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Introduction

Over sixteen years ago, His Royal Highness Prince Mohammad Al Faisal Al Saud and myself met with some top Western bankers at a dinner in London. During the meeting, the subject of Islamic banking and its prospects came up for discussion. At the time, Islamic banking was little more than an idea which some pioneers, like Prince Mohammed Al Faisal, were trying to give a practical shape. Surprisingly, all the Western bankers present were of the view that the prospects for Islamic banking were bleak as the underlying ideas were not feasible.

When I mentioned that Pakistan was contemplating Islamising its banking, a leading British banker said that in that event the British banks in Pakistan would close down and move out. I disagreed with him and politely said that as long as the British banks were able to make profits, they would stay in Pakistan and would actively compete with other banks. When Pakistan did decide to Islamise its banking, not only did the existing British banks stay and accept the Islamic system, but many other Western banks did the same. Within less than two decades, despite the initial scepticism, Islamic banking has emerged as a strong entity. Already well over 100 Islamic financial institutions are operating around the world and are managing an estimated 80 billion dollars.

The spread of Islamic banking in the Muslim world was never in doubt. What has surprised many has been the reversal of views of Western bankers. More and more Western bankers, especially in Europe, are not only acknowledging the viability of Islamic banking but also its considerable potential.

This book contains the views of executives of some of the leading European banks and law and accounting firms about Islamic banking. In Chapter 1, the Governor of the Bank of England, Eddy George, while acknowledging the fact that London has emerged as a leading centre of Islamic finance, lists some of the issues that must be resolved to ensure that the services offered by Islamic banking in the UK meet the national legislation. In Chapter 2, the Bank of England's Senior Manager, Michael Ainley, refutes suggestions made in certain quarters that the Bank of England is opposed to Islamic banking and points out the fact that it was a London Bank which introduced the first Mudaraba in Pakistan. Like Governor Eddy George, he emphasises the Bank of England's supervisory role and states that "in the UK the reality is that the Bank of England must implement the law as it currently stands, and the success of institutions in developing Islamic products in London suggests that there is no fundamental impediment". According to him "It might be fair to say that Islamic banking is no longer an experiment."
In Chapter 3, R T Fox, Vice-Chairman of the Kleinwort Benson Group, traces the increasing involvement of his Group with Islamic banking. In Chapter 4, Richard Duncan, Director of Islamic Finance, ANZ Grindlays Bank, focuses on planning for the future market and discusses the issues involved.

The subject of accessing Islamic finance is dealt with in Chapter 5 by Stella Cox, a director in the Kleinwort Benson Group.

In chapter 6, Anne Simpson and Paul Willing of Price Waterhouse welcome the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions in 1991 in Bahrain. “This is a step in the right direction”.

Islamic banking from a Western lawyer’s perspective is the subject of Chapter 7. The authors, Michael Clode, Partner, and William Elliot, of Freshfields - a leading UK law firm - see Islamic banking as “extremely dynamic and complex”.

Problems of protecting the investments of Islamic banks are discussed in chapter 8 by Jeremy Martin, partner, Tower and Hamlin.

In Chapter 9, David Cowan, a writer on Islamic banking, discusses factors that should form the basis of an effective strategy for Islamic banks.

In Chapter 10, Dr Eric Hirsch, of Bayerische Variensbank, Germany says that the development of an Islamic capital market, where long-term risks are exchanged for liquidity, is an extremely important requisite for co-operation between conventional and Islamic banks.

Duncan Smith, Chief Executive, Islamic Investment Banking Unit, United Bank of Kuwait, examines the question of integration of Islamic banks with conventional banks in Chapter 11.

In his detailed account of the history of the development of Islamic banking, Dr Rodney Wilson of Durham University says, “It is clear that Islamic banking is no mere passing phenomenon..

Stella Cox, of Kleinwort Benson, deals at length with the crucial question of Research and Development for Islamic banking and identifies the areas that need attention. The very rapid expansion of Islamic banking, says Stella Cox, “surprised many.

In the last paper, David Cowan analyses the reasons for the lack of Islamic banking in France, notwithstanding the fact that Islam is the second largest religion in France. He shows that there is a huge potential market for Islamic banking in France.

It is clear that the initial scepticism about Islamic banking has been replaced by a firm belief in its viability and bright prospects for its growth both in the West and in the Muslim world.

Muazzam Ali
Chairman,
Institute of Islamic Banking and Insurance
My role is certainly not that of an expert in the field, but that of an interested observer of the growing importance of Islamic banking in the Muslim world and its emergence on the international stage. We in this country have always welcomed financial innovation. London's position as an international financial centre has been built upon a tradition of openness and encouragement of strong and well-run financial institutions from all parts of the world. We welcome competitive innovation in financial market and banking practice to enhance the services that London can provide for the users of those services - both domestically and internationally. And that is the context within which we, at the Bank of England, seek to understand Islamic banking. As I understand the basic principle, it is that making money simply out of money is contrary to Islamic law - that wealth should accumulate from participation in trade and ownership of real assets. The Bank of England entirely respects that perception, and we can readily see the connection with the teachings of the Qur'an about social responsibility and cohesion. Even within a purely secular context we can understand how such an approach can help the financing of industry and trade.

But, of course, we have responsibilities as banking supervisors to ensure that Islamic banking facilities offered in this country are in accordance with our national legislation. To do that, we need to improve our understanding of what is
involved and we have to work together with the Islamic banking community to identify and solve any problems that may exist.

There are a number of issues that we need to address. One is that, as I understand it, there is no single definition of what constitutes Islamic banking. Different institutions interpret the acceptability of Islamic banking products in their own way. Individual boards of Sharia advisers apparently have equal authority, so that in some jurisdictions there is no definitive answer as to the status of a particular Islamic banking product. This leads to uncertainty about what is, and what is not, the 'acceptable' way to do particular business, which in turn can complicate assessment of risk both for the bank and its customers.

Another complication is understanding how transactions are approved, which involves understanding the management systems in Islamic banks. Supervisors are generally required to be satisfied that the management of banking institutions is fit and proper. In particular, this means that we would expect decisions in respect of banking products, particularly credit decisions, to be taken by experienced bankers. In Islamic banks, the precise role played by Sharia Boards in approving particular credits is sometimes unclear to us. Knowing whether the Sharia Board's role is only to approve products as opposed to individual credits may provide some clarification, but it is undoubtedly the case that there are likely to be more non-bankers involved in making banking-type decisions in an Islamic bank than there are in a conventional bank. Understanding precisely who makes decisions is therefore important to the supervisor, in order that he can be satisfied that the risks associated with the assets put on the books have been properly assessed.

There are questions, too, about how Islamic funds would be classified within our own legal framework. To what extent, and in what precise forms, are funds placed with an Islamic institution capital-certain, thus falling within our Banking Act definition of deposits, or to what extent are they participating in a collective investment scheme, falling under the Financial
Services Act? My understanding is that Islamic funds may fall into either of these categories or indeed others, but we certainly need to deepen our understanding of the developing principles and practices in this area. But whatever form they take, I think it is likely that the concepts will be familiar to the supervisors and regulators here in the UK and that we can find satisfactory answers to these questions, perhaps through the organisation structure.

A further issue is risk. In Western banking, a key method of managing liquidity, pricing risk and allocating credit is through the use of interest rates. The absence of interest in Islamic banking places a greater burden on risk managers within the Islamic banks. And Islamic banks' earning assets may tend towards the long-term and the illiquid, which may require the institution to hold higher levels of overall liquidity, with implications for its profitability. I do not believe that these are insuperable problems, either for the banks concerned or for their supervisors. For any institution, supervisors will require assurance that risks are properly assessed and controlled, and that a bank has adequate resources in terms of management, liquidity, systems and capital. In this sense, from a supervisory perspective, Islamic products do not raise fundamentally different issues from any other banking product, be it swaps, options, syndications or whatever. But they do cause the supervisors to probe thoroughly for explanations that they fully understand. We are bound to do this as a matter of statutory duty, and it is right that we should - just as we are properly obliged to probe all the less familiar banking products. That solutions can be found is evident from the fact that London is often cited as a leading centre for Islamic finance. There are certainly a growing number of institutions in London that are active in Islamic products.

A related issue which is often raised is the level of capital which Islamic banks should be required to maintain. The Basle Committee envisages that all banks should be subject to the same minimum capital requirements. Given the nature of Islamic
banks' funding, however, especially when on a risk-sharing basis, the need to carry a level of capital equivalent to that required by banks which are obliged to repay their funding in full, whatever their financial position, sometimes leads to suggestions that this is unnecessarily restrictive. On the other hand, regulators of Islamic banks in some Islamic countries take the view that because Islamic banks are dealing in many new and unfamiliar forms of finance, and many of their assets are rather illiquid, they are different from most conventional banks, and they have argued for the need for perhaps a greater safety margin. This issue is, I know, the subject of continuing debate.

Another question concerns the interface between Islamic and conventional banking systems and how that can best be managed. While there are some areas which the two systems approach entirely differently, there are also areas and products in which Islamic banks and conventional banks directly compete. Clearly, where both types of banks are in the same market, they should be subject to the same oversight, and the same 'rules'. In what form this oversight should be, and what body or bodies should set (and enforce) the 'rules' are questions to be addressed. The list of issues is a long one.

Some of these questions are more readily understood and perhaps more easily addressed where there is greater standardization. In this context, the central bank of Malaysia, Bank Negara, has taken the lead in establishing standard definitions for Islamic financial products and introducing a degree of standardization of procedures. They have also encouraged what in a European context might be called 'critical mass', with a large number of players, a broad range of instruments and the development of an inter-bank market.

Mr. Eddie George,
Governor of the Bank of England
As a banking supervisor my perspective is conditioned by the requirement in the 1987 Banking Act to look after the interests of depositors. This means that we have to be satisfied that our banks - of whatever origin - are prudently run and that their management is fit and proper. 'Prudently run' is not defined in the Banking Act but has particular requirements as to capital, liquidity and risk management. Fitness and properness means that management must be adequate in breadth, depth and experience, and it must be competent to run the business.

We apply these principles to all the 350 or so bank's that we supervise. The more complex or unusual a bank's business, the greater we need to understand the bank's business rationale, its operating policies (including its approach to risk management) and its strategic direction. A relevant factor here is the Bank of England's interest in maintaining the efficiency and integrity of our domestic banking system; and there is also the international dimension, where we are co-operating increasingly closely with other central banks and supervisors.

As importantly, the UK has always welcomed financial innovation. London's position as an international finance centre has been built on a tradition of openness and on encouragement of strong, well-run financial institutions, from all parts of the world. We welcome any competitive innovation in financial market and banking practice which will enhance the services.
London provides - both for domestic and international users.

We have responsibilities as banking supervisors to ensure that the banking facilities offered in this country - whether Islamic or not - are in accordance with our national legislation. To do that, we need to improve our understanding of what is involved; and we have to work with the Islamic banking community to identify and solve any problems that may exist.

What is Islamic banking?

In considering the implications of Islamic banking, we face a particular difficulty at the outset. There seems to be no single definition of what constitutes Islamic banking, at least as I understand it. The basic principle is, however, clear, namely that making money out of money is contrary to Islamic law. Rather, wealth should accumulate from participation in trade and the ownership of real assets. The Bank of England respects that perception; and we understand the connection with the teachings of the Qur'an on social responsibility and cohesion. Even within a purely secular context, it is evident how such an approach can help the financing of industry and trade. In the context of the 1980's debt crisis, for example, the Bank of England has emphasised, on more than one occasion, the dangers that heavy reliance on debt, rather than risk-sharing, could pose.

Another complication for us is understanding how transactions are approved. Many institutions offering Islamic banking products do so under the guidance of a board of Sharia advisers. According to my contacts in London and the Middle East, different Sharia Boards interpret the acceptability of Islamic products in their own way. Each Sharia board, as I understand it, has equal authority. Also, the concept of 'precedent' does not generally chart the development of Sharia law. In some jurisdictions, therefore, there is no definitive answer as to the status of a particular Islamic banking product.

In some ways, this may be not too different from the introduction of new products in a conventional banking system. These can start as closely-guarded innovations, giving the
institution a competitive edge until they acquire a more generalised commodity status. In these cases, too, it sometimes takes time for accounting and other aspects of the transactions to become standardised. But for Islamic banking products, the lack of clear definition can lead to considerable uncertainty about what is, and what is not, the acceptable way to do particular business. We, at the Bank, have noticed important differences in practice between the Middle East, on the one hand, and the Far East on the other.

A third point here: Islamic banking has developed as an alternative to conventional banking for those who wish to adhere to Sharia law. But the possibility of becoming a complete alternative to conventional banking depends, I suggest, on Islamic banking being able to offer their customers all the facilities they need.

In this regard, the ability to offer global banking facilities on an Islamic basis would seem to require a presence or operating ability of some sort in the major western markets, particularly of London and New York. Indeed, London already seems to be developing as a major centre of Islamic banking; the presence of the Institute of Islamic Banking here is a testament to that and one means of fostering the development of interest-free banking. I would also note that it was a London bank that introduced the first Mudaraba in Pakistan. I always find it a little odd, therefore, when I read suggestions that the Bank of England is somehow opposed to Islamic banking.

How developed is Islamic banking?

There is no doubt that Islamic banking, broadly defined, has grown and is growing. There is now a confirmed Islamic banking presence in at least 25 counties, notably in Africa, the Middle East and the Far East. The number of institutions offering Islamic products is also increasing. One (private) estimate of the present size of the market is $60-80 bn. According to Ernst & Young, 15% of private assets in the Gulf states are invested in Islamic banks. Islamic banking, it might be fair to
say, is no longer an experiment.

Even so, a single Islamic bank, or even a few Islamic banks in any one country, do not constitute an Islamic banking system. Bank Negara Malaysia have said in one of their Annual Reports that a banking system, whether Islamic or conventional, requires at least three ingredients to qualify as a system. These three ingredients are:

First, a large number of players. There must be an adequate number of different institutions participating in the system, to provide depth. This may be the case in a few countries, such as Bahrain and Malaysia, but not, I think, in several others.

The second ingredient is a broad range of instruments. A variety and range of different types of instrument must be available to meet the needs of customers and those of the institutions.

The third ingredient is an interbank market. There must be an efficient and effective interbank money market to provide a means for institutions to manage their liquidity. This is difficult if there are only one or two Islamic banks in the system. But it is important, if not essential, for supplementing retail deposits or disposing of excess liquidity. The Islamic Development Bank has done useful work in developing thinking in this area.

To what extent does Islamic banking meet these three criteria? All that can be said with confidence is that the state of development differs in different countries, depending in part on whether the domestic financial system is or is not Islamicised.

London is often cited as a leading centre for Islamic finance. Certainly, there are a growing number of institutions in London that are active in Islamic products. Periodically, also, banks from Islamic countries discuss with us their plans to introduce Islamic banking in one or other form. So far, at least, these discussions have tended to be preliminary and to focus on fact-finding by both sides.

Based on these discussions, Islamic banking is well placed to contribute to the financing of industry and trade and to the provision, say, of leasing facilities. In these areas, Islamic banks
can provide straightforward competition to conventional banks. But there is, I believe, some way to go before Islamic banks generally are able to offer customers a full range of facilities. As the vice-present of the Faisal Islamic Bank of Bahrain has said, there is scope to develop services in areas like Fund Management, securitisation and corporate finance.

On the funding side, deposit-taking on interest-free current accounts or, as in Iran, on terms where the capital is certain but the return is not known at the time the deposit is placed, is not a problem. Here also, Islamic banks can compete directly with conventional banks. But monies taken on a risk-sharing investment arrangement, where the amount to be repaid is uncertain, do not fit comfortably within the definition of deposit-taking, at least as it is defined in UK banking legislation. However there are, of course, many institutions in the UK offering such facilities under our Financial Services rather than our Banking Act.

All banks must be able to meet the short term demands of customers, and so liquidity management is a significant issue. It is perhaps particularly so for Islamic banks, for whom there are relatively few remunerated outlets for short-term liquid funds. Because of this, their earning portfolio tends towards the long-term and illiquid. This means that such institutions may be required to hold higher levels of overall liquidity, with implications for profitability. The existence of an interbank market is essential to assist them in efficient liquidity management. So, too, are deeper markets and a wider range of monetary instruments. The easy availability of such short-term instruments would also increase the ability of Islamic banks to offer a home for short-term savings.

Interaction of Islamic Banking with conventional banking systems

The development of Islamic banking will involve finding ways to co-exist with other banking systems in order to provide a full service to global customers. It is one thing, for example, for a
domestic banking system to be founded on Sharia principles, where the local central bank and supervisor can exercise oversight in markets where they have authority and act as lender of last resort; but it is quite another for Islamic banking to operate successfully and on an equal basis in the international economy. Unless progress is made to establish a complete alternative banking system, co-existence and co-operation are vital. Re-inventing the wheel is surely in no-one's interest. Rather ways should be sought of using the technical and commercial expertise in conventional banks to develop Islamically acceptable products. There is little justification, it seems to me, for believing that in all cases one has to start from scratch.

This said, there are a number of problems to be solved in dealing with requests that institutions be permitted to offer more general Islamic banking facilities in a conventional economy.

From a supervisory perspective, Islamic products do not raise fundamentally different issues from any other banking product, but it swaps, options, syndication or whatever. But they do cause the supervisors to probe thoroughly for explanations that they fully understand. We are bound to do this as a matter of statutory duty, and it is right that we should - just as we are properly obliged to probe all the less familiar banking products. That a growing number of institutions are active in Islamic products in London shows that solutions can be found in this area.

Some central bankers in predominantly Islamic countries have argued that the central bank should itself be equipped to judge which kinds of contract are acceptable in Islamic law and which are not. There is certainly a supervisory case for this. For example, a perception that a bank was engaging in Islamically unacceptable business could put that bank's liquidity under strain. Malaysia is an example of a country where there is a common Sharia Board advising the Central Bank and commercial banks alike.

In this country, however, as in many western countries, we
would expect all banks, as a matter of course, to take legal advice to ensure all contracts conform fully with local law. But we leave it to the banks themselves, and their Sharia advisers, to judge what is acceptable in terms of Islamic law, because the systemic and liquidity risks are proportionately much less here.

**More particular issues of supervision**

I think there would be little argument with the proposition that Islamic banks should be supervised, just as any bank is supervised. Indeed this proposition was agreed by the Central Bank Governors of Islamic States as long ago as their 1981 meeting in Khartoum.

Islamic banks, like any other bank, take funds from the public and so there needs to be some authority watching over the interests of those member of the public - particularly those who are more vulnerable. There is also the issue of confidence in the banking system, which is equally important to the fortunes of Islamic banks as it is for banks in conventional systems.

Whether there are persuasive arguments for Islamic banks being supervised under special rules, perhaps to different standards in view of their different approach to banking, is perhaps more debatable. In the UK the reality is that the Bank of England must implement the law as it currently stands; and the success of institutions in developing Islamic products in London suggests there is no fundamental impediment.

It is certainly the case, I suggest, that any supervision should be directed at the whole of a bank, and that this supervision should encompass all activities undertaken by the organisation which might affect either its financial position or the banking systems in which it operates. Supervision of the whole bank seems to me to extend also to a banking group, however it is structured and however may countries it operates in. This certainly is a key element in the Bank's current supervisory approach.

The globalisation of financial services means that financial regulators are dependent more and more on their counterparts
abroad. These days, financial disturbances can originate in almost any significant market in almost any country. This can lead to quite unpredictable knock-on effects, transmitted through payments and settlement arrangements, anywhere in the world. Partly as a result, banking supervisors in different countries increasingly work together; and the members of the Group of Ten who meet together in Basle under the auspices of the Basle Committee have issued a number of joint papers on their approach to the supervision of banks. These have tended to set a benchmark for supervisory best practice in other parts of the world.

To work out how the supervision of Islamic banks fits into this established approach, one of the fundamental concerns of banking supervisors is to understand how Islamic banks are presently supervised and the methods and procedures used by local supervisors in assessing these operations. We would also wish to understand the basis on which the supervision of these banks is founded.

In the UK, as in many countries, the fundamental objective in supervising banks is to protect the interests of depositors. This is a single, clear objective. There is perhaps an equally clear objective in the case of wholly Islamic banks where the supervisor’s task would be to protect both depositors and investors from poor controls and management. Clearly defined accounting rules in the allocation of profit between shareholders and investors, and between different categories of investors, have a crucial role to play here. However, it seems to me that the task of supervision can get particularly complicated when there are different sets of risk-sharing funds involved. So we need to understand - clearly - the local system of supervision and then try to see how it measures up to the practices laid down by the Basle Committee.

A further issue in supervising banks operating in different jurisdictions is the question of consolidated supervision. As part of the Basle minimum standards for the supervision of international banks, all banking operations must be capably
supervised on a consolidated basis. For Islamic, as well as other banks, this involves questions of structure, which can often lead to difficulty in identifying the precise group to be consolidated - especially where ownership is established through common individuals rather than companies. Islamic banks may also operate differently under different regimes, which can complicate the consolidated picture. For example, a number of Islamic banks in London operate on a conventional basis here - such as Iranian and Pakistani banks - although their Head Offices are part of an Islamic banking system.

