

NOTES

1. Interestingly, similar forms of deposit were found in Europe in the Middle Ages (Lewis 2007, pp. 73–4).

2. Tier 2 capital includes undisclosed reserves, revaluation reserves, general provisions, hybrid instruments and subordinated term debt. It is the second line of defence for meeting unexpected losses, after tier 1 capital, the bank's equity capital plus retained earnings and often also irredeemable and non-cumulative preferred stock.
3. A. Jalaluddin and M. Metwally (1999), 'Profit/loss sharing: an alternative method of financing small businesses in Australia', *The Middle East Business and Economic Review*, **11** (1), pp. 8–14; cited in Gait and Worthington (2007).
4. Kahf (2004) notes that the Mit Ghamr Bank and its siblings induced higher savings among the poor and stimulated small-scale entrepreneurship, but that Ahmed al Najjar never published any figures on the activities of his banks.
5. In August 1983 the Iranian parliament passed the Usury-Free Islamic Banking Law, which banned fixed interest on most borrowing and lending operations. The banks got 14 months for the transition, starting in January 1984 (Gafoor 1996, p. 40).

In 1984 President Numairy of Sudan decided that the banking system should forthwith be run according to Islamic principles. The banks got a full two months to bring the transition about. This of course led to some window dressing in that 'interest' in loans contracts was replaced by 'profit', so that murabaha contracts suddenly predominated. In 1990 further steps were taken to create a fully-fledged Islamic financial system, including setting up a training programme for bank staff and the obligation for all banks to appoint religious researchers who had to keep an eye on daily operations to see to it that they complied with the sharia.

6. One name that will be familiar to frequent readers of Islamic financial news is that of Muhammad Taqi Usmani. Sheikh Usmani is a retired judge of the Federal Sharia Court of Pakistan and of the Sharia Appellate Bench of the Supreme Court of Pakistan. He is said to have close ties with Maududi's Jamaat-e-Islami (El-Gamal 2003b, p. 6). Sheikh Usmani sits on the sharia boards of numerous financial institutions, including HSBC Amanah, Citi-Islamic, Abu Dhabi Islamic Bank, Bahrain Islamic Bank and Dow Jones Islamic Index. Further, he is a member of the Bahrain Monetary Agency sharia board, heads the AAOIFI sharia council and sits on the newly formed IRA's sharia council (Euromoney 2007a; Khalaf 2008).

Sheikh Nizam Yaqubi (or Jacubi) is another well-known name. He is not only an adviser to Abu Dhabi and Bahrain Islamic banks but also to Dow Jones Islamic Index and to Shariah Funds Inc., a division of Meyer Capital Partners, which launched an Islamic fund of hedge funds in 2004. His name further appears on Lloyds TSB's sharia committee.

A third ubiquitous name is Sheikh Hussein Hamid Hassan, a graduate of both New York University and al-Azhar, who helped found Dubai Islamic Bank in 1975 and became its leading sharia adviser, whose advice is also sought by many other financial firms. In 2007 he chaired the sharia boards of at least 15 Islamic banks and other financial institutions (*The Economist*, 9 June 2007).

7. A quite complicated overdraft facility was developed in 2007 by Abu Dhabi Commercial Bank (ADCB) for one of its clients, Abu Dhabi Investment House (ADIH). The agreement was based on a mudaraba relationship between the bank and ADIH and required ADIH to pay ADCB a profit rate of not less than three-month EIBOR (Emirates Interbank Offered Rate) plus 150 basis points over the 12-month tenor of the overdraft (Euromoney 2007b). ADIH received a bonus if the share of the profits of ADCB in the activities funded by the overdraft exceeded a certain threshold, but if profits were lower than forecast ADIH promised to pay ADCB compensation. Obviously, this is not a model fit for providing overdraft facilities to SMEs. Apart from the moral-hazard risks associated with mudaraba, how could one ever establish the profits made specifically with the money borrowed under such an arrangement? One way out might be to assume that the profit rate equalled the profit rate on the whole business, but even then the moral-hazard risk would remain.