A related issue which is often raised is the level of capital which Islamic banks should be required to maintain. The Basle Committee envisages all banks being subject to the same minimum capital requirements. Given the nature of Islamic banks' funding, however, especially when on a risk-sharing basis, the need to carry a level of capital equivalent to that required by banks which are obliged to repay their funding in full (whatever their financial position), sometimes leads to suggestions that this is unnecessarily restrictive.

On the other hand, regulators of Islamic banks in some Islamic countries take the view that because Islamic banks are dealing in many new and unfamiliar forms of finance, and because many of their assets are rather long-term and illiquid, they are different from most conventional banks. As a result they perhaps need a greater safety margin. This view was expressed by Abdul Malik-al-Hamar, a former governor of the UAE Central Bank, when he said: 'Because of the differences in their nature and operations, Islamic banks, especially at the start, require more strict supervision than is usually conducted vis-a-vis traditional banking. This issue is, I know, the subject of continuing debate.

A related question is the need to understand better the accounting and auditing principles and practices of Islamic banks. There is a lack of clarity and consistency at present which makes it almost impossible to compare financial statements of different Islamic banks. It is encouraging that the major
accountancy firms and some of the major players in Islamic banking are now collaborating to produce new common standards. Some of the concerns here include how to treat investment accounts, whether on or off balance sheet; and this, of course, could have a significant impact on capital adequacy calculations in some cases. As important, are the principles governing disclosure on the audit side where local practices continue to differ. For supervisors these two areas are critical.

Conclusions

As a central bank and as banking supervisors we have no difficulty, in principle, with Islamic banking. As banking supervisors we also have responsibilities to act in the interests of depositors and we apply our supervisory principles to all banks in an even-handed way. There is still some way to go to ensure that we understand all the intricacies of Islamic banking and the way it operates, in particular the implications of Sharia boards taking different views about similar transactions.

Islamic banking is developing steadily, but is still not yet at a point where customers can choose from a fully comprehensive range of Islamic products. There are, undoubtedly, ways in which Islamic banks can co-exist with conventional banks; and there are areas where co-operation would avoid re-inventing wheels. There are, however, still issues to be dealt with concerning the extent to which Islamic products conform with local law; and there are also a number of supervisory issues which, in a jurisdiction such as the UK, need to be addressed. But I do not believe that these issues are insuperable.

In short, we need to improve our understanding of what is involved in Islamic banking and we have to work closely with the Islamic banking community to identify and solve the problems that arise.

Mr Michael Ainley,  
Senior Manager at the Bank of England,  
Surveillance and Supervision, Bank of England
There have been over the years different aspects of Islamic banking which have caught the attention of those working in conventional banks. One aspect inevitably was the assertion that there were large cash balances around on which the bank was actually not allowed to pay interest. This was over 20 years ago, interest on current accounts was a dream, interest rates were of course considerably higher than today and a bank was delighted to have a customer who left large balances in his or her current account.

There were then few conventional banks in London which thought constructively about the possibility of doing business with Islamic banks. Those who found the idea of engaging in trading ventures with Islamic institutions and customers most acceptable were either banks which specialised in trade finance world-wide such as Citibank or those merchant banks who still had trading companies within the group, and Kleinwort Benson came into the second category. We not only had a bullion trading company, Sharps Pixley, which specialised in trading base metals and had a substantial business with a number of counterparties in the Gulf and Saudi Arabia, but also a full service trading company, Fendrake, which was a dealer in soft commodities and also was among other things the Sainsbury’s agent in the Gulf selling groceries and, incidentally, selling a wide range of goods, including chocolates and agricultural machinery all over Eastern
Europe.

It was relatively easy for conventional banks who were involved in trade in such a close way to develop a flow of transactions, and the early examples of Islamic financings arranged in London were almost entirely trade related transactions, involving the purchase and sale of a range of physical commodities. Banks with strong Middle Eastern connections, such as Saudi International, were also developing their own Islamic financing and investment business. It is fair to say that at that stage most other conventional banks did not think that Islamic banking was going to be a major factor, even in the Gulf and Saudi Arabia, let alone further afield.

However, Kleinwort Benson was extremely interested in the concept and developed a reasonably sized business based on the assumption of the underlying transaction, counter-party, credit and completion risks in both directions. This meant that we could only grow to a certain size as it was unrealistic to expect the Islamic investors to continue to place ever larger amounts of funds with us. In fact, we had a certain amount of embarrassment from time to time as we were unable to access a sufficient volume of suitable and, of course, profitable investments outside the Kleinwort Benson credit for the very large funds that were occasionally available.

As with most problems, more communication and a certain amount of education of the Western companies helped the management of these short-term bottlenecks. The cause was particularly well served by the spread of Islamic institutions in Europe led by the DMI and Sheikh Saleh Kamel's Al-Baraka Group. The Al-Rajhi presence in London was another contributing factor to the development of the Islamic capability in our domestic market. London has always thrived on competition and the establishment of new markets. The presence of so many participants persuaded the Western counterparties that Islamic institutions were a large and continuing source of finance and they began to review and adjust their own trading methods and financing requirements accordingly. The market
grew until it was being said, and I believe it is still true, that London is the largest single Islamic banking market in the West. It was, and remains, amongst the largest world-wide, which is quite an achievement.

The conversion of the basic short-term commodity financing into medium-term facilities with the investor taking the full risk associated with the investment has been the task of the past five years or so. Much has been done in this area and the transactions advertised by the Islamic institutions and City houses, including United Bank of Kuwait, have been very impressive. These include project finance and substantial leasing transactions involving large ticket assets such as jet aircraft. We understand now how Islamic finance can be used in conjunction with other forms of finance. For example, in the projects area, export credits are now being used alongside segregated Islamically structured financings based on Ijara and Istisna principles. The growth of equity funds which qualify as Islamic is also most encouraging. Given this ability to co-exist with the conventional financing system, I can foresee a very bright and expanding future for Islamic banking. We are now able to show reciprocity to the market through Kleinwort Benson's direct involvement in its customers' own transactions and have been invited to participate in the syndicated financing for the Haramaien development project in the Kingdom that is presently being arranged by the Islamic Investment Company of the Gulf.

Kleinwort Benson has recently become a subsidiary of a German bank. German banks have been criticised in the past for their lack of interest in Islamic banking, but Kleinwort Benson will be doing all it can to alter that attitude at at least one German bank, and certainly intends not only to continue but also to develop the range of Islamic products and services as an active member of the Dresdner Bank Group.

I am very optimistic about the future of Islamic banking but it would be being unrealistic if I did not touch on some of the problems which still do exist and should be solved if possible. In Malaysia, a country which I have known well for over 20 years, I
was impressed with how well the authorities are coping with the development of an Islamic financial system alongside a conventional one. Most of the banks now have Islamic banking windows, there is an Islamic stock-broking company which is a member of the Kuala Lumpur Stock Exchange and there is also a substantial Islamic savings institution, Tabung Haji. A particular strength of the Malaysian system is that the central bank, Bank Negara, has its own Sharia Council which in effect lays down the rules for the whole country. This is an example which could well be followed in other countries where considerable confusion has been caused in the past, and still is occasionally today by the different interpretation of the Sharia by different councils and advisers. Common standards would lead to the ability to trade assets and the development of a market for Islamic products that would offer liquidity within a long-term investment framework.

Another area which needs attention is accounting standards. Work is going on here which is crucial if outside observers are to be able to judge the credit standing and profitability of Islamic banking institutions. This leads on to the problem with central banks and banking supervisors. One part of this problem relates back to the accounting issue in that it is not always clear-cut what risks the Islamic institution is running, how long-term are its liabilities, how liquid its assets. These are difficult questions to which to give firm answers. They could worry bank supervisors who already have a lot to worry about. The whole question of capital adequacy is very topical.

The other part of the problem relates to responsibility. If Islamic banks want banking licences in countries in which their shareholders are not resident, it is asked why the parent organisations, which may be called Islamic banks, are not fully authorised and regulated by their own national authorities. I know from the dealings we have had with them on a number of occasions that the Bank of England pays particular attention to the existence of a Regulatory Authority, usually another Central Bank, which has the ability to supervise the relevant group on a consolidated basis and, if necessary, act as a lender of last resort.
It may be that a solution to this type of problem can be found, but, at the moment, the problem does exist.

But the positive trends in Islamic banking are much stronger than the problems and many extremely skilled and resourceful individuals and organisations are trying to sort out these problems. The Institute of Islamic Banking and Insurance's programme of lectures and meetings in London has brought greater understanding of the whole range of Islamic banking products and investors. Its journal, 'New Horizon', is also helping in this educative process.

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Chapter 4

Islamic Financial Products:
Planning For The Future Market

We are at the crossroads in the market in Islamic banking. Looking at the current position Islamic banking is moving to a scene where change is necessary and where traditional products can no longer be regarded as relevant for the next four years and for the twenty first century. As serious players in this market we have to look for new ideas, examine the issues together and move forward. A failure to achieve this will lead to lack in progress, rather like standing still against the competition which is conventional banking.

Looking at the international scenes in Islamic finance, and the motivations and concerns for the investors, firstly and most importantly, Sharia acceptability is everything. There is no point in being involved in the Islamic financial market if Sharia acceptability is not there. If as bankers we cannot obtain this we should not be doing business. This relates to the terms and conditions which investors want to place on documentation. All serious players in this market over the past few years have seen these terms and conditions become far more stringent.

Investors are demanding higher degrees of documentation. They are requiring more proof that funds are being handled in a way that is acceptable to their interpretation of the Sharia. This in itself has become an issue for structuring transactions. The
lack of uniformity of a Sharia interpretation is an issue for investors. If the market is not uniform, it is very difficult to build products which are generally going to be acceptable.

Investors, by the nature of being Islamic investors, have to be involved in the underlying transaction and undertake risk. But the continuing desire to have those risks enhanced by western banks' guarantees is an issue which has to be addressed. Where are the costs arising and will investors continue to be willing to pay the costs of ensuring that risk is enhanced and in place. That is a serious issue as banks are under considerable pressure on their own balance sheets and under pressure to increase their own returns. This is directly opposed to the interests of the investor.

Investors are very keen to see the returns on their investment being enhanced. It is only right that they should be receiving a fair return from the risk that they have been required to undertake. However they are short of term in appetite, and is this an achievable objective, given the low levels of interest rates around the world. Central authorities across the West and in the Asian world too are driving down interest rates. Interest rates are at historical lows and considering the competitive position against other markets, no-one will assume Islamic finance if it is more expensive. This is the bottom line in the international financial markets.

Liquidity demands that are placed on Islamic investors, particularly the institutional investors, is an issue that has to be acknowledged and dealt with. Most funding from the institutional investors is received on a short-term basis and given the lack of capital market instruments that investors can invest in, if there is no liquidity we certainly don't want to see a situation where long-term assets are being funded by short-term liquidity. There has to be no doubt that unless we find capital market and its instruments, investors are going to be seriously disadvantaged against the competition, the conventional banking market.

One of the major concerns for investors is the issue of
taxation. Because we have the lawyers who are well versed in
the tax issues involved in short-term trade finance, taxation is as
much of a serious problem as in days gone by. Most western
bankers are also well versed in the issues involving short-term
trade finance. However when we consider long-term leasing
projects and project finance, these taxation issues can certainly
become serious and will need to be addressed very carefully, or
else investors will find themselves in serious difficulties.

The track record of the agents/arrangers who are actually
western banks who are involved in the market is also crucial.
Western banks have a very important role to play, for instance,
ANZ with 14 branches in Pakistan and with branches right
throughout South Asia can find deals there which otherwise
Islamic investors from the Middle East would not have access to.

Track record is important in the sense of building trust.
Investors have to trust the people that are handling the funds for
them. To trust that they can handle the funds properly, they have
to trust they can handle the issues arising from the Sharia
properly and that they are reputable institutions.

What are the borrowers motivations and concerns for using
Islamic finance? The real motivation for the users of funds has to
be pricing. Why would a Western institution or for that matter
any institution use Islamic finance when they can issue
commercial paper, or borrow money from their banks? For
instance, a Japanese trading house can go along to its own bank
and borrow money at a few basis points over libor. Why would
they use Islamic finance if it is more expensive? The lack of
currency hedging programmes in Islam can be an issue in terms
of pricing as you cannot hedge forward, at least in the general
market.

The financial market is awash with short-term money.
Japanese banks are now pouring short-term money into the
market, while Western banks are very short-term in their
outlook. Islamic banking is just another source of short-term
money. Nowhere in the traditional markets of Islamic finance is
this better illustrated at the moment than in Pakistan. A year ago
the Rice Export Corporation of Pakistan was issuing Mudarabas at around 200 basis points. Last month that same deal was done at 100 basis points. The margin has been halved in just over a year. This is a quite dramatic fall in price and that is a fall in return to Islamic investors.

New solutions have to be looked into and developed. A failure to achieve this will result in a continuing fall in returns. Investors will be driven from the market by lower than expected returns. Banks and institutions will struggle to give good returns to their shareholders. After all they are profit making organisations at the end of the day.

Stringent requirements placed in terms of the Sharia has led to resistance from new customers. In fact users of Islamic finance have already begun to walk away from the market. Traditional users of Islamic finance, Japanese trading companies have exited the market citing stringent Sharia requirements and have said that they no longer wish to be involved in Islamic finance because of stringent requirements. If we don't wish to see other users of Islamic finance exiting the market, the issue has to receive attention.

There is no doubt that borrowers are increasingly seeking longer-term finance. Why use Islamic finance if it proves to be more expensive, when borrowers can access the bond market. If the market can provide long-term competitive finance in the coming years then borrowers will work their way back to the conventional market and we will lose business.

The lack of support for export bids is also of concern for users of Islamic finance. This concern is being shown by European companies wishing to do business in the Middle East, South Asia and the Far East who are going into bids for contracts. Companies tendering for bids need to be sure that they have solid financing packages behind the bid. Those who can't support a bid situation have put themselves out of the market. I have not come across once this year an Islamic institution willing to provide a commitment to a Western company trying to sell in the Middle East or South Asia,
medium-term capital assets so that they know that they can enter into that transaction. The run-of-the mill business is passing the Islamic finance market by and we need to find ways where by we can actually stay competitive and support bids for export transactions.

What motivates the agents/arrangers in Islamic finance? Providing customers with good service is the most important issue. Agents have to provide customers and investors with top quality service and gain their trust, so that they come back to them. One-off transactions are not effective. However banks have to get a fair return for the amount of work that is going on. To a certain extent that balance has shifted and we have seen a drive by investors, because of low interest rates and falling margins, to try and reduce the fair return to the agents/arrangers, which has caused people to exit the market, not a healthy situation.

Because of a lack of commitment of Islamic investors and because of the inability to bring in investors to finance export contracts at the bid stage, we are back to short-term trade finance as the only way to get investors involved in transactions, except however for the one-off situations where nobody else wants to do the deal. Is that where the Islamic market wants to be? No, Islamic bankers want to be competing directly for the same transactions as the conventional financiers.

If a bank is bringing an investor into a deal, it is the duty of the bank to make sure that the investor is adequately protected. Part of the job of the agent/arranger is to make sure that all the angles are covered, that the investor is getting the full story, that banks don't take inappropriate deals to investors where the risk is abnormally high. If these deals are not taken to retail investors in this country, why should the same deals be taken to retail investors in Islamic countries?

The Basle convergence agreement, when it came into effect, drove up the costs of those western banks involved in the Islamic market. Where guarantees could be applied to transactions at no real cost, capital against these guarantees has to be applied now.
These are now real costs for those banks. Capital adequacy levels have driven down returns to investors and is holding down the growth of the industry that otherwise would have been there. Overlaying levels of guarantees and credit enhancement all adds to costs.

The political situation is also a concern to agents/arrangers. There is an on-going debate in some countries as to whether Islamic finance should be actually allowed into the market. This is providing a barrier to entry for a number of firms. How do we actually present and market in those countries? Is it right to call it an ethical fund, perhaps, as opposed to an Islamic fund? Does that have an issue for Sharia interpretation?

There is a wide 'gulf' in the interpretation of Sharia in Malaysia and that of the Persian Gulf. We have seen deals being undertaken over the last few years in Malaysia, which we are told would be totally unacceptable in the Middle East. Deals which have taken place in the Middle East are not deemed permissible in Malaysia. How do we bridge the gap in interpretation? In some shape or form, an authority has to be established where we can find a standard uniform interpretation of the Sharia which will enable users of funds to quickly identify situations where they can actually use Islamic finance. At least the guide-lines should be uniform. This is a key issue for the growth of Islamic banking, particularly in the longer term.

In planning for the future, several important issues arise; conflicting aspirations between users of funds and the investors, long-term funding versus short-term funding. Is it right to move down the project finance route, or should we be looking at more equity based solutions? This is something each individual institution has to look at; however the market in general has to take a direction.

Historically low interest rates: there is a real desire in the conventional markets in OECD countries to keep interest rates at historically very low levels. Although interest rates are going up in America, rates will probably come down in Germany. I don't think that we will go back to the levels of interest rates we were
seeing a few years ago. This will continue to be an issue for Islamic investors.

Falling margins in traditional markets: in Pakistan margins have been halved for government risk in just over a year. This will continue to happen as more and more money pours into the traditional markets. There is an utmost need to develop new products, products which are not just specific to short-term cash. There is too much short-term cash in the market, the competition is too serious.

Malaysia’s capital market has developed strongly over the last few years. The Middle East market should be learning lessons from Malaysia. This may not fit some of the Sharia interpretations which are applied by some of the organizations. But perhaps we should at least learn from the lessons and build on that which has been set.

Moving into the longer-term export finance area, there needs to be co-operation with export credit agencies, development agencies and the World Bank to develop longer-term export finance products where credit enhancement, rather than just coming from a western bank balance sheet, which is proving to be more and more expensive, can actually be brought in.

Export credit agencies are willing to look at ideas, and are now willing to consider project finance. Project finance is real Islamic business, the bank being actually involved in the transaction, participating in risk alongside the developers and owning the assets. Project finance is a very new market. It is a very new market for many conventional banks. However, having all the tools available, this is one market where Islamic banks should be leading the conventional banks rather than the other way round.

Project finance is traditional Islamic business, and this is one area of business Islamic banks need to develop. We have seen transactions already take place in Pakistan for building and operating power projects and in Oman with the Omana project. These projects can be financed Islamically. And yet Islamic finance wasn't even considered for these transactions. Why?
European Perceptions of Islamic Banking

This is an area which we should be looking into, researching and developing. With project finance, the rewards are high, and so are the risks. But with proper analysis, these risks are assessable, and workable.

If we really believe that Islamic financial institutions and Islamic investors should be taking the risk to get the return, rather than just having everything guaranteed by the bank, perhaps project finance is where we should be moving. We, as serious players in the Islamic financial market, should apply ourselves to these issues over the next few years.

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Accessing Islamic Finance

Introduction

This chapter attempts to show that much of the short-term Islamic trade finance arranged through London by Citibank, Kleinwort Benson and ANZ Grindlays (amongst others) was, and is, for the western blue-chip end-users. This statement is somewhat hard to substantiate. What is apparent, however, is that the three institutions were all, because of their own business orientation and established Middle Eastern investor relationships, well placed to deliver the specific services sought by Islamic institutions and investors during the initial phase of accelerated growth within the Islamic financial system.

Often we read press articles and financial journals claiming London as the hub or centre of Islamic financial activity. Most would consider that such a comment made on a stand-alone basis is, at best, ill-informed nowadays, but there is probably greater justification for observing that a good percentage of trade-based activity has, to date, been arranged in London, and regularly routed through the conventional banks. To establish the reasons for this and whether the bulk of investment has traditionally been directed toward western, blue-chip corporates we need to begin by exploring the evolution of the multi-billion dollar, London-based, trade finance sector of the Islamic financial system and the institutions' motivation for developing corporate relations in the West. We can then consider who is accessing Islamic finance facilities and why.
A developing financial system

During the late 1970's and early 1980's the fledgling Islamic banks and finance houses were actively seeking outlets for the growing volume of liquidity under management. Those institutions seeking to diversify their asset-base and profitability through international investment at an early stage of their own development had to address a number of issues.

Firstly, one needed to consider the development strategy of the institution itself. In their nascent stage, the Islamic banks required a spread of opportunities that, first and foremost, conformed with the requirements of the Sharia jurisprudence committee but also represented a relatively low-risk investment with commensurate profitability. With little or no recourse to liquidity in the absence of a viable alternative to the conventional money-markets, it was essential for obligations to retail depositors to be met through the punctual repayment of the funds invested by the institution.

Secondly, there was a factor of external credibility. It is not easy for any financial institution to develop international relationships and there is often considerable reticence on the part of third parties to explore an emerging market capability. Attempting to promote the capability whilst simultaneously introducing unfamiliar techniques and terminology, in a mature and competitive conventional financing environment, was a challenge.

There was also an issue of internal resources. The developing Islamic institutions' priority then was to consolidate their positions and represent serious competition for the domestic commercial banks. To do so they had to obtain a sizeable share of domestic retail deposits, and effort was focused towards marketing initiatives to identify suitable assets within those home markets. As many of the developing institutions were operating with a limited number of personnel, this obviously imposed restrictions on the level of manpower available for concerted, international marketing efforts. Furthermore, the capability to identify, analyse and administer
acceptable assets and liquid trade transactions offshore was not always present.

Establishing international trading partners

With these considerations in mind, the Islamic financial institutions had two reasonable alternatives for developing international contacts and trading partners. Those larger houses with substantial resources often chose to forge direct bi-lateral relationships, relying on the marketability for their large-scale liquidity. The others approached conventional banks and appointed them as their 'agents' for the purpose of identifying investment outlets.

There were a number of advantages for the emerging Islamic banks choosing the second course of action. The geographical coverage and distribution capability of large, international banks was extremely useful to investors without an international ground presence seeking introductions to new credits and country risks. Their involvement as agent enabled the Islamic banks to overcome some of the technical problems creating barriers to entering the western markets too.

They rapidly identified the potential of the emerging Islamic financial system and understood that the first test any Islamic investor applies to a financing proposal is whether or not the transaction will satisfy the stipulations of its Sharia Committee. If it does not, then the deal will not be concluded, regardless of credit rating, pricing or any other commercial consideration. Grasping this fundamental concept enabled them to work with the Islamic houses to ensure that the unfamiliar financing techniques could be presented favourably to western, corporate end-users, whilst simultaneously taking due care that the Sharia requirements of the investor were fully incorporated into the structure.

Their established trading relationships ensured that those names with businesses that were ethically acceptable to the Islamic institution, as well as being able to satisfy commercial considerations (such as creditworthiness, status and dependable
trade flow), were easily identifiable. This saved a great deal of
time and preparative groundwork for the financier.

A number of other factors determined the suitability of
specific, conventional bank appointments as agents or arrangers,
including:

- location, and those resident in London were particularly
  favoured because of their relative proximity to the Middle East;
- their business focus and ability to deliver the investment
  opportunities that matched Islamic bank requirements at a time
  when trade and commodity investment were at a premium. They
  provided acceptable, short-term, outlets that involved the
  physical transfer of tangible assets and represented the main
  source of international investment for most of the market
  liquidity. The London-based trading or merchant banks had the
  added advantage of direct involvement and penetration of a very
  mature trade finance market;
- their existing exposure to large corporate and industrial end-
  users enabled them to act as a conduit for introductions, comfort
  the Islamic bank by sharing in the risk of the credit or even,
  perhaps more controversially, provide support by guaranteeing
  the obligations of the names that they promoted; and the scale of
  in-house resources to handle all the necessary aspects of
  negotiation, documentation and administration, including the
  legal and taxation issues relating to individual structures.

For the reasons highlighted above, the London-based,
conventionally managed banks, with developed trading
credentials, were not only able to act as an agent for their Islamic
principal, they actually became regular end-users of Islamic
finance to support their own in-house and subsidiary trade
requirements. The additional benefit for them was also being
well positioned to offer a greater, more diversified range of
options to corporate clients and this was to take on greater
significance as the system matured.

Initially, the comfort of a very low-risk investment strategy
was of immense importance to the developing Islamic
institutions. It is generally known that, in some instances, to
protect their trade placements, Islamic institutions insisted that individual investments should bear the support of Letters of Credit and guarantees issued by international banks with an identifiable credit rating. Whilst this supposedly ensured that obligations to depositors would be met promptly, it also incurred the displeasure of the Sharia advisors, who required their institutions to assume a full profit-and-loss-sharing participation. Those investing with the trading subsidiaries of conventional merchant banks found that they were able to satisfy the regulatory concerns of central authorities, as well as the moral concerns of those who found the issue of guaranteed, financial support fundamentally unacceptable.

We can therefore establish that, initially, the conventional bank involvement assisted the Islamic bank to diversify and develop its asset and investment base and achieve an acceptable balance of sectoral and geographical risk and return. Certainly, in our instance, we were not approached to seek opportunities in the Middle East or Pakistan, where our clients have their own networks to generate business and have often been better placed to bring proposals to us! As a British merchant Bank, our mandate was to generate introductions and structure facilities within our core focus areas. We had extensive commercial activity in the physical trade and commodity markets and our subsidiaries included major exporters and companies trading physical commodities on regulated exchanges. Our primary regional focus was determined by our international ground presence and outside of the UK this included Continental Europe and the Far East.

**Expanding the corporate client-base**

The increasing momentum of the Islamic trade financing capability helped it to gain acceptance in western markets quite rapidly and considerable demand could be identified amongst UK and Western European trading companies independently active in the physical trade and commodity markets, as well as amongst the London-based subsidiaries of many of the giant, Far
Eastern trading companies. Apart from the benefit of geographical location and relative proximity to the Middle East highlighted earlier, an added appeal of corporate beneficiaries based in London was their large ongoing trade requirements and connections with the terminal exchanges.

As the market expanded, there was an increasing appetite amongst investors for new investment outlets yielding a net profitability to the Islamic bank that would not be negatively impacted by the direct support of conventional institutions. As the Islamic banks became more comfortable with the technicalities of the European trade and commodity markets and the performance of the credits involved, some sizeable, short-term, trade purchase facilities were delivered through direct principal relationships between financier and recipient. These have often endured to the present, albeit they sometimes originated at pricing levels the credit could not justify with conventional market sources.

The conventional bank intermediaries began to assume a different role and were required to provide more than agency or broker services and to justify a profit share. Third parties unable to add real value to a transaction started to disappear when significant contacts with London and European based corporations were established. Rather than arranging and/or supporting the credit of the transaction directly, conventional banks were now required to share the risk of the facility with the Islamic financier through a joint disbursement of funds or an exposure to the credit on their own book. Effectively, the agent was now expected to assume the full role of Mudarib and, additionally, the onus of credit analysis of individual corporate end-users often stayed with them, as did the responsibility for the more onerous aspects of the negotiation process. This suited many of the institutions as they retained the added comfort of an agent with a physical presence in the London market to actively monitor the business and ensure that both the religious and commercial stipulations of the investor were at all times rigorously enforced. The conventional bank, on the other hand,
was able to secure the continuity of its own relationship with its Islamic principal.

Developing the corporate facility

The Islamic banks and investment companies have continued to target the London market in search of fluid, dependable, low-risk investments and have often specified a desire to penetrate the European, blue-chip names with track-records of dependable performance. I should emphasise that our own international corporate clients also approach us to arrange introductions and deliver Islamically provided facilities to them. Each Islamic investor has certain, specific and individual Sharia and commercial criteria to adhere to but the motivating factors for western, blue-chip corporations assessing the viability of Islamically provided finance have remained fairly standard. If the following commercial criteria of the end-user can be satisfied, most are responsive to admitting Islamic institutions to their funding group:

First and foremost, corporate facility users are motivated by the all-in cost of an Islamic facility compared to that of conventional finance. Western end-users have recourse to a range of financing options and the short-term, Islamic facility must compete against the conventional alternatives that include Bills of Exchange, commercial paper programmes and cash loans.

Reservations about Islamic terminology and unfamiliar concepts can sometimes present difficulty, although this is not usually, in our experience, insurmountable.

Many of the London-based companies that Kleinwort works with find that, once they have overcome those initial reservations about terminology and application, the Islamic facility is a valuable resource. Interestingly, much of Islamic trade finance's western acceptance has been due to the success of the much-maligned Murabaha trade finance contract. It is a powerful and competitive product when employed as it should be, and that is to promote the physical flow of trade through principal to principal purchase and onward sale with immediate delivery on
deferred settlement terms. The concept fits quite naturally into the trade purchase mechanisms of many western corporates and presents a diversification from the other funding sources available. Also the structure of the facility need not necessarily impact on the corporate balance sheet in the same way as conventional debt.

Although, in theory, one of the major disadvantages of an Islamic facility for a western user is the comparative lack of desire on the part of the financier to provide commitment, in practice we now find that if a facility is appropriately structured, the sheer scale of liquidity in the market means that funding is usually available.

The length of time needed to complete the full approval process has sometimes been regarded as onerous. This can be addressed by a conventional bank intermediary being willing to commit its own resources to research and development with investors before approaching potential end-users, and ensuring that facility recipients are aware of the Islamic institutions' two-tier approval structure requiring ratification by both commercial credit and Sharia committees.

Once comfortable with the Islamic bank's ability to provide the facility, one must consider the degree of flexibility afforded by the structure. A significant disincentive to the end-user has been the very short-term nature of the facilities made available (often no more than one month deferred settlement granted). There is little motivation for an investment grade corporate to commit its own resources to negotiating facilities with inflexible terms and maturities. Whilst Sharia considerations will call for a firm structural guideline with set definition of commodity or asset category, storage or shipment technicalities and delivery and usage of goods, the net effect of these restrictions can often be offset against a degree of flexibility in other key areas. Choice of tenor or individual and aggregate size of drawings, may be all that is needed to differentiate the facility from others than can be raised in the conventional market.

The majority of western companies accessing direct trade
finance facilities are large, often world renowned names of undoubted creditworthiness. They have identifiable physical trading capability in oil, sugar, base metals, textiles and a range of soft commodities or a requirement to finance the purchase of specific assets and they have been well positioned to reap the benefit of dependable, short-term facilities with a stable cost of funds. Most of the original facilities extended to European, blue-chip names are still in place and the innovation and structure of Islamic trade finance facilities ensures that, at the short-date end of the market (ie up to 12 months), they are an attractive and regularly utilised alternative to conventional, competitor products provided by international banks.

**Structuring for the Islamic Investor**

Nowadays most of the trade facilities that we are requested to arrange enable the investor to assume clean, corporate risk, often in conjunction with KB. Many of our Islamic clients still have an ongoing requirement to expand bi-lateral, corporate sector relationships in OECD markets that generate investment grade comparable opportunities. The main disadvantage of short-term, investment grade risk is always the level of net profitability for, whilst triple-A-rated assets provide a solid base on an institution’s balance sheet, the profit margins available from some of the structured facilities provided to blue-chip names are very thin.

Islamic institutions are obliged to exercise due care in ensuring that their investment funds are used for the benefit of society and in accordance with the ethical principles of the Muslim faith. We should not forget that they are also required to produce an acceptable return for depositors and shareholders. Generally the low-risk segment of the trade portfolio is now complemented by a layer of performance-driven investment to enhance overall profitability. Re-aligning the risk profile of investments to comply more precisely with the fundamental profit-and-loss-sharing principles of the financial system by assuming a direct, risk position in the transaction has certainly
helped to enhance the investor's net profitability in the short-term sector of the market. Rather more recently, however, Islamic banks have been able to provide added value to their corporate counter-parties through the investors' own appetite for specific cross-border risks, particularly for those countries with majority Muslim populations.

London and European based companies exporting to the Middle East, Africa and Asia have identified a capacity amongst the Islamic institutions to assist with their export programmes through the extension of deferred payment facilities to ultimate, overseas purchasers. In doing so they are providing a valuable service to corporates that is not always available from the conventional banks, who might have significantly less country capacity for some of the more difficult credits. This can reduce the level of receivable on a corporate balance sheet and has the added attraction of assisting the company to penetrate some of its more challenging export markets and access new ones. The geographical bias can be arranged to complement the Islamically compatible investment objectives of the financier, as well as generating higher yielding opportunities in lesser developed markets.

The trade transactions that we have focused on with our clients in the past year have supported exports of trade from the UK, and further afield, to purchasers outside of the European markets. By example, this includes the purchase of nickel cathodes from the UK markets for export and delivery to a South African entity for stainless steel production and oil procured from a Middle Eastern supplier on behalf of an African end-user. In conjunction with Islamic institutions we are arranging project financing for Pakistan, part of which facilitates exports to Pakistan by western suppliers. European based business has included the provision of a trade purchase facility to a German corporate, but with a second tier to the arrangement that facilitates exports to global industrial counterparts of that same company.

Conventional banks publish few statistics or detailed
information of specific investment structures, and again the only indications of volume and distribution are based on our own activities, but I can confirm that in our instance the total volume of trade transactions structured for and in conjunction with Islamic clients comfortably exceeds US$5 billion annually. Other conventional banks in London are also reporting trade volumes that run into billions each year, although I believe that aggregate volumes can be misleading as they tend to fluctuate in response to movement in the conventional currency and money markets. Currently, short-term funds invested with or through ourselves in short-term, trade finance total around US$1 billion. Of this total, approximately 40% has been made available to corporates and organisations in the UK and Europe, 35% is directed to the Asian market, 15% to the Middle East and the balancing 10% to African recipients.

**Conclusion**

**Investment today through the conventional banks**

So, can we establish that the majority of short-term Islamic trade finance made available today through the conventional banks in London is still delivered to western corporations? It is certainly very difficult to ascertain the percentages of geographical distribution overall, but public notification of transactions delivered by others has seen facilities arranged for entities in Saudi Arabia, Turkey, Pakistan and India as well as the European and US markets. It is not unreasonable to assume that their product development and distribution is also concentrated on their own areas of sectoral and geographical expertise and is not necessarily confined to meeting the requirements of blue-chip, western European names but driven by substantial investor demand.

Although financier’s and investors’ western and European relationships have always been important, they were often initiated at a time when the volume of liquidity in the Islamic financial system exceeded appropriate investment outlets. I see no indication that these contacts are of any less importance as, in
our experience, Islamic banking remains relationship-based and the building of trust and comfort from initial point of contact is vital. It is the alternatives available to the Islamic investor that have increased and diversified and those initial provisions of Islamically structured finance to western, blue-chip corporations has developed into a more sophisticated capability. Latterly, it is the development of cross-border, flexible financing solutions, rather than the arrangement of direct, one-off transactions that has moved the boundaries of the London market.

The funding techniques employed more recently have certainly enabled western end-users to access an expanding range of produce to provide solutions to their own requirements. Not only are they in a position to produce the more familiar Murabaha or syndicated Mudaraba financings, but Istisna development facilities that inject working capital into the development phase of structured, longer-term asset and project financing and ijara leasing packages that support the acquisition of capital equipment. Accordingly, although western corporate credits are still well placed to directly accommodate the increasing volumes of liquidity circulating in the Islamic banking system, it is the outflows of assets and trade from the London and European markets that is of greater interest to Islamic financiers. Bi-lateral facilities consolidated, they are now choosing to focus on the business stream, contacts and markets of their own established relationships and trading partners in the west, to achieve the diversification of commercial and country risk and will enable both performance and strategic objectives to be attained.

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Introduction

Islamic banking is still a relatively new sector of the financial services industry, having started in essentially its current form approximately 20 years ago. The last 5 years have seen an upsurge in interest in Islamic finance generally, particularly from some of the larger names more usually associated with Western style banking.

It is the relative infancy of the industry generally that is linked to most of the current issues in the financial reporting and auditing of Islamic banks. The recent introduction of new participants has placed increased significance on these various issues.

The relevance of the industry's infancy is highlighted by the continued lack of an internationally accepted framework of uniform and comprehensive accounting standards or auditing guidelines.

Because of this, different Islamic banks have developed their own accounting policies which may result in a widely varying accounting treatment for essentially similar transactions, leading to different revenue recognition methods, and differing bases of classification and disclosure in the financial statements of Islamic banks.
This variety of treatment is in turn encouraged by the local regulatory requirements of the country in which the banks operate, which can differ dramatically, and is typified by the treatment of investment accounts, which is discussed later. The end result of this is to render the comparison of financial statements of individual Islamic banks difficult, and sometimes impractical.

As a response to this situation, the Financial Accounting Organization for Islamic Banks and Financial Institutions was established in Bahrain in 1991 and has recently been re-named the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

This organization has been responsible for developing various statements for financial accounting by Islamic banks, and has so far released three, which were approved in October 1993. These existing statements cover the objectives and concepts of financial accounting for Islamic banks, as well as the presentation and disclosure of their financial statements. A number of more specific statements, relating to matters such as the accounting treatment of Murabahas and Musharakas are due to be debated later this year.

ACCOUNTING ISSUES

Some of the more common accounting issues to which Islamic banks and financial institutions are exposed are:

1. Treatment of investment accounts

Currently, some Islamic banks include investment accounts on their balance sheet whilst others present them as funds under management, shown off balance sheet. Such classification is often determined by the regulatory environment in which the Islamic bank operates.

Islamic banks may distinguish between on and off balance sheet investment accounts by applying the risk and recourse criteria in classifying such accounts. Funds managed at the client’s risk are reflected off balance, but when investors place
funds with the Islamic bank at the bank’s risk, such funds are presented as part of the bank’s own assets and liabilities.

Other Islamic banks may similarly differentiate between discretionary and non-discretionary funds.

The AAOIFI has proposed that discretionary investment accounts be classified on balance sheet irrespective of whether the investment accounts are managed by the Islamic bank without risk or recourse to itself. Accordingly, only non-discretionary investment accounts are required to be reflected off balance sheet.

Any such method of differentiation will always be subject to the interpretation of the contracts governing the management of the investment accounts.

2. Income recognition

Islamic banks often adopt different policies for the recognition of income arising from investment in Islamic instruments.

Certain banks are known to recognize such profit immediately at the inception of the transaction whilst profit is recognized by other banks when actually received or amortized over the life of the instrument.

Such differing methods of income recognition, apart from affecting the comparability of financial statements of Islamic banks, have wider implications due to their effect on the allocation of profits between investors and shareholders.

3. Allocation of expenses and overheads

Similarly, there is currently no consistent basis for the allocation of expenses and overheads to investment accounts.

Certain Islamic banks deduct only direct investment-related expenses from profits paid to customers, while others also apportion indirect overheads, such as depreciation and directors’ remuneration to the returns accruing on investment accounts.

The adoption of such diverse bases for the allocation of expenses and overheads to investment accounts results in
undesirable fluctuations between Islamic banks in respect of the profits payable on investment accounts. Accordingly, a consistent basis must be developed and agreed to by the investors.

4. Disclosure of social activities

Non-profit activities which make a positive contribution to society are actively advocated by the Sharia. Islamic banks are therefore required to undertake social activities, and disclosure of such is likely to be of interest to the users of such bank’s financial statements. No consistent level of disclosure is currently practised, with such disclosure varying from nothing to extreme detail.

There is therefore a need for uniquely Islamic accounting matters such as this to be addressed.

AUDITING ISSUES

There are a number of audit issues arising both from the accounting issues dealt with above, and from the nature of the operations of Islamic banks. Some of these are:

1. Investment accounts

There are a number of auditing issues related to investment accounts:

a. The inclusion of such managed funds on a bank’s balance sheet will obviously inflate the assets and liabilities of that bank. This can have a significant impact on the capital adequacy and lending ratio requirements of the bank under certain regulatory regimes. The effects of any non-compliance must be considered by the bank’s auditor.

b. Due to the nature of many Islamic financing activities, such as Mudarabas, it is common for the bank’s own funds and client funds to be invested in the same venture. Although not a problem unique to Islamic banks, this does raise the question of clear segregation of client funds. The auditor must therefore satisfy himself as to the adequacy of the internal controls to
ensure proper segregation of such funds, and their related risks and rewards.

c. There is no formal requirement in many jurisdictions regarding the financial statement disclosure of off-balance sheet funds. Given the nature, and often significant volume, of such funds, disclosure of such matters as maturity profile and geographical analysis may be considered essential information for the users of the financial statements. The auditor must often consider the balance between ensuring a true and fair view, and disclosing potentially competitor-sensitive information.

2. Liquidity management

The absence of liquidity and maturity parameters in many jurisdictions combined with investment in long-term Islamic financing projects may increase the liquidity exposure of Islamic banks.

The ability to manage such an exposure may also be hindered by the difficulty in obtaining suitable off-the-shelf management information systems, which are normally designed for western style operations. The extent of the banks ability to manage this risk must clearly be considered by the auditor.

3. Rates of return to investors

Islamic banks are competing with established western style-banks for investors' funds, and must often therefore demonstrate that the products provided by them generate a comparable rate of return.

The nature of many Islamic finance products is, however, often inconsistent with the generation of a steady income stream that is comparable with those generated by interest-based products.

The Islamic bank may therefore smooth the reported profits, through the operation of provisions and reserve accounts, in order to report a market rate of return.

The auditor must always consider whether such activities are permissible under the relevant legislation, and are fairly
4. Sharia compliance

Clearly, the question of Sharia compliance is significant to the audit of any Islamic financial organization, and the role of the external auditor must address this. This significance may be considered greater when the Islamic bank is operating within an Islamic jurisdiction, and is therefore subject to the Sharia courts. However, even when not directly governed by the Sharia law, compliance must be essential, given the impact to the bank's operations should, for instance, its products be no longer considered acceptable by its target market.

The Religious Supervisory Board of most Islamic banks is responsible for ensuring the Sharia compliance of the bank's activities and products. The external auditor's role in this issue is complex, due largely to the lack of sufficient expertise of most auditors in the Sharia law. As a result, reliance will often be placed on the competence of the bank's own Religious Supervisory Board, which should theoretically be independent of the commercial interests of that bank.

While the auditor must take steps to satisfy himself on this matter, as he would if relying on any other expert, his task is complicated by the subjectivity of interpretation of the Sharia, which has seen many conflicting opinions given by the Religious Boards of different banks over recent years.

The establishment of rules and regulations, covering specific investment products, would go a long way in effectively ensuring that Islamic banks comply with the covenants of the Sharia as well as in the performance of their fiduciary duties and obligations to their investors.

The Future

As mentioned earlier, the Islamic banking market has expanded considerably in recent years. This growth has necessarily focused the attention of conventional banks on this sector, and it remains to be seen what impact this will have.
It is clear, however, that the use of the financial statements of Islamic banks by clients and competitors who are used to operating in a conventional, western-style environment will increase the risk of an expectation gap. Such a gap will, to no small extent, be due to a lack of understanding of the religious basis for Islamic finance generally. This is clearly a matter that will need to be addressed by the Islamic banks themselves in these ever-more competitive times; it is certainly a matter that will be of concern to the auditors of such banks.

The current progress towards developing an accounting framework for Islamic banks is a step in the right direction; it remains to be seen whether such a framework can become widely accepted by national regulators.

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Introduction

The aim of this chapter is to provide a Western lawyer's view on specific aspects of the extremely dynamic and complex Islamic banking scene. We intend first to examine general legal issues confronting Islamic financiers from an English law perspective and, secondly, to provide an overview of two common types of Islamic transactions: Murabaha and Ijara.

The aim of the discussion on general legal issues is to describe the aspects of Islamic transaction documents which, from the English perspective, we often have difficulty with. The transaction review will demonstrate how these difficulties arise in practice and illustrate how these transactions are actually structured. Many people find books on the issues of Islamic banking helpful but what they really need to understand is how those issues arise in practice.

The relevance of English law to Islamic transactions derives from the choice of governing law for the financing documents and other agreements relating to those transactions. As for many international financial transactions, the banking community requires the certainties which interpretation of documents in accordance with English law is considered to provide. In the context of a large number of Islamic countries, because of the historical relationship with the English law system the
similarities between local and English law mean that the choice of English law is often not particularly controversial. There is certainly nothing to indicate that the practice of choosing English law will change.

GENERAL ISSUES IN THE ENGLISH LAW CONTEXT: LENDER LIABILITY, WARRANTIES AND REGULATION

LENDER LIABILITY

In nearly all of the traditional forms of Islamic finance the lender is at some stage the owner of goods which are the subject of the financing involved, and clearly, the longer the financier retains the asset, the greater the exposure to ownership-derived liability. In Ijara this will be as the owner of the goods being leased and in a Murabaha as the seller of the goods concerned. In contrast, such an element of risk does not exist in a conventional transaction where a financier merely lends money to a borrower for the acquisition of an asset.

To date, I believe that there has been little (I suggest too little) concern expressed as to the risks to which these roles expose the lender. However, increasingly, legislation - either new legislation in the traditional areas of operation or existing laws in new areas of operation - imposes liabilities on owners or vendors. Even where the lender's liability may seem remote, the lender's deep pocket will inevitably result in it being considered as a potential target for litigation.

A financier's ownership of goods gives rise to a range of potential liabilities in English law governed transactions and I have no doubt that similar problems arise in other jurisdictions.

Third Party Liability

Under English law a lender cannot normally be held liable for damages or losses caused by an asset merely because the lender owns the asset - the lender must be at fault in some way except where the lender assumes liabilities pursuant to a contract, although in a few cases strict liability applies.
Nevertheless, lenders must be aware that third parties harmed by an asset owned by a lender may well seek compensation from them. In a leasing transaction lessors will seek to avoid fault-based liabilities and potential contractual liability by ensuring that the following are covered by the lease:

- lessor only gives such title as it receives;
- only warrants quiet enjoyment as against itself;
- reasonable excludes warranties on quality (discussed in greater detail later); and
- lessee obligation to inspect the asset before delivery and to maintain the asset.

**Occupier's Liability**

A lessor may also have liabilities imposed on it under the Occupier's Liability Act 1957. This may be the case if the lessor decides to impose restrictive maintenance conditions on the operator. The Act focuses upon the degree of control exercised over the asset in question. If a lessor is considered to be an 'occupier' by the Act, it owes a duty of care to persons, for example, passengers, who are legitimately on the premises. For the purposes of the Act, assets such as aircraft are deemed to fall within the definition of 'premises'.

Under the Unfair Contract Terms Act 1977, an owner would be prevented from excluding liability for death or personal injury caused by its negligence in such circumstances. Attempts to exclude other liability must accord with the terms of the Unfair Contract Terms Act.

**Environmental Liability**

Lenders owning or leasing land face civil and criminal sanctions under the wave of new legislation designed to protect the environment. The penalties are not restricted to those who cause pollution; land-owners may have to meet the cost of cleaning up polluted land irrespective of whether they were responsible for the damage. Environmental surveys should
therefore be considered wherever there is a potential for environmental liability.

European legislation is having an increasingly profound impact in this area, extending its influence to air and water pollution. Proposals have also been made to make fault irrelevant in allocating liability for environmental damage.

Product Liability

Product liability arises wherever sub-standard goods cause damage or injury to a user. The statutory basis for this liability is the Consumer Protection Act 1987. Overseas lenders can still be affected by the Consumer Protection Act: defective goods provided from outside England to customers in England are a potential source of liability.

With the increasing complexity of the transactions involving Islamic finance, with the world becoming increasingly litigious and with the ability of a party to protect himself by contractual terms increasingly restricted, I believe that this is an area which will need considerable attention in the next few years. I am sure that these problems are manageable but I do not believe that at present they are being addressed, or at least not in an adequate manner.

WARRANTIES

As more and more sophisticated goods become the subject of Islamic finance, the need to ensure that the eventual user has the benefit of warranty claims against the manufacturer becomes increasingly important. At the same time the lender or owner will wish to avoid potential liability. Islamic lenders, as vendors or lessors, are, under English law, subject to several statutes, most notably the Sale of Goods Act 1979 and the Sale and Supply of Goods Act 1994, which imply certain conditions into contracts involving their assets. These implied conditions cover, for example, the quality of, and the lender’s right to sell or lease, the goods. Contrast this to the position in a transaction where a lender of money does not assume such responsibilities.
Since Islamic lenders deal primarily with commercial customers, the implied term as to quality can be excluded, but only where an exclusion is reasonable in the context of all relevant circumstances. On a practical note, the lender should aim to exclude as far as possible any implied conditions as to quality.

It is not possible to exclude the implied condition as to title. A lender should therefore ensure that it has good title to an asset before selling it on to a customer in a Murabaha transaction.

Again, I believe that these matters can successfully be addressed but that they are currently largely ignored. I also believe that, particularly given that many of the countries in which Islamic finance is operated have legal systems based on the English common law tradition with its emphasis on the importance of privity of contract, insufficient attention has been given to maintaining the responsibility for the original producer of goods for damages suffered by the eventual user. Interposing the ownership of the financier breaks the privity of contract which would apply if there were a direct sale contract between the manufacturer and the eventual user.

Conflicts of Laws

As I have mentioned, the particular relevance of English law for Islamic transactions derives from its choice as the governing law of many transactions.

Although the principal agreements, for example, in an Islamic transaction may be English-law governed, it is likely that some of the documents will be under local law, eg, in a Murabaha financing, the purchase agreement and the agreement which governs the relationship between the local agent and the purchaser. Such agreements are not expressed to be governed by English law because they involve only local parties and will therefore be most effectively enforced in the local courts. Indeed, if appropriate recognition of judgement treaties does not exist between the relevant countries, an English court judgement may have no value at all in enforcing against the local counterparty in
its home country.

Two particular considerations need to be borne in mind in relation to the conflict of law position:

1. On the basis that some transaction documents are subject to different interpretation from others, are there any inconsistencies in the transaction structure as a whole?

2. Are there any concepts which do not properly fit the governing law system to which they are subject? Problems often occur where concepts have been incorporated into local law documents from the English law financing agreements. Local lawyers obviously need to confirm that the relevant provisions are effective. For example, Murabaha transactions typically rely on a chain of agencies with the agency agreements governed by different legal systems. Agency is always an uncertain area of law and there are real risks of disparities between the agency arrangements, resulting in exposure for one or more of the parties.

REGULATION

A further development which we see as becoming increasingly relevant from the English lawyer's perspective is an increase in the regulation of Islamic banks. Although it is not appropriate here to speak in any detail about the regulatory regime currently applying to Islamic banks in this country, this is likely to be an area to which increasing time and attention will be paid in Islamic transactions. The increase in regulation is in part due to the world-wide trend towards greater regulation, triggered, at least in Europe, by some spectacular failures of regulation. The most high profile was, of course, BCCI, with which I was very much involved acting for the Provisional Liquidators. There the fact that there was no one country with overall regulatory responsibility appears to have been a major factor in delaying the discovery of the massive frauds and losses involved. A shortfall of $7 to $8 billion is a staggering amount - equivalent to over 10% of all Islamic deposits. It is fortunate that the Islamic Banking arm of BCCI was relatively small.
There have, of course, been other failures. Barings springs to mind, as does Johnson Matthey. That case was interesting in that there was no real fraud involved - only massive incompetence. The only minor fraud concerned a small bribe to a junior official who was so naive that he allowed the briber to draw the money from his Johnson Matthey account, had it over at Johnson Matthey to the miscreant, who promptly paid it back into his own account at the Bank. Not, I think, in the same league as the BCCI fraudsters.

However, strengthening of regulation arises also because the regulators themselves have until now been somewhat frightened of Islamic banking, because they have not altogether understood it. I believe that this is no longer the case in many jurisdictions and that as the regulators become more confident and more experienced the regulatory regime will tighten. I note, for instance, that Pakistan has recently introduced new prudential regulations. Of course, hand in hand with regulation must go the question of accounts and auditing. I believe that some progress has been made towards agreeing common bases for assessing risk in Islamic financing. For the majority of banks increased supervision will not be a problem and indeed many banks may welcome a tighter watch being kept on other less scrupulous banks whose default might damage the reputation of the industry generally.

We now look at the two most common forms of Islamic financing: Murabaha and Ijara.

TRANSACTION STRUCTURES

I am going to look at typical transaction structures for Murabaha and Ijara financings. This will hopefully provide a helpful overview of the way in which these transactions work in practice and also put some of the legal issues into context.

MURABAHA

There are a number of key features which we have seen in nearly all the Murabaha transactions we have dealt with. Before
identifying these features it is probably worth reviewing the typical structure of a Murabaha financing, including the parties involved and the stages in the transaction.

The parties involved include, of course, the banks who want to lend into the structure and their agent, the Mudarib, appointed under a Mudaraba agreement. At the other end of the structure there will be the purchaser who is seeking the benefit of the facility in order to purchase goods and the supplier or manufacturer of those goods. The local agent who acts as an intermediary and agent to the banks is a frequent feature of these transactions and I shall go into more detail about his role in a moment.

The stages of a typical Murabaha transaction are therefore as follows:

(i) Purchaser submits order to local agent for goods it requires;
(ii) local agent informs Mudarib, its principal, of the proposal;
(iii) Mudarib agrees to finance the purchase of the proposed goods;
(iv) Local agent passes this information to purchaser through an offer;
(v) Purchaser accepts the offer, which binds it contractually to purchase the goods;
(vi) Local agent, acting through purchaser, enters into a contract to buy goods from supplier;
(vii) Purchaser, acting for itself, enters into a contract to buy good from local agent;
(viii) Banks make their contributions to the Mudarib;
(ix) Agent passes the funds to its agent, the local agent;
(x) Local agent pays the supplier.

The transaction is then completed until the purchaser's repayment obligation arises after a period which is normally between 6 and 12 months.
(xi) The purchaser then pays the deferred sale price, being the purchase price plus costs, to the local agent as agent for the Mudarib;

(xii) The local agent pays this amount, less its fees, on to the Mudarib;

(xiii) The Mudarib distributes it to the Banks pursuant to the terms of the Mudaraba agreement.

Following that quick overview of a typical Murabaha structure, I would like to look in more detail at various aspects of the transaction.

(a) Advances

The Murabaha financing documents usually envisage a series of draw-downs (stages viii and ix). The availability will be limited to a specified period after signing and a provision is usually included providing for a minimum amount to be drawn-down per month. The multiple draw-down mechanism is included because some purchasers have on-going rather than day one requirements. However, it is equally possible to provide for the full facility to be drawn down on day one.

(b) Deferred Payment Term

The purchase price will be paid by the banks to the supplier on day one (stages viii, ix and x). The purchase price to be paid by the purchaser to the Banks will be paid on a deferred date after receipt of goods, (stages xi, xii and xiii). This is often twelve months after receipt of goods although the price may be payable in instalments, eg, six, nine and twelve months after delivery.

A renewal mechanism can also be incorporated into the Murabaha documents. This will allow the bank, through its agent, to review the Murabaha financing at the end of the initial deferred payment period. The outstanding deferred payment is therefore made but immediately followed by a new financing on exactly the same terms as the previous financing. This technique may give the purchaser the comfort of some assurance as to the continuing availability of funds in the market where
development is impeded by the deficiency of long-term funding. However, it should be noted that the banks are obliged to renew the arrangement, although they have a number of 'material adverse change-type' let-outs if they do not wish to proceed. These let-outs will cover circumstances in which the banks are experiencing funding difficulties.

(c) Purchase Price

The basis for determination of the bank's fees is a matter for agreement with the purchaser who will find these costs included in the purchase price. The fees charged by lenders in the interest-based banking community may be an influence. The risk borne by the Mudarib which, applying Islamic principles, justifies its fee is, the Bank's ownership risk in the asset being transferred to the purchaser.

(d) Local Agent

The Mudarib may appoint a local agent to purchase the commodities on its behalf and to act as its agent in the relationship with the purchaser. The reasons for this appointment may be two-fold:

(1) The local agent's experience in setting up commodity purchases of the type envisaged by the transaction. It may in fact be a form of state-owned financial institution conducting such agency activity for the purpose of attracting foreign investment; and

(2) The residence of the local agent in the locality of the purchaser and the supplier.

The local agent can also have a currency exchange function; converting the foreign currency to local currency before paying the supplier (stages ix and x) and vice versa (stages xi and xii) when passing funds up to the Mudarib. The local agent may also have responsibility for making any necessary arrangement with the central bank to ensure sufficient foreign currency is available.

The local agent will often be required to guarantee that a
specific percentage of the purchase price will be paid by the purchaser. The local agent’s liability for the purchase price collected from the purchaser (stage xi) is limited to this percentage amount. The risk justifies the local agent's fee and also gives the Mudarib the additional comfort of a local agent having conducted some due diligence on the purchaser. The local agent’s fees are deducted from the sale price between stages xi and xii.

(e) Purchaser as Agent

To simplify the relationship with the supplier, the purchaser will usually act as the local agent’s agent for the purchase of the goods (stage vi). This means that the supplier need only deal with the purchaser. It also gives the purchaser a direct role (albeit as agent) in the relationship with the supplier. This is sensible in a situation where the bank and the local agent are not giving the purchaser any warranties in relation to the commodities and therefore will expect the purchaser to rely on its relations with the supplier. The purchaser will need to notify the supplier that he is the agent of the local agent (and in turn the Mudarib) in respect of the purchase. This is usually a benefit as the supplier knows that he is paid by a bank and sometimes discounts can often be negotiated in exchange for the relative certainty of payment.

(f) Syndication

The Mudarib will syndicate the loan to a series of banks. The syndication document will be a form of Mudaraba agreement. It deals with, inter alia, the manner in which the participating banks fund their contributions and the allocation of the fees earned by the agent (or principal Mudarib) on the transaction.

IJARA

I shall now look briefly at some of the issues relating to Ijara. In fact Ijara contracts tend to be very similar to non-Islamic
leases. Obviously I shall only be looking at some of the differences.

At a more general level it is worth noting that in non-Islamic leasing transactions the bank’s return is based on the cost of the assets leased. This would be unacceptable under Islamic laws and therefore the return to the bank under Ijara is related to the profitability of the asset used by the lessee.

Ijara contracts may be entered into for long, medium or short term and may be adapted to fulfil the functions of either conventional finance or operating leases.

The following points distinguish Ijara from conventional non-Islamic leases:

(a) Rental Payments Based on Cost of Funds

Difficulties arise where a lessor has financed the acquisition of an asset with floating rate funds and this asset is to be leased to an Islamic lessee. In these circumstances in non-Islamic transactions the owner will usually, through a finance lease, pass the fluctuating rate down to the lessee through the rentals payable by the lessee under the lease. Obviously, this poses difficulties in the Islamic context, where lease rentals cannot be expressed by reference to interest rates.

A possible approach is for lessor and lessee to enter into successive leases with rental amounts to be included in all but the first. For example, if a three-year lease was proposed, three one-year leases could be entered into. The first one-year lease would have the rent included but the second two have the rent to be completed. The rent would be agreed between the parties in year two and three. However there is the obvious danger that agreement is not reached and therefore the leasing arrangements collapse. Alternatively, some form of agreement could be entered into describing the basis for agreeing the rental figures in year two and three.

(b) Default Interest

Non-Islamic leases provide for default interest on late
payment of amounts due under the lease. In an Islamic lease a different approach must be adopted: this can be achieved by providing for some form of discount formula. This could be by way of an agreed rate of discount for each day that payment is made prior to a backstop date. If payment is made on the due date no extra charge is payable. If payment is made after the due date no extra charge is payable. If payment is made after the due date but before the backstop date, an agreed amount of discount is deducted from the rental payments. However, if payment is made after the backstop date, the lessor cannot recover further compensation for the delayed payment.

The backstop date is chosen to reflect a commercial period in which funds might be expected at the latest to be paid, perhaps 30 days. Alternatively, the 'payment-on-time' discount can be applied to reduce the amount payable to exercise an option over the asset.

(C) Insurance

In Islamic transactions, the owner or lessor of an asset should assume or be responsible for the management risk in respect of the asset. The owner/lessor thus agrees to pay for insuring the asset for certain risks. In an aircraft lease, these would usually be hull all risks, war risks and spares. Liability insurance can be left with the operator. The lessee contracts for the insurance and the owner/lessor pays the lessee.

A conventional operating lease will provide for the obligation to arrange and pay for insurance to be the responsibility of the lessee. The increased responsibilities of the owner/lessor will be reflected in the amount of the lease rentals payable.

(d) Maintenance

Islamic law, in contrast to the approach taken in conventional Western leases, envisages that the lessor would be responsible for maintaining the asset. The lessor may however appoint the lessee to carry out the maintenance on its behalf. In a
similar way to insurance costs, allocation of maintenance responsibilities is likely to be reflected in the amount of the lease payments due from the lessee.

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The development of an Islamic system of banking based on Islamic theology which prohibits dealings in interest according to the Qur'an, has created problems in terms of how the Islamic banks are to protect their investments. In order to avoid the prohibition on interest, specific forms of financial arrangements exist and the nature of the security depends upon the type of transaction involved. Islamic banks are in many ways at a disadvantage to conventional banks because, in addition to the currency risks, country risks, political risks and counter-party risks, there are additional documentation and structural risks. Approval of the Sharia committee and/or the Religious Advisory Board can cause delay and restriction and commercial businesses dislike delays. When taking security the Islamic financier or appointed agent is often in a much stronger position than a conventional banker in that he is either an owner or a lessor. This is likely to be the case with trade finance. As an owner or lessor of goods his security is less likely to be compromised by claims from other lenders. If a bank owns the asset then the claims of other creditors are likely to become less significant.

The three main types of transaction are the Mudaraba, the Musharaka and the Murabaha.

Mudaraba
This transaction is a partnership in which the capital is
provided by one party (the investor), the energy and labour is provided by another party (the entrepreneur) and the bank or financial institution putting the other two parties together. This contract states that the investor will bear the whole of any loss up to the amount of capital paid in by him provided that the loss is not incurred due to the negligence, fraudulent behaviour or bad management of the entrepreneur. The entrepreneur has a free hand to manage the business and does not have to give a pledge to the bank or to the investor and this contract involves no form of security. For this reason Mudaraba is likely to constitute a very small part of a bank’s business.

**Musharaka**

This contract is a partnership between two or more persons pooling their financial resources in order to undertake a commercial transaction. It is worth noting that from the Islamic point of view, no security can be requested from the entrepreneur for such partnerships because, according to Islamic law, capital and enterprise form a single factor of production in an arrangement of profit-and-loss-sharing. However, in practice most Islamic banks request security against the risk of negligence or willful misconduct of the customer or his non-compliance with the terms of the partnership contract. This security is likely to take the form of either a security deposit to be held in an investment account with the institution or other securities, such as the mortgage of land, assets, or project equipment. This provision for security is the major difference between the two contracts of Musharaka and Mudaraba.

The lending institution is expected to impose controls on withdrawals and deposits to the secured account. The capital is likely to be paid in at once and not by instalments as happens with Murabaha contracts. In Musharaka no-one can take a profit without sharing the risk so that even if there is a clause which says that all the loss should be borne by one party, that is contrary to Islamic jurisprudence. Nevertheless the entrepreneur may bear all the loss if he is guilty of willful misconduct or fraud.
The bank as a partner in the Musharaka is part owner of the goods. The bank may sell its share in accordance with the contract but must give first right of purchase to the customer.

The inadequacy of collateral provided to the bank means that Mudaraba and Musharaka are not of great attraction to lending institutions. Dr Omar Marashdeh, in an article entitled 'Intellectual Capital: The Way Ahead' (in New Horizon 1995) suggests that intellectual capital is the ultimate collateral which can be provided to secure financing. He recognises that evaluating knowledge can be a problem but he suggests that this is an area which is ideally suited to the Mudaraba modes of financing. He believes that the financial value of intangible knowledge is less susceptible to changes in the economic cycle as compared to tangible assets such as real estate.

Bankers, like most of the rest of us, are in business to make a profit and this argument from Dr Marashdeh is too nebulous to be obviously attractive. Again Musharaka may well not amount to more than 10% of the business of an Islamic bank so I propose to concentrate on the most important and widely used form of Islamic banking contract, namely the Murabaha.

**Murabaha**

This transaction is essentially a contract to resell at cost, plus an agreed profit margin. From the point of view of a bank, Murabaha is the most successful way to finance domestic transactions under the Islamic banking system and equates to a loan or an overdraft for conventional banks. It is ideal where the customer does not have the money to buy the goods in the first instance. Theologically there are those who dislike Murabaha on the basis that it is very close to interest. It is, however, regarded widely as acceptable because the 'profit' is open and known to both parties from the outset. The concept of the profit being open and known is important and it is not just the profit. I want to stress the question of disclosure, which is essential in Islamic transactions. In the Western world we are all conscious of Credit Ratings, Moody's Index and Triple A ratings. Such indices are
not so widely available in many areas where Islamic banking is prevalent, and this fact makes the question of disclosure all the more important.

Full disclosure is required from the entrepreneur about his background, his financial strength, his business acumen and his track record. Disclosure is required from the bank about its profit margin management, security requirements and enforcing its security. Based on such disclosure both parties evaluate the risk and the amount of profit required.

The security can of course be first class from the bank's point of view in that the bank will own the goods and when the goods are paid for the money will come direct to the bank. An owner or lessor of goods has much better security than a conventional bank because his security is less likely to be compromised by claims from other lenders. With a specific deal the Islamic lender can pinpoint the cash attributable to that particular deal. The amount of profit the bank will require depends not only on the amount of risk but also the time spread between the advance and the repayment of the funds.

When the bank and the customer enter into the Murabaha contract, the bank must be capable of delivering the goods to the customer. This means that the bank should acquire the title from the supplier before contracting with its customer. The customer may pay in cash or in instalments. If the latter the profit will be higher. Normally the customer provides the bank with the specifications and quantity of the goods to be purchased. The customer promises to provide a guarantee at the time of the signing of the written agreement.

An Islamic bank will take security and especially so from customers without a track record or when the customer wants to delay payment. Fatwa No 263 of the Kuwait Finance House specifies that a guarantee should not be obtained until the Murabaha sale contract is signed between the bank as a seller and the customer as a buyer. In practice this is likely to be done simultaneously. This procedure does not offend Sharia law and provides security for the bank. Money paid by the bank in fact
belongs to its own investors who have deposited funds with the bank for investment. The bank therefore has an obligation to protect investors, funds from losses. It is to provide protection for its own customers that the bank can be said to take the guarantee. Banks are permitted Islamically to take one or more of the following forms of security:

Most of these can be used for leasing as well as standard Murabaha contracts.

1. Personal guarantee.
2. Real estate owned by the customer or others on mortgage.
3. Assignment of funds relating to supply contracts.
4. Physical goods other than those the subject of the sale. The minefield started by the Romalpa case and Romalpa clauses which have kept UK lawyers so busy since the decision in 1976 have not yet, as far as I know, excited the jurists in Islamic law.
5. A reserve of an amount of money from the current or investment account of the customer.
6. A bank guarantee from another bank.
7. Cheques for the instalments equal in value to the remainder of the sale price after deducting any advance.
8. Insurance of the subject matter of the Murabaha against all risks for the benefit of the bank until full payment has been made. Strictly the bank covers the risk by insuring the goods itself; in practice the customer pays for the insurance and meets all ancillary costs.
9. Some banks request the customer to pledge goods to the bank, especially if they are machines, cars or other durable equipment. Because of the other types of security open to an Islamic bank, pledge can be a ‘security of last resort’. It is however traditional and still useful. Pledge is a substantial subject in itself, so much so that I propose to outline some of the specific rules involving a pledge:

Pledges

The Qur'an supports the idea of furnishing a pledge against
a debt. Pledge or ital is to give property as security in respect of a right of claim, the payment for which may be taken from the value of the property. The main laws relating to pledges are:

1. The pledge becomes a concluded contract by offer and acceptance. The contract becomes irrevocable after the pledge is received by the pledgee. The pledgee can annul the contract at any time.

2. One pledge may be exchanged for another.

3. When a thing is pledged to secure a debt, an increase of the debt to be secured by that pledge is lawful.

4. A thing that can be sold can also be pledged. It should be existent at the time of the contract, must be definable by price and be capable of delivery. When Oscar Wilde arrived at New York airport, and said he had nothing to declare but his genius - this genius would not have been pledgable.

5. Two different creditors may take a common pledge from a single debtor. This pledge will secure the whole of the two debts.

6. A consequence of making a pledge is that the pledgee has a right to possession until the payment of the debt. And if the pledgor dies, he can take full payment of the debt from the pledge. On the death of a pledgor, his heirs, if they are of age, stand in his place, and it becomes necessary for them to free the thing pledged by paying the debt from the estate of the deceased person.

7. Acceptance of the pledge is no impediment to the demand for repayment of the debt by the creditor.

8. If the pledgor has destroyed or damaged the thing pledged, he must pay compensation. If the pledgee has destroyed or damaged it, the amount of its value is struck off the debt.

9. If the pledgor purports to sell the pledge without the leave of the pledgee, the sale does not become effective and the right of the pledgee to possession is not destroyed. Once the debt is paid, the sale becomes effective.

10. If the time for paying the debt has arrived and the pledgor refuses to make payment, the pledgee may approach the
court to compel the pledgor to sell the thing pledged in order to pay the debt. The court may sell the pledge to pay the debt. Note the difference between death and failure to repay. My understanding is that a clause may be inserted authorising the pledgee to sell in the event of default in repayment.

There are other detailed rules which can be made available.

An example of the provision of security in a contract of Murabaha sale can be found in Articles 7 and 12 of the Dubai Islamic Bank Standard Contract. Article 7 provides that the bank may require guarantees of payment either in the form of certified cheques, bank guarantees or mortgages on property. Article 12 provides that if there is a guarantor acceptable to the bank, such guarantor shall guarantee and secure the repayment of the debt.

There is a problem inevitably with delay in payment. Unlike a conventional bank an Islamic bank will not charge interest. Delays can therefore be a very serious problem and can present difficulties which should not be underestimated. Interest mounts up thus giving an incentive on the debtor to pay. The security offered to an Islamic lender often depreciates. The lender can, however, claim compensation for 'harm or injury'. (Al Ashker v Islamic Business Enterprise). Article 42(1) of the Civil Code of the UAE supports this.

Old texts supporting the idea of charity imply that banks should not force payment out of a man in financial difficulties. If the bank has taken security along the lines mentioned above the problem should not arise. Modern trends seem to be taking the compensation route - see UAE Civil Code. I am told that the Qatar Islamic Bank is inclined to favour an arbitration procedure before a panel of three arbitrators and that, this panel has been known to award compensation on the average rate of return achieved by the bank.

One of the reasons why small traders use an Islamic bank rather than a conventional bank is that an Islamic bank takes the responsibility for the goods until they are delivered to the customer. A conventional bank does not. The Islamic bank loses
one valuable tool of security but it gains in that it owns the goods. At least one Islamic Property Fund with which I have been connected has given and received security which has satisfied it and conventional UK bankers.

This Fund has been approved throughout by its Sharia Committee and has three points in its favour. First it is leveraged, thus enabling investors to purchase a wider spread of UK properties. Secondly, it is an example of co-operation between an Islamic institution and conventional western banks and thirdly, the UK borrowing sets up a UK interest charge which is extremely efficient for UK tax purposes.

Traditional Islamic writings concentrate on the elimination of injustice and exploitation in financial dealings to bring about the equitable distribution of wealth and to encourage entrepreneurs and mutual co-operation, to support the individual against the Institution, the borrower against the lender. Modern trends (as shown by the UAE laws quoted above) indicate that the pendulum may be moving in favour of the banks by giving greater significance to compensation for ‘harm or injury’. That argument works just as powerfully for the bank as for the borrower.

Islamic banking is encouraged by the Islamic revival. What is sometimes branded by the media as Islamic fundamentalism is better regarded simply as an Islamic revival. In certain cases it may not help the tourist industry of some countries. This revival in countries such as Pakistan, Iran and more recently Egypt, Libya and Algeria has increased the importance of Islamic banking.

Jeremy Martin, Partner, Trowers & Hamlin,
London
Reflecting on the current state of banking and economics, and Islamic banking, it is fair to say that there is a nagging feeling that bankers and economists have no real locus or centre for their ideas and motivations. There is also the growing realisation that Western bankers and economists are not the source of all knowledge, and perhaps Islamic bankers and Muslim economists have a unique contribution to make.

Islamic banking has its locus in Allah, and the banker, like all other people, is the custodian of God's resources. The bottom line is that profit must yield to the social concerns of economic policy. The essential first principle for the Islamic banker is that he must have a moral obligation to his customer and vice versa. Each shares in the good fortune of the other as productive agents of God's earth. This principle cannot be forgotten, for it is the singular principle that makes Islamic banking what it is.

Rooted in this principle is the question of how to develop products and services for customers and what is the unique contribution of Islamic banks? The Islamisation of a bank by itself is not enough. It will not attract customers simply by appealing to the piety of Muslims, since for most clients other factors such as convenience of location, personal relationships and especially the kind of services on offer are the basis on which
an individual chooses a bank.

If an Islamic bank can offer a good network and range of services, and on top of this makes the Islamic argument compelling, only then will they be able to attract new customers. The strategy cannot be reversed. One does not convert the believer to the argument and then ask the question “how are we going to deliver?” or force the customer to forgo certain services that he has been used to with a conventional interest bank.

Customers often take a good track record into account when considering opening a bank account, but Islamic banks often cannot show evidence of such a track record. Nor on pricing can direct comparisons be easily made between the two types of bank. Indeed it is difficult at this early stage of Islamic banking to gauge the impact of Islamic banking, but investment funds have been estimated at having anything from several billion dollars up to $50b under management. In 1993 Kleinwort Benson saw a 40 per cent rise in funds under management, and the United Bank of Kuwait’s Islamic Investment Unit estimates that growth in Islamic investments in 1993 was about 20 per cent in real terms.

So it is up to Islamic bankers to advertise their services. Whilst Muslims are aware of the ban on interest, due to the explicit objection made in the Qur’an, there is a lack of awareness of the alternatives that are Islamically acceptable. The concept of Murabaha is understood by some in the merchant field, but Mudarabah and Musharaka are still little understood techniques in the business community. This is changing as Islamic banks become more active, but it does leave the banks with a tremendous need for education.

The complexity of formulae for working out the financing of these techniques does not make the task any easier either. This task is again not helped by the fact that customers have highly sophisticated requirements. Most customers are already used to the high standard of financing or services offered by the large Arab banks or the foreign banks. A customer would need to have their experience translated into Islamic banking terms and
be approached in a professional and sophisticated manner. Islamic banks will succeed if they can offer good returns on investments and deposits, good financing techniques and a variety in product offerings. Traditionally, an Islamic bank’s activity has fallen into two categories. First, services which a bank renders for a fee, or on fixed charges, such as safe deposits, funds transfer, handling trade financing deals, property sale and purchase, and handling investments.

Second, investment of capital on the principles of partnership or Mudaraba. This is where the bank can add value particularly to entrepreneurs, providing supportive funding. In this way, the bank has acted as a partner in the business, and can provide the fee-based services as well.

Many of the Islamic banks to date have generally tended to go after the business customer, followed by the private bank customer, but consumers are now being targeted more aggressively. If a customer can marry financial satisfaction with religious duty, then s/he will be a loyal customer, and indeed prove to be a hard customer for competitors to lure away.

There must be now about 100 Islamic banking institutions operating in over 45 countries. Among these institutions there is division over what constitutes good Sharia practice. The stance taken by countries such as Pakistan and Sudan, where interest has been totally banned, does not really further the cause. Social responsibility cannot be forced; we can only offer a way towards it and encouragement to go in that direction.

Islamic banking will be more attractive to Muslims and non-Muslims alike if they are able to deliver efficient services, and demand effective use of technology. Investment in technology and appropriate financial software for Islamic requirements is an essential strategy for Islamic banks.

Many banks in the Middle East are currently investing in re-engineering their back offices, replacing outmoded computer services.

One of the ways this is being done is by importing Electronic Data Interchange (EDI), computer-to-computer linkages based on
a standard format used by all parties to any given transaction without manual intervention, re-keying information or paper. This allows banks and companies to integrate their operations internally and externally.

This would suit banks in the Middle East where there is revolutionary change and not a gradual evolution of systems as in the West. EDI would allow an Islamic bank to think about its present situation as well as what it would like to create in the future, and create a software environment where adapting to change and to new products is built into the bank's infrastructure.

For Islamic banking, this is the crucial point. As Islamic banking grows in market share, so too will the need for new financial products.

Having efficient technology is only the starting point; it gives the potential to offer a cost effective and timely service. However, to fully utilise this base and implement what Islamic banking has to offer, education and training is also a crucial element.

Unfortunately, education is sorely lacking. Islamic banking often invokes one of two reactions, being either cynically interpreted as replacing interest with fees or dividends that match the interest rate, or charging as simply not interest. Both customers and potential customers need to be educated as to what range of services are available to them.

Following on from having a technically competent infrastructure, a keen commercial sense and innovative products, a well-trained staff is also needed to communicate the message of Islamic banking. The market must also be educated - there is a large Muslim population to be reached, not just in the Arab world but globally.

The opportunity exists for Islamic banks and funds to reach Muslims in all corners of the globe. An Arab banker said recently that "we are good at propaganda, but not so good in public relations." Islamic bankers must learn to be communicators, to master the art of public relations, if they are to
escape the backwaters of the financial world.

To reach a global audience requires good marketing, well-researched documents and a clearly stated mission. True, relations with the Western media can often be difficult, but within the last year major positive stories have appeared in prestigious publications such as the Wall Street Journal and the International Herald Tribune.

Undoubtedly the media must be used to convey the message of Islamic banking. Once the groundwork is all in place, the next question to be asked is - what is it that Islamic banks are really offering?

An Islamic bank must be able to compete successfully alongside conventional banks by offering a full range of products and services to fit the requirements of most retail customers, namely, cheques, charge cards, current accounts, bill paying/zakat payments, investment funds, loans and mortgages.

More attention is required on the need for Islamically based retail investment products, since much of the financial engineering which Islamic banks can do lies in the area of offering retail investments, making use of investment trusts, unit trusts and mutual funds. Many Islamically accepted funds have been created, and they are successful in offering capital appreciation for customers, often outperforming conventional funds. More work needs to be done in defining how far banks can go in engineering such products, especially in the area of international funds.

In the modern world, credit cards are essential for people travelling abroad, and useful at home in reducing manual work and paper. A structure that strikes me as being most beneficial is a charge card tied to an investment fund, whereby the customer places X amount of funds into an investment which is held as security for the card, and then uses the card to leverage off those funds.

The benefit of such a card is that the bank has guaranteed repayment and the customer is able to have liquid funds while accruing value on the initial deposit which is being put to work.
The money is thus productively used in two ways, as a means to invest and in consumer spending. For most customers this could become the norm for an Islamic credit card and current account, since cheques and bill payments can be conducted in much the same way.

Attempts are being made across this region to generate liquidity in the local stock markets, and since it is easier to find Islamically acceptable equities in these markets than abroad, this may be a good place to start. The current problem for the stock market lies in attracting investment; a circular situation arises where liquidity is required to attract investors, but without investors there is no liquidity. Funds attracted by deposit-backed charge cards could be directed into local markets and benefit the local region greatly, taking another small step towards success in the stockmarkets of the region.

In the area of consumer loans, there are two broad groups of people who ask for bank loans. Firstly, those who require financial assistance because they want something they cannot afford out of their own resources, or have need of something they can’t pay for. The problem in the first instance is that banks can only advance loans to consumers from whom repayment may be guaranteed in some way, and such loans should be provided for under some form of state support or subsidy.

The second group are those who have assets and a source of income to secure or guarantee repayment of the loan, and require a loan to meet a temporary need from promised future income. In this case, overdraft limits may be agreed or certificates of sale, which act like a commercial bill of exchange, may be used as security to a sale. In addition, loans may be raised on a similar basis to the charge card scheme as outlined earlier.

Mortgages too have to be taken into account as in western economies, many consumers who were crippled by fluctuating interest rates on their mortgages, struggled to repay the interest due on the loan, leaving the banks with problematic mortgage portfolios. A great many people had to leave their homes, which were left vacant and unpaid for. This has a knock-on effect in the
economy which begs the question as to whether interest and credit creation are desirable economic goals, or effective means of financial measurement. This particular question cannot be addressed here; suffice to say many banks had their fingers burnt in the process.

The underlying point is that Islamic banks should not encourage the creation of credit beyond the needs of their customers, nor in a way that threatens conformity with the Basle Concordant. On this last point, there is some concern that certain Islamic banks do not meet the provisions required by the Bank for International Settlement (BIS). If Islamic banks are to be accepted as part of the normal fabric of financial life, and in international markets where there is a large potential Muslim market, then falling in line with the BIS is a necessary prerequisite.

Banking success lies in three elements. Firstly, by safeguarding depositors, money, not protected by a guarantee fund or financial insurer, but by bankers. Such safety will ensure the trust of one generation and gain the habit of the next. Second, ensuring that funds and deposits are invested safely with good returns, and make enough money to pass onto the customer whilst retaining a profit for the bank. Finally, by keeping expenses low, investing in technology, good administration and delivery of services and products.

In the last twenty years Islamic banking has made a significant impact, and it does have a unique contribution to make to the economic debate, not just in the Muslim world, but to all nations. The marriage of Islamic principles with modern commercial experience will ensure success for the next twenty years and beyond.

David Cowan
In recent years we have seen a great increase in the establishment and expansion of Islamic banks in Islamic countries of the Middle and Far East. Nonetheless, contacts with conventional banks have remained, with few exceptions, very limited. Where such contacts exist, they usually consist solely of adoption of conventional bank products such as L/Cs within the framework of Murabaha transactions or structuring of leasing transactions.

The products taken over by Islamic banks in such cases were established instruments used by conventional banks.

In other words, so far it has been more a question of Islamic banks tending to adopt products of conventional banks rather than conventional banks adapting to the needs of their Islamic colleagues.

I must emphasise the "so far" here: because Citibank has confirmed that they will be opening an Islamic bank in Bahrain. This is the clearest proof of the fact that opportunities for mutually profitable co-operation exist, otherwise Citibank would hardly be inclined to take such step.

What, now, are the foundations, what is the basis for co-operation between Islamic and conventional banks? Above all, the foundation consists of regulatory levels on which co-operation is based.
In international operations, the regulatory level for conventional banks consists of specific business practices or conventions which govern transactions ranging from handling L/Cs to bidding in connection with Eurobond issues.

Not only are these business conventions or customs uniform but even more important - so are international and national laws which constitute the second level. These laws must be observed for every financial transaction.

As conventional bankers, we have grown used to these levels. We all know how complex these regulations are. I am thinking here of the national tax laws and international tax legislation, for example. In this context, co-operation between an Islamic and a conventional bank would not be anything out of the ordinary. However, in addition to the regulatory stages, a third level comes into play when we co-operate with Islamic banks: - the Qur’an and its interpretation by the Sharia board.

This is a crucial point which - so far, at least - has been a potential source of problems.

a.) For one thing, the normal conventional banker has no idea what we are talking about here. Of course, it is fairly clear to us, but only to the extent to which specialists understand specific questions in their field which are not clear to a generalist.

We may consider ourselves fortunate if we meet a colleague who, when asked about Islamic banking, at least replies, 'Oh yes, that's banking without interest, isn't it?'

In other words, the first problem for co-operation is a problem of understanding or of the conventional banks knowledge of Islamic banking.

In this context, let me mention briefly a comment which appeared in “New Horizon” in October 1994. The title here was 'Islamic Banking - Too Many Conferences?' The critic, whose name was not published, is no doubt correct in many respects. But only from his personal standpoint. Considering that co-operation between Islamic and conventional banks is fundamentally a problem of understanding, I myself think that there are by no means enough conferences on Islamic banking.
However, these conferences should not be held in Tehran, Dubai or Kuala Lumpur. Here I find the critic is right: when talks are held on Islamic banking in these cities, it is not sufficient to give a general explanation of Islamic banking because the audience is already familiar with the basics.

None of us see Islamic banking as a closed shop with a few exotic offshoots like Citibank, Kleinwort Benson, ANZ, Goldman Sachs and now the Vereinsbank Group. On the contrary, we aim to develop co-operation on a broad front, so informative events such as conferences are necessary, and not just in London, which is certainly an exception, but in Frankfurt, Paris, Zurich, etc. This is exactly where the “general talk on what Islamic banking is about”, which the critic rejected, is absolutely indispensable.

Remembering the third regulatory dimension, the Sharia board, the first two being business practices or conventions and National and international law, Islamic institutions must be more active in approaching conventional banks in order to better explain these regulatory levels:

In Germany, we have a proverb which goes: “What the farmer doesn’t know, he doesn’t eat”

b) The second obstacle to co-operation is the general lack of knowledge on the part of conventional banks about the Sharia regulatory level and its interpreters, the Sharia board. As far as I know, there is no generally binding standard for interpreting the Sharia with reference to structuring financial transactions. I have found, for example, that fundamental aspects of co-operation with an Islamic bank in Malaysia are subject to other interpretations by the Sharia than is the case in Saudi Arabia or Iran.

For co-operation in a multitude of areas, however, we need a body of regulations which we know and can rely on, because in the final analysis, everything depends on the individuals who must carry out the various transactions.

The first time a conventional-bank officer does business with an Islamic bank, he calls in his legal department, the member of the board of management responsible for this area, etc.
Once this initial transaction with an Islamic bank has been concluded successfully, for example in Malaysia, the officer goes to other customers and offers them a similar deal. He finds a new client, who is interested in performing this very transaction, but in Iran instead of in Malaysia. The Sharia board of the Islamic bank in Iran rejects the transaction as not 'Islamic' - hopefully, with some indication as to how it should be structured, in order to make it 'Islamic'.

The officer from the conventional bank goes back either to his board of management or his legal department, which naturally is more time-consuming.

If he overcomes these obstacles and the transaction is concluded, it will be a big deal with a high margin because now that the individual departments of conventional banks are organised as profit centre- as indeed they should be - the deal must warrant the amount of time and trouble invested in it.

To sum it up, my second thesis is this:

A certain type of business is approved; conventional banks do not submit each individual transaction to the legal department for approval. Analogously, a formula must be found for co-operation with Islamic banks which will provide clear guidelines at least on a national level so the bank’s Sharia board need not be called in for every transaction.

Can this be done? I think so. A step in this direction is certainly the establishment of the “Council of the Islamic Fiqh Academy at Jeddah” in Saudi Arabia under the supervision of the Organisation of Islamic Conference (OIC). I hope that this approach will be developed further.

Since - as far as I can see - such a system is not yet in place, we only hear about large individual transactions such as ANZ and Al Rajhi in connection with the Pakistani Hub Power Project. We hear nothing about co-operation between an Islamic and a conventional bank which would be comparable, for example, to the traditional correspondent banking system.

At this point, I would like to make a distinction between co-
operation on large individual transactions and co-operation in so-called day-to-day business.

I see no distinct co-operation between Islamic and conventional banks on the level of day-to-day business.

To achieve this, banks would inevitably have to advertise, by means of active marketing (for example at conventions) in European and American financial centres, and to establish national Sharia boards for this purpose.

Should this happen, I believe there would be many opportunities for co-operation on several levels, since we as conventional banks can not only learn a great deal, but can also benefit, particularly on account of Islamic banks' liquidity overhang, from transactions which would be profitable for both sides.

c) A distinction must be made between co-operation in day-to-day business and in large individual transactions.

Administrative problems are of lesser importance here. Considering the risk involved, it is necessary and wise to have the Sharia board make individual decisions and to call in legal departments. Moreover, time plays only a secondary role. It is not by chance that Islamic banking has taken hold at merchant banks which specialise in transaction-oriented deals and not at commercial banks which are geared to standard business. (The only exception so far seems to be Citibank.) However, in large individual transactions, we encounter a structural problem for Islamic banks.

The client of an Islamic bank gives his liquid assets to this bank so that this liquidity, in compliance with the regulations of the Sharia, is introduced into the economy. It should be noted here that the client can always demand that these funds be returned to him. The bank must therefore maintain a high liquidity reserve at all times. This is because there are no Islamic capital markets so far where an Islamic bank can turn its long-term assets into tradable securities and where this bank can find daily liquidity.

The high liquidity reserve of Islamic banks is also the reason
why practically all Islamic banks are fairly expensive. I will return to this point later. Furthermore, co-operation between conventional and Islamic banks in large individual transactions is only worthwhile if the Islamic bank can participate in financing over the long term.

The reasons for this are as follows:

Large individual projects are usually long-term infrastructure projects in the broadest sense, involving financing construction of atomic energy plants, airports, roads and hotels. Only under certain circumstances do banks have the opportunity to offer financing for such projects; either in countries which themselves do not have the funds for these projects or in countries where the bank as financier is supposed to bear part of the economic risk, i.e, what is called project financing.

These two situations present problems for conventional banks. Only countries which cannot borrow money long-term in the capital market to finance infrastructure projects turn to banks for a solution. This is because calling in conventional banks to structure a deal naturally makes financing the project more expensive. The problem for conventional banks is then the credit risk. If investors do not want to lend to the country in question, why should banks?

As a rule this only happens if banks are better informed about the infrastructure project than the normal investor. If this is the case and the bank believes the project will be a financial success, it provides credit facilities whereby the project itself represents the collateral.

This is not the PLS or profit-and loss-sharing principle. The conventional bank does not invest in order to participate in the profit or loss, but takes the profitability of the project itself into consideration as the main aspect of the collateral construction.

Although this cannot be harmonised with the PLS principle of the Sharia, it is a strong rapprochement of the interests of conventional and Islamic banks which can supplement each other ideally. What, now, are these interests?
Infrastructure projects are urgently required for the economic development of those very countries which have trouble accessing capital markets. Usually, these are Third World countries, although in this respect we must include countries such as the Czech and Slovak Republics, Hungary and the successor states of the Soviet Union.

In contrast, much of the machinery and construction material comes from companies in the industrial countries to which conventional banks have maintained ties for decades and in some instances even for centuries. So much for the customer base. What conventional banks do not have or have very little of and because of their philosophy have never learned, is the willingness, in line with the PLS principle, to participate with the customer in the infrastructure project.

Here might lie the beginning of a well-balanced co-operation between Islamic and conventional banks since their interests are complementary.

As already mentioned, Islamic banks have so far not been able to invest in such projects over the long term, meaning more than five years. Yet this is precisely the time frame required to finance dams, airports and other infrastructure projects.

I would like to emphasise once again that the development of an Islamic capital market, where long-term risks are exchanged for liquidity, is an extremely important prerequisite for co-operation between conventional and Islamic banks.

So far I have mentioned the foundations which I believe must be laid or improved in order to facilitate more widespread co-operation between Islamic and conventional banks.

Nevertheless co-operation does exist. In most cases, co-operation has to do with leasing or short-term commodity financing.

The spread of Islamic leasing funds is an area with potential for co-operation with those conventional banks which are not willing to make their tax base available for specific leasing structures, for example the double dip.

The big advantages of conventional banks are their customer
base and their customer and market know-how.

Here I see opportunities to cooperate, in particular in financing these clients' liquid assets. Working capital loans are very frequently extended for purchasing and processing raw materials. I can well imagine that a conventional bank functions as a broker here and arranges a Murabaha transaction for a fee. I can imagine situations in which a working capital loan may be more expensive, since the client has already exhausted his credit lines with conventional banks and now must obtain liquidity from other sources.

In concluding, I would like to mention briefly the subject of pricing and Islamic banks since this is naturally an important point for co-operation. In general it is thought that Islamic finance is not only complicated but expensive. I won't go too far into detail about the reasons why Islamic finance is frequently more expensive than average. I have already mentioned one reason, namely the high liquidity reserves. Another reason is the PLS principle which, results in higher administrative costs.

What is important is that Islamic and conventional banks only co-operate when cheaper loans cannot be obtained. Islamic banks will have quite a difficult time in highly developed markets such as those in Europe or the U.S. with their multitude of financing possibilities.

This does not appear to be the case in emerging markets. In South Africa, for example - an area I know particularly well - I see good opportunities for developing co-operation between Islamic and conventional banks. In this context I would like to refer to an article in the New Horizon, September 1994, 'Islamic Banks pricing themselves out of the market' in South Africa. I agree in full with this article. I do not see the slightest reason why in this market an Islamic mortgage has to be more expensive than a conventional one:

"The real shock comes when the bottom line is reached. Very often the Islamic banker will concede that the mortgage repayment is equivalent to the conventional base rate plus a certain percentage which is always two or three percentage
points above the conventional interest rate for a mortgage bond etc. As such it is not surprising that potential Muslim clients of Islamic banks walk out in disgust.” (New Horizon, Sep. 1994, p.3)

In emerging markets like the South African Islamic banks can be competitive - at least I can see no reason why not; or are Islamic banks not willing to compete with conventional banks, i.e. do they separate the Islamic banking system from the conventional one on purpose?

Conventional banks in South Africa, which were banned from international capital markets for years for political reasons, not only do not know enough about obtaining cheap capital, but the risk assessment of conventional correspondent banks abroad is so conservative that obtaining capital is very expensive for South African banks. In a market like this, Islamic financing methods can most certainly compete with conventional banks when it comes to prices; but they must want to compete!

In general we can conclude that co-operation is likely to be far more successful in newly developing countries than in the markets of industrial countries.

Initial steps in the direction of co-operation have already been taken. To put these moves on a broader footing, Islamic partners must make it clear to their conventional partners that they have an additional regulatory level, the Sharia, which makes co-operation more difficult.

Conventional banks which are not used to or are not familiar with these regulations can only offer their entire product range passively. The Islamic banks, i.e. the Sharia board, must then decide which products they can accept, with or without changes. In order to do this, and I wish to emphasise this, Islamic banks themselves must have or develop the entire range of product expertise so that they can invite the more independently acting conventional banks to co-operate after the Sharia board has made its evaluation. I am convinced that there will be close cooperation in future. As markets continue to develop further and further, the margins of conventional banks will become
increasingly narrow. Opportunities for arbitrage within their own system will be limited. It is an elementary law of economics that in such cases, those involved will seek profitable opportunities for arbitrage. Where could opportunities for arbitrage be greater than between different banking systems? The market economy will inevitably bring us together.

Dr. Eric Hirsch,
Head International Products,
Bayersche Vreinsbank
There is much debate as to whether or not Conventional banks and Islamic banks should, or even could, co-operate. The opposing positions are broadly the following:

The anti-co-operation lobby's position - which comes largely from two groups - from Western as well as Islamic sources - is that Islamic banking should stay purely in Islamic financial institutions. Conversely, those in favour of co-operation say that first, the more people there are trying to find the answers to some fairly complex, practical questions the better; and second, that philosophically and, importantly, financially - co-operation leads to efficiency. In short, inefficiencies within the current Islamic financial markets can best be overcome by experts in Islamic and Western banks working together.

But the subject of this chapter is interaction rather than co-operation and I want to build some ideas on the co-operative theme looking at parallels in past and current developments in conventional banking and what I believe may be happening in the Islamic market.

From these, I have spent some time considering future points of interaction between the two financial systems, Islamic and non-Islamic.

The first parallel involves the historic separation between
commercial banks and investment banks in many western countries - notably the U.S.A. Historically, there has been a division between, on the one hand those financial institutions which have, as their bread-and-butter business, been active in the routine deposit and loan markets, dealing with the man or woman in the street, financing, by loans or overdrafts, corporate manufacturing or trading activities; and, on the other hand the investment banks or houses which have concentrated on the securities markets, bonds, equities and so forth.

Before the share capital and debts of companies became regularly tradable in paper form, there was no separation between commercial banking and investment banking. In a very real sense, all banks fulfilled the functions of both investment banks and commercial banks.

Here is the parallel; I believe that in Islamic banking we are at the point where we are beginning to see a similar type of separation or division of roles and functions. This is not, however, being driven by the regulators and legislators.

On the one side we have the now fairly well established commercial Islamic banks, particularly in the Gulf, which have developed to serve the needs of the local centres in which they are based, by taking quasi-deposits through savings accounts and financing local, and frequently international, trading by low risk, short-term commercial facilities (through Murabaha, Istisna or similar instruments).

On the other side we are beginning to see specialist Islamic investment boutiques being established in places like Bahrain, Kuwait, Qatar, Pakistan and recently Malaysia. These new entities will - given half a chance - become the Morgan Stanleys, Goldman Sachs and S.G. Warburgs of the Islamic financial system. The function of the new Islamic investment banks or companies will not be to compete with the routine retail, commercial aspects of the Islamic banks, but rather to bring a new brand of innovative and sophisticated Shariah-compatible investment structures and products to the Islamic financial marketplace.
Where then, in this new set up, will the interaction between Islamic and conventional banking take place?

Commercial Islamic banks and commercial conventional banks have been working closely together for fifteen years or more. My proposition here, however, is that what will bring the two systems into closer interaction will be the developments in Islamic investment banking; specialised structured financing and funds, Islamic securities trading in a fully fledged secondary market and eventually certain types of derivative instruments which conform to Islamic principles. It will be interesting to see how the commercial Islamic banks react to the changes.

The second parallel which will, I believe, bring increased interaction is the growth in ethical investments by western investors. This is a large, well documented topic; suffice it to say that it has many echoes in the Islamic investment universe. But, to build further on this first thought; more currently, during the last year we have seen the worst bond markets - bond markets being the flagship of the conventional financial system - since 1926. In fact (measured by the Benchmark 5-year treasury), this current year has been almost twice as bad as the previous worst year (out of 70). By some calculations some investors have seen 20% or more wiped off the capital value of holdings which, in years past, have been seen as totally safe (like U.S. Government Bonds, for example). But what has happened in the 'real' market? The most noticeable thing has been the worldwide rise in the price of commodities - of basic things which people use and consume - coffee, metals, oil etc. And what of the previously fashionable habit of leverage, of borrowing money to finance larger holdings of financial assets? One has only to look at what has been happening in Orange County, or to some extent the large hedge funds, to see the chaos that this can cause.

The point I am making here, in the context of future interaction, is clear. In two distinct areas - ethical investment and a need to concentrate on financing real assets with real money - the conventional financial system will have a much more compelling reason to interact with Islamic commercial and
investment banks in the future.

Let me pull the strands of my two parallels together to close. Imagine two quite separate systems, one Islamic banking and one conventional, co-existing, with only sporadic interaction, and one of these - that of the Islamic banks - has had something of a shock in the last year or so; it has a new, dynamic and, in a technical sense, a conventionally trained and oriented set of Islamic investment bankers challenging the old order;

The other system, the conventional financial system, has had something of a shock too, first the old orthodoxies of amorality have been challenged by the progress of ethical and so-called green funds; second - and I think it has more to it than whether we are in one cycle or another - there has been in some quarters a cultural shift away from purely paper, financial assets to real assets both in the developed and the emerging markets.

It may be that we will see the two systems moving closer together. As they move closer there will be more interaction. I believe that more interaction is not only beneficial - to the western as well as the Islamic financial markets -but necessary and, in a global market, inevitable.

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London.
This chapter provides a review of Islamic banking development. It stresses how the position of international banking vis-a-vis the Muslim world has been reversed. During the European colonial period it was largely international banks that were influencing financial change in the Muslim world. Today it is the new Islamic banks which are starting to influence financial developments in the Western world. There are challenges for ethical institutions operating in markets largely where the motivation of other participants is solely financial. This chapter addresses some of these challenges, especially in the field of investment banking.

The Penetration of Colonial Banking

Modern banking was first established in the Islamic world in the mid-nineteenth century. Financial intermediaries were not of course new to the region, as the sophisticated Muslim trading economies had long used specie as a means of exchange, and moneychangers and moneylenders carried out their business in most urban centres. Moneychangers were especially active in the cities of the Hijaz such as Mecca and Medina, catering for needs of the pilgrims, demonstrating that there was no Islamic objection to currency dealings and the exchange of precious
metals. The prohibition of riba or interest, in the Qur’an meant, however, that there was much suspicion of conventional commercial banking in the form in which it had developed in Europe.

The early commercial banks were all European owned, the Imperial Ottoman Bank being an Anglo-French Imperial Bank of Persia, British owned and managed. Much financial intermediation in the Ottoman territories was in the hands of Greek Christians or Jews, rather than Muslims. The latter were keen traders, and indeed the Prophet Muhammad had been a trader, but there was a reluctance on religious grounds to get involved in the collection and lending of money. Muslim traders granted credit in kind on a deferred payment basis rather than charging interest. Advances were covered from personal and family equity rather than from savings attracted from strangers by the promise of interest.

The Imperial Banks served the government and the trade of the European Empires rather than the local Muslim business community or the wealthy landlord class. The management of Ottoman debt was a major undertaking, and the Imperial Ottoman Bank acted on behalf of the Sultan in arranging bond issues in London and Paris. The Imperial Bank of Persia was closely involved with the Anglo-Iranian oil company, latter to become British Petroleum. The National Bank of Egypt, a wholly British owned institution, was mainly involved in the finance of cotton exports, on which the Lancashire textile industry depended. This trade was controlled by Greek and Levantine merchants rather than Egyptian Muslims. In Malaya the Hong Kong and Shanghai Bank was active in the finance of the rubber trade, but even the plantation workers were immigrants rather than indigenous Muslims.

Muslim Owned Commercial Banks

It was not until the 1920s that groups of Muslim businessmen began to realise that traditional financial intermediation was of limited value in modern economies. For
large-scale deals, especially with foreigners, letters of credit, guarantees and acceptance of bills were indispensable. Such facilities significantly reduced transaction costs, and could result in deals being made which might otherwise be missed opportunities. Yet money lenders and money changers were unable to provide such facilities. At the same time potential Muslim clients often experienced difficulties in obtaining credit from the European-owned banks.

The only answer was for Muslim businessmen to found banks themselves. It was these pressures that resulted in the establishment of Bank Misr of Egypt, the Arab Bank, a Palestinian institution, the Habib Bank in British India and other similar commercial banks in many Muslim countries and communities.

Banks had been kept out of Saudi Arabia by King Abdul Aziz who believed that only infidels or unbelievers patronised western banks, whose practices could never be Islamically acceptable. With the kingdom's development and the discovery of oil there were strong pressures to admit foreign banks, and even Bank Misr applied for a banking licence, as its directors thought their Muslim credentials might impress the king. Permission to establish a branch was refused however, but when two well respected local moneychangers applied for a banking licence, the Bin Mahfouz and Kaki families, the king agreed, after consultations with some prominent Jeddah merchants. The licence was conditional on the bank operating in a way which was acceptable to the majority of the Muslim faithful. This meant avoiding interest payments or receipts. The institution established the National Commercial Bank, charged fees for its services, and provided current accounts for its customers on which no interest was paid. Lines of credit had to be agreed in advance, and contracts between the bank and its clients set out clearly, according to the prescribed Quranic rules on just trading practice. The Sharia religious law would apply to banking in Saudi Arabia, as it was this that governed all commercial practice.
Nationalisation and Muslim Nationalism

The political revolutions in Egypt, Syria and Iraq in the 1950s resulted in both the colonial banks and the private Muslim banks being taken into state ownership. In Pakistan the banking system was nationalised a decade later, and in most Muslim countries the state was to play a significant role in the financial system. The intervention by the state was not due to Islamic ideology, indeed the Sharia law is concerned with inheritance matters in the context of the private ownership of property. Rather the nationalisation measures reflected the adoption of a planned approach to economic development, and an attempt to introduce heavy industry following a Soviet type of model.

The nationalised banks mainly advanced funds to the new state-run industries, the allocation being determined by the priorities set out in the development plans. Quotas were set for each industrial sector, and even individual plants, which meant there was scarcely any flexibility to allow for changing circumstances, or indeed new opportunities. In practice the funding available was often less than had been anticipated, which meant across-the-board reductions in lending ceilings rather than selective cutbacks on which it might have proved difficult to get agreement.

One problem was that the nationalised banks failed to attract new depositors. Ordinary citizens appeared unimpressed by the fact that their deposits were more secure, as government-owned banks were unlikely to go out of business. Interest was paid on savings deposits, but the rates were low, and scarcely compensated for inflation. Financial repression prevailed in the sense that savings were not harnessed by the formal banking system. Instead there continued to be much hoarding of gold and, to a lesser extent, silver. Moneychangers and moneylenders continued in business, catering for needs which the nationalised banks clearly did not cover.

Evidence of the failure of the nationalised banks is easy to find. Bank deposits were worth less in Syria and Iraq, for example, than they were in Jordan, a much smaller country,
where there had been no nationalisation measures. The ratio of bank assets to gross domestic product was static in Egypt, and fell in Pakistan, indicating financial shallowing rather than the deepening that might be expected with development. The bureaucratic nature of the nationalised banking business put off many potential clients. There was a reluctance to widen the range of financial services on offer, and no competitive pressures to innovate through the introduction of modern technology.

In some Islamic countries, notably the Gulf states, Malaysia and Indonesia, governments have favoured privately owned banks in the form of publicly quoted joint stock companies. There has nevertheless been a desire to see a majority ownership stake in the hands of local Muslims. Following independence in Kuwait the branches of the British Bank of the Middle East were sold to indigenous investors and the bank became the Bank of Kuwait and the Middle East. In Saudi Arabia sixty percent of Citibank's operation was offered to the public, and a new institution created, the Saudi American Bank. The injection of Saudi Arabian capital into the hitherto foreign owned banks enabled them to expand, creating a more competitive financial environment.

An Islamic Financial Alternative

There was considerable dissatisfaction with conventional commercial banking in most Islamic countries, both on the part of Muslim scholars and intellectuals, and amongst the general public, who were aware of the Quranic position on interest. Merely having fees and service charges instead of interest was not seen by many as a satisfactory solution, and in many Muslim countries interest was quite open. Some thought that only usury was prohibited and in any case charging interest to business borrowers could not be a problem on religious grounds, if the aim of the prohibition on interest was to protect the poor private borrower from suffering hardship. In the United Arab Emirates a court ruling outlawed compound interest, but permitted simple interest. In Turkey, where inflation has long been a problem, it
was argued that nominal interest to compensate for price rises was justifiable, as long as there was not a real interest burden on borrowers.

Such arguments, however, did not impress fundamentalist thinkers. Their concern was not merely with the prohibition of interest, but with the introduction of participatory finance as a real Islamic alternative. Earning a predetermined return for merely hoarding could not be justified. Profit as a result of risk-sharing was not only legitimate, however, but highly desirable.

**Profit-Sharing**

The principle of profit-sharing, which was well established in Islam, was known as Mudaraba. Depositors could earn a share in either the bank's profits or the profits from a specified investment. Usually profit-sharing deposits are described as investment accounts, with the depositor required to give a minimum period of notice for withdrawals, usually from one month up to a year. The rate of profit is declared by the bank at the end of the financial year after the accounts are audited, and the depositors' profit share is greatest for the longer notice accounts. If the bank is making a loss, no profit share may be offered, although profit payouts to depositors generally take precedence over dividend payments to shareholders.

The value of deposits is usually guaranteed, unlike bank equity, the price of which depends on stock market conditions. There is less risk therefore for holders of investment accounts than for equity investors, but the latter have voting rights at the annual general meeting of the bank, whereas depositors do not.

Islamic banks also offer current account facilities for transaction balances, which can be instantly withdrawn by cheque or automatic teller machine. No return is offered to current account holders, but in some cases international charge cards such as Visa are offered to depositors, though these are managed on a direct debit basis rather than as credit cards. Usually only current account holders can apply for credit.
Credit Facilities

The use of bank funds reflects the demands of their clients and the environment in which the institutions operate. As much of the finance required in Islamic countries is to fund trading activity, Islamic banks are not surprisingly most active in this field. Islamic trade financing is offered on a Murabaha basis whereby the bank purchases goods on behalf of the client, and later resells them to the client at a mark-up. The bank charges the mark-up to cover its costs and to allow a return for the risk it takes on during the period it owns the good being traded. The Islamic bank usually does not take delivery of the goods itself, but it has the responsibility of ownership, unlike a conventional commercial bank.

Islamic banks also offer longer term credit facilities through leasing or Ijara, especially for items of capital equipment. In some cases this may involve hire purchase or instalment sale where the customer eventually acquires ownership of the equipment. Longer term participatory finance is also provided by an Islamic bank becoming a partner in the business according to the principle of Mudaraba. The bank may provide all of the funding, acting as sahib al mal, the financier, while the business partner, as mudarib, provides the entrepreneurial skills and management.

Under a Musharaka equity-sharing arrangement, funding may be provided to an existing company. Alternatively a new company can be established as a financing vehicle which may be wound up after an agreed period.

The Spread of Islamic Banking

The first modern Islamic banking institutions were farmer credit unions in Pakistan in the 1950s, and the Mit Ghamr Savings Bank, a small rural institution founded in Egypt in 1963. The latter was modelled on the German local savings banks which had impressed Ahmad al Najjar, the bank's founder. Influential elements in Nasser's political party, the Arab Social Union, and some of the senior managers in the country's
nationalised banks disliked al Najjar's initiative, and the Islamic nature of the institution. In 1971 it was incorporated into a new government controlled institution, the Nasser Social Bank, which had responsibility for the collection of zakat, the Islamic wealth tax. Many saw this new institution as a state agency rather than a bank.

The major expansion in Islamic banking came in the 1970s with the establishment of the Dubai Islamic Bank in 1975, the Faisal Islamic Banks in Egypt and the Sudan in 1977, the Kuwait Finance House the same year, the Jordan Islamic Bank in 1978 and the Bahrain Islamic Bank in 1979. The impetus was partly the oil revenue boom in the Gulf and the growing economic muscle of the more conservative Muslim states of the Gulf at the expense of the more secular Arab Nationalist movement. There was in any case a growing dissatisfaction with Arab socialism, especially amongst the young, and a feeling that there should be a greater emphasis on Islamic values in all spheres, including the economic and financial.

The Internationalisation of Islamic Banking

Gulf business interests strongly supported the new Islamic banking movement. Prince Mohammed bin Faisal of Saudi Arabia was the instigator of the Faisal Islamic Banks. Sheikh Saleh Kamel's Dallah group based in Jeddah aided the Jordan Islamic Bank and funded the Albaraka Islamic Banks which spread from Turkey to Tunisia, and even to London. The al Rajhi-money changing group applied for an Islamic banking licence in Saudi Arabia, and offered Islamic financial services internationally through their London-based investment company. Prince Mohammed founded Dar al Mal al Islami, the House of Islamic Funds, as an international financing institution based in Geneva.

The new Islamic banks had to compete with the conventional interest-based banks in most Muslim countries, but appear to have been particularly successful in attracting deposits. The Kuwait Finance House accounts for one fifth of total deposits in its home country, and the Jordan Islamic Bank has
succeeded in attracting deposits from poorer people who had not previously used banks. Financial deepening has been helped by the new banks, which often complement rather than serve as a substitute for existing banks. Islamic banking has now spread to Malaysia and Indonesia, and Bank Islam Malaysia has funded many promising industrial ventures, including those run by Chinese-speaking non-Moslems. Bank Muamalat Indonesia would appear to have enormous potential in a rapidly industrialising country with 160 million Muslims.

Some commercial banks have started offering Islamic banking facilities, including the state-owned banks in Egypt and the National Commercial Bank in Saudi Arabia. Even some European banks offer Islamic financial products, including Kleinwort Benson of London and the Swiss Banking Corporation. Islamic financial instruments are increasingly accepted internationally, even in non-Islamic countries, and the basic principles understood.

In Iran and Pakistan, the entire financial system was Islamised in the 1980s, and all banks in those countries operate under the Sharia religious law. Not only is interest prohibited, but all deposits are accepted on a participatory basis and financing is entirely through Islamic instruments. It is too early to assess the success of these experiments, as Iran's economy was severely damaged in the lengthy war with Iraq, and Pakistan has been subject to political instability and ethnic tensions.

It is clear, however, that Islamic banking is no mere passing phenomenon. Ethical concerns are perfectly consistent with profitability, and the Islamic banks have been able to harness long-term savings on more favourable terms than secular institutions. The substitution of equity for debt finance is advocated by many development agencies. Participatory finance is especially suited for small business, and there is a venture capital gap in many Muslim countries. Islamic finance can meet these needs, and provide a workable alternative to conventional lending. Of course, teething problems have inevitably occurred, but the experience so far is encouraging. The best motivation is
moral rather than merely financial, and Islamic financial intermediation has been welcomed by many with considerable enthusiasm.

**The Future of Islamic Banking**

Islamic banking has become a $50 billion industry in terms of assets held. Yet this represents less than one percent of bank assets world-wide. There is clearly considerable scope for expansion both in countries with majority Muslim populations and in the financial markets of the West. At the retail level it should be possible for Islamic deposits to account for around one quarter of the total in the Gulf states, Jordan and Egypt by the year 2000. Progress in other Arab states such as those of the Magreb may depend on political developments. In Syria and Iraq, which at present have no Islamic banks, political factors will also be crucial. In the fastest developing Muslim economies, Turkey and Malaysia, Islamic banking is poised for expansion, with the increasing wealth of the Bumiputra in Malaysia providing much of the momentum. In Turkey there are no official impediments to Islamic banking, it is very much up to the banks themselves, the crucial factor being to convince the banking public through effective marketing.

Iran and Pakistan should see their Islamic financial systems developed, with a wider range of products on offer, and more emphasis on long-term equity financing. The Islamic Banking Law of 1983 has proved successful, as the banks have been able to maintain their deposit base in spite of the financial difficulties caused by the Iraq Iran War and the fall in oil prices. Although Iran has currently some problems with its international indebtedness, some firming of oil and gas prices should help its economy in the years ahead. The effort put into getting the country's education system to cope with a greatly enhanced number of pupils should start to pay off, especially with numbers now stabilising.

For Islamic banks one of the major challenges will remain how to handle their liquidity. The banks have been more
successful in attracting deposits than in identifying funding opportunities. Some have merely catered for their liquidity needs by re-depositing funds with other institutions, including Western banks which have undertaken to use the deposits in accordance with Islamic principles. This may be satisfactory as a temporary expedient, but in the longer term Islamic banks will want to handle more of the business themselves rather than passing it to other institutions. To do this they will need to build up their expertise and establish a wider range of business contacts, including those with non-Muslims in the West.

Internationally Traded Mudaraba Certificates

One major problem is the absence of an international market in Islamic financial instruments. A number of instruments have been issued in Pakistan and are traded within that country including Mudaraba certificates of Islamic investment companies, solidarity bonds of Islamic insurance companies, and participating term certificates. The latter were issued as a replacement for interest-based debentures and are based on the principle of profit-sharing, but in practice are less liquid than conventional bills or bonds. For such instruments to be traded in international markets they would have to be sponsored and accepted by the major multinational banks. This would be feasible if there were a demand from governments in the Islamic world to finance their foreign spending through such instruments. Some criteria for performance would have to be worked out, such as growth in foreign exchange receipts as a proxy for national profits. Countries could obtain funding from international markets on the basis of projected foreign exchange receipts which would give an indication of ability to repay.

The more favourable the projection for foreign exchange receipts, the more attractive would be the instruments for investors and the greater the country's capacity to tap international markets. This would ensure that only countries with the ability to generate foreign exchange earnings from foreign exchange receipts obtained funding, thus preventing
more of the Third World Debt problems that created such international financial problems in the 1980s. If foreign exchange receipts were less than those projected, then a lesser amount or even no profit would be distributed to investors. If the foreign exchange receipts were higher than the amount forecast, then a profit rate above the benchmark would be paid. Clearly the forecast for foreign exchange earnings is crucial. These forecasts could be provided by the Islamic Development Bank in cooperation with the International Monetary Fund to ensure international credibility. The Mudaraba certificates could be issued for a period not exceeding five years, as forecasting foreign exchange receipts is difficult. As the aim must be to make the certificates attractive to international investors, it seems appropriate that new, untried instruments, should be issued for a shorter period than conventional bonds.

It is important to bear in mind that this type of Mudaraba finance represents commercial funding, not foreign aid. Muslim countries such as Malaysia and Turkey are likely to benefit the most and states like Sudan and Bangladesh the least. This finance should not be seen as a substitute for development assistance, but rather as a way of attracting Euro market funds, which would not otherwise have gone into Islamic instruments. The advantage is that the access to global capital markets is enhanced for those Muslim states that can best utilise international finance. Such states are not competing with poor Muslim countries for funding, but rather with non-Muslim newly industrialising countries in East and South East Asia and Latin America.

**Islamic Equity Investment**

Participatory finance through Musharaka was one of the earliest forms of Islamic finance involving a partnership between the provider of the capital and the user or entrepreneur. Such financing was used widely and successfully in the Muslim world, usually for the funding of small businesses. Short-term trade finance was available through Murabaha arrangements,
but longer-term capital projects were funded through Musharaka. There was usually a formal contract between the parties specifying the amount of the funding, the proportion of the profit shares, what happened in the event of losses, and the terms of divestment. Usually the Mudarib would have to be consulted if the provider of the capital sold his stake in the business to another party. Divestment was the usual ultimate outcome, but this could not simply be carried out unilaterally as happens with the sale of equity in a traded stock.

Traditional Musharaka can be looked upon as a type of venture capital financing, with relatively high risks involved for the provider of the funding. The risks are greater today given the much more competitive international conditions than they were in the isolated, and to a large degree, sheltered markets of Muslim countries historically. In this modern context the number of individuals who are in a position to provide Musharaka financing is limited, although modern Musharaka funding through equity market participation may have much smaller risks because of the ease of divestment.

Perhaps the best method of Musharaka financing in a modern financial context is through Islamic banks. Because the banks have the resources to build up diversified Musharaka portfolios, they are able to engage in such financing at much lower risk to themselves. Yet Islamic banks appear to concentrate excessively on short-term Murabaha financing, and have neglected to a considerable extent the possibility of Musharaka. In so far as they undertake longer-term finance it is through Ijara or leasing. Although useful for many Muslim businesses, this cannot be regarded as a substitute for Musharaka, which involves risk-sharing through partnership. Musharaka is regarded by many Sharia scholars as the mode of financing which comes closest to the Islamic ideal, and there have been many who urge its use more widely. Given such opinions, why have Islamic banks not undertaken such financing to a greater extent, and what can be done to encourage its development?
Stock Markets in the Muslim World

If Islamic banks could liquidate their Musharaka investments they would be more willing to undertake this type of financing. Stockmarkets are underdeveloped in most Muslim countries however, perhaps reflecting ethical concerns about the speculative nature of much of the buying and selling in such markets. One possibility would be to have a parallel Islamic market which was run on more ethical grounds, but from a financial, and perhaps conceptual standpoint, this is by no means straightforward. There has been some debate over the merits of having a specifically Islamic stock exchange, mainly in Malaysia in the context of securing greater access to the financial markets for the Bumiputra. Kuala Lumpur has by far the largest stock market in the Islamic world, but much of the trading is dominated by Chinese brokers dealing largely in the shares of companies with only a minority statutory Bumiputra stake. The debate has included proposals to Islamise the Kuala Lumpur stock market, which is regarded in some quarters as too speculative. There are also proposals to create an alternative Islamic market, while leaving the main market free to operate in its present form. Another more modest possibility is simply to have Islamic windows into the existing market, where equities would be vetted to see if they are acceptable from the point of view of the Islamic investor.

Such vetting is already offered by private Islamic investment companies, who could perhaps co-operate to draw up a joint code for the vetting of investments. This co-operation could be voluntary in nature, with the companies jointly funding an association concerned with the standards for Islamic financial products, and possibly also training for those involved with such products. The association's brief could also include promotion and marketing of a general nature, or in other words, “image building” for Islamic investments.

The other stock exchanges in the Islamic world which are classified as emerging markets include the exchanges in Istanbul and Amman. The former is the second most active after Kuala
Lumpur, and the ambitious Turkish privatisation programme is expected to give it a considerable boost. Turkey is attracting the attention of western fund managers as a market with good potential but only moderate risk. Amman attracts funds both from local investors and Jordanians and Palestinians living overseas. If the Middle East peace process moves forward it could be given a considerable boost, as it is the logical place for companies serving the Palestinian market to be based, at least for a lengthy interim period. The stock exchange in Amman has not surprisingly been volatile to political developments in recent years, however, and potential investors should weigh up the political risk factors.

Although the Cairo stock exchange is the oldest in the Islamic world, with a financial history that goes back over a century, it has only recently recovered from the long period of uncertainty that followed the nationalisation under Nasser in the 1950s and 1960s. There has been much debate over privatisation, but vested interests in the public sector, and the ultra cautious policy of the Egyptian government has prevented much progress being made. In Iran the stock exchange continues to mark time, as the attempt to boost investment in the early 1990s only resulted in the growth of international debt as oil revenues were below expectations. In Pakistan political uncertainties have inhibited the development of the Karachi market, not least the inconclusive debate about whether the economy should be Islamised and what this means in practice. Bangladesh faces daunting economic problems, which the development of effective institutions on the Grameen Bank model could help solve, yet economic and financial matters seem a low government priority as its politicians argue about issues of no significance for development. Both domestic and foreign confidence in the country remain low.

Halal Investment in Western Financial Markets

Given the lack of development of stock exchanges in much of the Islamic world, one option for Islamic investors is to simply
place their funds in western markets. There has of course been much recycling of oil revenues from Muslim oil-exporting countries since the 1970s, both official and private, although the oil price falls and the defence expenditure needs arising out of the Gulf war have eroded the official asset holdings of Saudi Arabia and Kuwait. Private Arab investments in London, New York and other major international financial centres remain considerable, with these being channelled through commercial banks, investment companies and to a lesser extent unit trusts, or simply placed directly into equities and bonds. There has also been capital flight from countries facing political uncertainties in the Islamic world, and often a natural desire to maintain hard currency earnings rather than repatriate funds into countries where rigorous foreign exchange controls are in force. The attraction of holding assets denominated in stable currencies has also kept funds in western markets, especially from those countries with rapidly depreciating currencies.

In the last 10 years there has been an increasing demand by clients from Islamic countries and Muslim residents in the West to ensure their that funds in western markets are placed and managed according to the Sharia law. What criteria should western investment management use if confronted with such demands, and from where should they get advice? There are of course numerous Sharia advisors versed in Islamic law who can be called upon to advise, although it is best to engage someone with an established reputation. The other alternative is to enter an arrangement with an institution which already provides such services, through either a one-off deal, or alternatively on an ongoing basis if there is likely to be substantial continuing funding.

Constructing banking facilities for deposits on a Mudaraba basis is relatively straightforward, as there are well established procedures for profit-sharing. More difficulty is likely to be experienced in deploying the funding, however, Murabaha mark-up trade financing being the most straightforward type of deal if suitable financing opportunities can be identified. The
alternative is simply to redeposit the money Islamically with an institution used to working in this area.

**Screening Companies from an Islamic Perspective**

What selection criteria should be used when determining which companies are acceptable from the point of view of Islamic investors? How should the companies be ethically monitored? Can such monitoring be carried out in a cost effective fashion given the large amount of published information available in most company accounts? How much attention should be paid to company mission statements? How seriously should press reports be treated? Does the rejection of companies on ethical grounds imply that an Islamically acceptable portfolio will yield lower dividends and smaller capital gains than one not subject to non-financial constraints?

There are a multitude of issues that confront any Islamic investors wanting to place funds in equity markets. Purists could of course argue that all investment in western markets and those of most Muslim countries is unacceptable, as quoted companies inevitably deal with interest based banks. Many deal in products which are not acceptable to Muslims, even if their main business is halal. Food retailers and hotel chains, for example, often derive a proportion of their revenue from alcohol sales, but does this mean that such businesses are to be classified with breweries and excluded from any Islamic investment portfolio?

Traditional arrangements involving Musharaka represented a type of high-risk Islamic venture finance, with the financier often unable to liquidate his or her assets as the company was unquoted, and a buyer could not easily be found. Such financing may be appropriate for specialist venture capital companies, but private individuals and conventional investment companies usually want more liquid assets. If finance is to revolve and deployment to work efficiently, marketability is essential. Asserting that all Islamic equity finance should be in small unquoted and highly risky companies is to deny Muslim
investors the opportunity of participating in global capital markets. For a diversified portfolio involvement in western markets is essential, with perhaps some exposure in Istanbul and Kuala Lumpur, although again this may not be seen as halal to some purists, given the involvement of the leading companies in these markets with interest-based banks.

In an imperfect world, where most financial markets do not function according to the Sharia law, pragmatism may be considered the most appropriate way of serving Muslim interests. The government of the Islamic Republic of Iran allows its companies and banks to deal normally in western financial markets, even though the internal financial system is Islamised. It has little choice but to accept this second best solution if it is to continue trading internationally.

For equity investment it can be argued that investing in companies involved with interest-based banks can be dealt with in a similar fashion. Furthermore what matters is the company’s main business activity, and it is inappropriate to boycott an otherwise acceptable trading company such as a supermarket chain simply because a small proportion of its activities are haram. Adopting a five or ten percent rule for unacceptable activities is possible, although such criteria are, of course, arbitrary.

**Muslim Values and the Conscience of Individual Investors**

For the ethical investor who wishes to deploy his or her funds according to personal religious values, the ultimate test must be the investor’s own conscience. Sharia advisors can help, but all human agents inevitably disagree. While respecting the advice given by eminent Sharia scholars, the devout Muslim can nevertheless read the Qur’an himself or herself, and seek guidance through prayer. The investor will want to ensure that not merely personal financial interests, but those of his or her family are safeguarded, indeed the interests of all those whose welfare the investor is responsible for. These responsibilities are also a matter of conscience which have to be balanced with the
quest for financial purity. Financial management concerns the stewardship of resources which, for the devout Muslim, are ultimately provided by the Almighty. The ordinary investor can only do his or her best to carry out financial responsibilities in an honest fashion.

Investment would be easier from an Islamic point of view if company accounts could be dissected, and halal separated from haram activities, so that Muslim funds could be concentrated on the former. This presents major difficulties, however, not least because it can be argued that any haram activities will poison the whole company. It is in any case impossible to separate out the share ownership of a quoted company as there is no split for ethical and non-ethical capital. The choice is either to purchase or refrain from purchasing. It would also be time-consuming to attempt to dissect company activities. The more time which is spent on investment appraisal, the less there is for other activities, including family and Muslim community obligations. It is easier for a recluse or a hermit to be absolutely thorough over financial activities than for some one leading a more balanced life.

In Islamic finance it is important to separate the activities of speculators from those of legitimate investors. Investment is the rational use of knowledge, and the rewards come from having and knowing how to use information. Speculative gains in contrast simply come from seeking out risk. With Mudarabah finance there are rewards for risk-sharing, but this activity of taking on the risk of others is different in nature from deliberately seeking risk. Speculators can actually increase risk for all market participants by churning stock, or by engaging in destabilising buying and selling. Yet it is impossible to prevent speculative investment in equity and bond markets through regulation. Taxing purchases or short-term sales may damage market liquidity and legitimate investment. It is only the intent of the speculator, which becomes manifest later on, that distinguishes speculation from genuine investment. Hence it is conscience which is the ultimate check, which implies that each
an investor must constantly examine his or her motives and objectives.

**Islamic Investment Companies**

One way of avoiding the time and hassle of individual equity selection is for the Muslim investor to rely on Islamic investment companies to handle the fund management. The investor can either place his or her funds in an existing trust or engage the investment company in a portfolio management capacity. Many private investors in the West use the services provided by investment trusts such as Foreign and Colonial, Dunedin Fund Managers, or Murray Johnstone because of their financial expertise. Islamic investors can use the services of investment companies such as Albaraka, which still provides portfolio management although it has ceased to operate as a bank in London. They can provide both financial expertise and an Islamic investment audit. Dar al Maal al Islami provides similar services from its Geneva office, which can be highly personalised for individuals of high net worth.

Care of course has to be exercised with placing funds in investment companies, which are not supported by central banks acting as lender of last resort. Egyptian investors of modest means regarded Al Rayan as a bank, but it was always a more risky venture, and with its collapse, many who could not afford financial losses suffered considerable hardship.

**Pension funds and insurance companies**

In the Islamic world, pension provision is minimal outside the state sector and most government schemes are funded on a current rather than a capital basis, with pensions being financed out of current contributions rather than past contributions by the pensioners themselves and their employers on their behalf. The prospects for developing unit trust business are best where there are properly capitalised schemes with investible funds available but, with the exception of some of the Gulf states, notably Kuwait, this is seldom the case in Muslim countries. The absence
of major private providers reveals a significant gap in the financial services sector throughout the Islamic world.

Insurance companies are often both unit trust providers and users in western financial markets, but here again there is a deficiency in most Muslim states. The insurance market is underdeveloped, with few household policies, car insurance being the main consumer item. There are Islamic objections to life insurance, but no prohibition of other types of business. Indeed there are specific types of Islamic insurance provided under the Takafol principle, which stresses the solidarity of the insured. In practice this means that Islamic insurance is best organised on a mutual basis, so there is no question of profits being made out of policy-holders, potential misfortunes. The concern is that with the conventional PLC company, there is a potential conflict between the interests of the insured and those of the shareholders, and that the management's responsibility should be to the former rather than the latter.

Islamic insurance companies are free to offer unit trust products to their clients but in practice none do, as all the companies are small, and most focus their efforts on the business market rather than a retail base of personal clients. Some simply obtain business from referrals by Islamic banks, rather than seeking business through their own efforts. One way of enhancing business would be to seek custom from conventional banks offering Islamic financing windows or products, but as many of the Islamic insurance companies are wholly owned subsidiaries of Islamic banks, this may mean conflicts of interest. With Islamic insurance only a tiny proportion of an underdeveloped insurance market, prospects for encouragement of unit trust development from this source remain limited.

Conclusion

This survey of Islamic banking and finance illustrates how the institutions involved are attempting to provide a comprehensive service for the Muslim saver and investor, as well
as potentially providing insurance and pension provision. There is evidently a long way to go, but a considerable amount has already been achieved, and a solid basis has been laid for further developments. Islamic finance has developed more instruments than any other type of ethical investment. There is much that those involved in the latter can learn from Muslim financial practices. As ethical savings and investment increase in popularity in the West, there are likely to be considerable synergies with Islamic financing.

Rodney Wilson, 
University of Durham
This chapter will cover the development of the Islamic financial market through from the late 1970s to the present day and beyond, concentrating not only research and development of product base, new structures and standardisation but on other factors essential to its development, including human resources, education and training.

The Islamic Financial System

Since the emergence of Islamic banking in the Middle East in the mid-1970s we have witnessed the development of a financial system that now reaches, at least to some extent, into most areas of the world. It remains difficult to assess the extent of the market accurately, although there is a general consensus of opinion that it will amount to more than US$100 billion by the turn of the century. Emphasising profit share related to risk assumption, and the total prohibition of trade in interest-based instruments, the system encompasses over 150 Islamic banks and investment companies; an ever-increasing number of conventional banks providing Islamic investment services to clients; corporates of the region that have re-aligned financing and investment criteria and a rapidly growing group of families and individuals.
Early market developments

During the 1970s and, indeed, for much of the 1980s, the liquidity of Islamic institutions and investors was mobilised for short-term (by this I mean less than one year) investment in a wide range of permitted trade and commodity based transactions. In reality, the average life span of such investments was probably closer to one month in duration than one year. Much of the initial trade investment flow was engineered by conventional, western banks who identified Islamic investors' need to access a regular, reliable flow of investment opportunity that would generate a profit, and be flexible enough to accommodate the ever-growing volume of funds and the very short-term investment profile of the business.

It is true to say that several of the larger Islamic houses chose to forge their own relationships with international corporates. For the remainder, constraints on manpower and the lack of analytical support facilities led to approaches to conventional banks and requests to research and develop deal flows that would enable funds to be deployed into structures with approved Sharia compatibility. Conventional banks, including Kleinwort, reviewed the concepts that were explained to them and, with advice and Sharia guidance from their Muslim clients, shared the investment structures. At this stage, the Murabaha contract was dominant and it could be readily tailored to provide a satisfactory alternative to the short-term funding options of a conventional, corporate client base.

Many of the initial facility recipients were international trading groups, particularly in Europe and the Far East. The undoubted creditworthiness of these counterparties, plus enormous ongoing requirements for trade purchase support, generated repetitive investment opportunities. These were able to accommodate the growing short-date liquidity in the system and could be adapted to comply with the Sharia stipulates of individual banks and investors. Furthermore, during the 1980s the rates of return for these short-term, primarily US dollar-based investments generated a profitability that could only
encourage substantial, annual increases in the total volume of funds circulating the sector.

The interest-based financial system has faced many, well publicised difficulties during its maturing process and these have been addressed with varying degrees of success to achieve its current position. I do not think that anyone involved in the development of the Islamic market and its institutional participants would claim that it has been without teething troubles, either, and in the early years of the 1980s produce development was hindered by the international inexperience and to a degree, the limited analytical capability of some of the Islamic houses involved.

To break into new relationships, direct, bilateral facilities were sometimes extended to international corporates on terms that gave Islamic financiers vastly inferior returns to those enjoyed by conventional bank relationships. In some respects, the legacy of this has prevailed to the present day and we regularly meet corporates professing to enjoy very established facilities from Islamic institutions that are far more competitively priced than the credit rating justifies. It then becomes almost impossible to make fresh introductions and develop new relationships, as the perception of the corporate’s treasurer is that Islamic funds are ‘cheap’ Any competitively priced arrangement offered by a new Islamic relationship is considered unattractive and perhaps directly jeopardizing the pricing of the his existing lines.

In some instances, the promotion of general and specific produce development for banks in the sector was not enhanced by the involvement of a number of conventional agents and brokers (banks or otherwise) appointed to research and identify suitable investment opportunities. As competition for depositors’ funds grew between the Islamic institutions in the second half of the 1980s, the requirement for enhanced profitability and return rose sharply. Furthermore, ill-advised credit decisions were taken by investors who had, historically, chosen to focus on Sharia application. On occasions, the
upwardly revised income targets of Islamic banks were achieved at the expense of the due diligence and security that had been contracted to third parties. Other banks did continue, due to limited alternatives imposed by resourcing constraints, to entrust credit decisions to conventional relationships who enjoyed substantial fees for providing structuring capability but were asked to play no active role in the mechanism or risk of the transaction.

The Market of the 1990s

The beginning of the 1990s heralded an acknowledged drive for progress and development amongst the banks of the Islamic financial sector than can be attributed to several motivating factors. Firstly and primarily, the downward yield curve of the US dollar impacted substantially on the returns achieved by the Islamic bank. After incorporating the cost of any security credit enhancement and the obligations of the institution, we moved to the boundaries of negative returns for secure, short-term investment. Then, poorly performing assets, some loss-making investments, and the cost of passive involvement of a number of conventional institutions, re-focused attention on the development of Islamic financial products, and the technical capability and foresight of individuals working in the financial market. The banks now had an urgent requirement to achieve an acceptable return for an increasingly discerning depositor base and that could not be satisfactorily accomplished by matched investments with a very short-term profile.

A feature of the 1990s has been the large-ticket, asset-based leases, and several innovative funds devised by Islamic and conventional banks in joint venture. In just a couple of instances, conventional banks reacting to the demands of their own Islamic clients have been willing to commit to the expense of researching and developing fund-type products themselves.

The services of conventional banks are still employed by their Islamic counterparts, and it is apparent to all of us with long-term involvement that we must contribute more than just
fee-based broking or introductory services and that add-on value is a prerequisite. The western banks that maintain continual presence and commitment are all able to add that value, whether by reciprocal participation on a risk-and profit-sharing basis; by fund management techniques supported with underwriting and seed capital; or, by product engineering, enhanced by the provision of professional and educational research.

The geographical coverage and distribution capability of large, international banks means that there is a continuing role to play in introducing the Islamic institutions to new credits and country risks. No longer, it should be said, at the expense of the Islamic investor, but to identify investment opportunities that will enable the Islamic bank to diversify and develop its asset and investment base and achieve an acceptable balance of sectoral and geographical risk and return. During the past few years, Islamic banks have been able to develop bilateral relationships with a range of prominent global corporates, and a good percentage have been engineered by conventional banks who can actively demonstrate their own risk appetite for the credit. These facilities have been structured on favourable terms for all involved and, in addition to the traditional Islamic bank strongholds of the Gulf and surrounding countries, North Africa and Asia, we are now witnessing trade facilities structured for organisations and corporates in South Africa, asset-based financing for the USA, and equity investment throughout continental Europe.

Whilst the Islamic banks have a natural desire and obligation to channel finance into established and developing Muslim countries, they must promote and secure their own development by strengthening their balance sheets and ensuring that they have a diversified, structured and prudent investment base that will maximise growth in the future.

Research and development for future products

For the banks' development to reach a new plateau and the financial market to progress from its newly post-nascent stage, a
movement from the aforementioned one-off financings that have accounted for a reasonable percentage of the Islamic banks' efforts of the 1990s must be an objective. Much of the impetus needed to spearhead Islamic banking's evolution from niche market to paralleled financial system could be generated through increased uniformity. The mismatching difficulties that previously tied Islamic investors to the short-term have not been universally addressed. The result is the bias towards short-term, secured, low-return but liquid investments and a lesser percentage of predominantly illiquid, medium-term assets with quite limited options that provide any degree of flexibility in between. Without general consensus of investment criteria, trading practice and system of settlement how will a functional Islamic capital market be implemented? How will we find a commonly acceptable solution to the currently fragmented answers we have to raising short-term liquidity and applying acceptable protection against currency exposure?

If the Sharia stipulations for equity investment can be satisfactorily addressed, this is one area that will assist in filling the gap. Many await the launch of the new style, screened equity fund products that are now in final development and promised before the end of the year. Others have addressed the situation directly and are involved in managing their own portfolios, traded with western investment banks and utilising the economic indicators and equity research that their analysts provide. A few Islamic banks have already moved into the developed and emerging market IPO opportunities, demonstrating the in-house capability to handle the analytical aspects that facilitate a technically complex investment.

Project finance is surely another area that will benefit from new research and development initiatives. There is some evidence of an increasing desire for Islamic involvement in project finance, particularly in the Middle and Far East where there are growing number of high-profile, new projects emerging. There has certainly been a degree of Islamic institutional and private sector investment in this area, but there
is scope for so much more and the financing of individual segments and assets can be superseded by involvement of Islamic institutions as equity investors and in prominent management roles. As a major project financing house, Kleinwort is only too aware of the enormous amount of commitment and capital outlay needed to research and provide a package that will support the development of a greenfield project. The necessity to provide commitment of funding a significant period in advance; the (initially) insubstantial income stream and the negotiation of the inter-creditor issues that would be generated by a multi-sourced financing all prove challenging. It is to be hoped that the Islamic compatibility of this type of investment will encourage allocation of resources and a desire to investigate and tackle the issues with vigour.

The emergence of the Islamic investment banks has brought an added dimension to the market. Their product focus has and will continue to enhance, expand and further develop the range of business in which Islamic institutions have involvement and continue to promote the transition from niche to fully-fledged market. This is already in evidence from the extensive research that is being undertaken by several institutions to find acceptable solutions to the quest of commonly acceptable equity participation. It is to be hoped that it will lead to the emergence of a new range of products to pave the way to establishing the elusive secondary market.

Development of Human Resources

During the past five years, we have witnessed a considerable crossover of executives, in some recent cases in very senior positions, from conventional banks to the Islamic sector. There is obviously a direct relationship between the development, capability and reputation of a bank and the calibre of its employees.

This flow of human resources has, and will, continue to escalate the engineering abilities of individuals and institutions as technical and structural know-how is imparted to others. An
added benefit is derived from the international business experience and the corporate and institutional contacts that these executives bring to their employers from a mature market environment; not to mention their ability to modify and apply sophisticated western financing techniques to Islamic jurisprudence.

We have witnessed growing evidence of this during the past few years and just one example is the Islamic banks positioning to compete directly against commercial banking counterparts for mandates to provide financing of commercial aircraft for flag carriers throughout the world, not only in the Muslim countries. This endorses the need for all Islamic bankers with direct client responsibility to attain professional presentation and marketing skills, that will serve them equally well when dealing with participants of both financial systems. Clear and precise presentation of the structure of a transaction is of utmost importance when seeking to attain approval from a Sharia committee, particularly when advisors have little exposure to commercial practicalities.

Education of graduates and other personnel entering the Islamic financial market is also more readily available. A number of Islamic banks and organisations have sponsored Islamic finance departments at universities in the Middle East. Undergraduate opportunities to study the Islamic financial system, either as a speciality or a major component of a business degree, are available at a number of European universities. The distance learning diploma course made available by the Institute fills another gap as it is targeted not only at Islamic financiers, but, importantly, is available to other individuals working in western markets and workplaces seeking knowledge of, and investment in, the Islamic banking system. It is quite evident that these venues of education will, in time, benefit the banks and the system as a whole and will enable those involved to educate potential customers, Muslim or otherwise.

Opportunities for private and institutional research have improved significantly of late. Whilst some might question the
validity of the number and frequency of Islamic banking conferences in the Middle East, Far East and UK (and admittedly with lesser frequency elsewhere), the benefit is usually derived from the opportunity to meet and talk with colleagues at first hand. Gatherings also promote discussion and debate, generate new business contacts and, ideally, lead to business development. Further opportunities now exist for cross training, with conventional banks welcoming the participation of Islamic bankers in their formal, technical and marketing training programmes, and, but as yet probably to a lesser extent, western bankers having the opportunity to accept exchanges to Islamic banks in the Gulf. Education and formalised training is a necessity but it is often bypassed and perceived as non-essential, not just by Islamic banks, because of the cost and the inconvenience of the absence, albeit temporary, of personnel.

The Bahrain Institute of Banking and Finance is positioning itself to directly address, through ongoing programmes, the training and development needs of the staff of the Islamic financial institutions within the region. The dynamic approach of some CEOs who have risen to assume control of a number of Islamic institutions and investment companies shows that the system is able to attract ambitious new entrants and, in such circumstances, is more than capable of nurturing its own stars.

Researching and developing Structural Standards

There are, of course, other research and development issues that need to be directly addressed by the Islamic banks and their scholars. A barrier to greater global participation in the Islamic banking sector is the lack of standardisation of product, as mentioned earlier, and documentation. Although many would call on an organisation such as the International Association of Islamic Banks to inaugurate a committee to approve the implementation of market standards, there needs to be a common willingness amongst all institutions in the sector to support and, importantly, finance the initiatives.

For almost twenty years, the structures and the facilities that
we have worked with have evolved around the individual Sharia interpretations of individual institutions. At this stage it appears unlikely that uniform opinion will be achieved in the foreseeable future, but the result of this is a series of isolated transactions with individual banks specialising in specific contract opportunities rather than the development of market accessible products. This is obviously a serious disincentive to corporates and organisations, who become reluctant to seek new relationships in the Islamic system if they are unable to obtain definitive product information and have no access to standardised trading mechanisms or facility documentation. The lack of standardisation would also hinder the implementation of an alternative pricing benchmark. Although I appreciate the desire to progress from an interest-linked LIBOR base, this is often the only benchmark that a new recipient may have to compare against other facilities and the familiar pricing terminology can motivate a desire to grasp new concepts. Unfortunately, many western corporates do look to their existing, western bank relationships to explain Islamic financing structures and techniques.

The final implementation of a uniform set of accounting practices for Islamic banks will also be a welcome development and the research efforts of organisations such as the FAOIBFI are to be applauded. Lack of common accounting standards does not assist the banks' endeavors to establish reciprocal relationships with others. Islamic financial institutionsí accounts must be comprehensible to outside users so that an Islamic bank's performance over a set period of time can be subjectively judged against that of another and, moreover, consistent, to generate confidence in the banks themselves both within the Islamic market and externally.

**Developing Future Co-operation**

In the past, most of KB's activities and products have been arranged and developed for a predominantly commercial banking environment servicing its own retail customer base, and,
apart from demonstrating reciprocity in transactions, the two-way relationship has not always been as developed as we might have wished. Although there has been a very real desire on our clients’ part to develop new ideas and structures, in some instances there has been considerably less enthusiasm to provide the financial resources and manpower that such endeavours undoubtedly require. During the past couple of years, however, we have discovered Islamic relationships with whom we can undertake joint research and development initiatives and who have actively been assisting us with the development of our own business in geographical locations that are new to us. For example, we are actively involved with an Islamic institution in an advisory capacity for corporate finance in Asia. Conversely, we have brought our relationships to our own, global IPO activities. This indeed demonstrates that banks can integrate activities to provide the most appropriate and complementary blend of conventional and Islamic financier capabilities and jointly bear the (sometimes unattractive) costs of development and start up.

There seems to be two extreme viewpoints amongst market participants. Half say that the Islamic market is stagnant and that nothing is happening. The other half are extremely buoyant and looking forward to the future. To those who claim that nothing is happening we should refer to the trade syndications totalling over US$ 2 billion arranged and provided, primarily for Pakistani enterprises, by Faisal Islamic Bank of Bahrain; to the wholesale Istisna and international lease financings provided by al Rajhi; the structured, multi-asset leasing package provided to Kuwait Airways by the International Investor; the range of investment funds launched by the Al Baraka Group companies and the structured finance facilities for emerging markets arranged and provided by the Islamic Investment Company of the Gulf. These are most definitely “happenings” and I apologise for omitting many other noteworthy transactions.

I would anticipate that the perspective of conventional banks reflects their individual commitment to the development
of the Islamic financial system, their allocation of research time and development funding and the strength of their desire to be perceived as a continual presence in the market.

Although Kleinwort has, and will continue, to maintain a segregated team to safeguard the interests of Islamic client relationships, we identified a requirement amongst our customers for direct access to a growing number of specialized product skills of executives working in the mainstream system. As a result of this, senior executives have been appointed within our Financing and Advisory, Equity, Investment Management and Treasury Divisions to research and develop new business with the team, and importantly, directly with its clients.

Conclusion

The very rapid expansion of Islamic banking has surprised many. It is now on the verge of further advances that should make it well placed to compete and prosper as an efficient market, as we move towards the 21st century. The effort needed to ensure that the research and development aspects that we have considered generate results, must derive from the system's growing international profile and the increased demand for detailed information of structure, application and practice delivered by professional spokespeople who are central to the market.


Stella Cox, Assistant Director,
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In France, Islam is the second largest religion with over four million Muslims and some 900 mosques, but no Islamic banks. Despite the market potential, particularly in the retail sector, no-one has sought to offer Islamic products to this market, and it has been some time since attempts have been made to promote the ideas of Islamic economics in France.

The Arab world at large is certainly no stranger to the country: Paris has the Institute du Monde Arabe (l’IMA) as a cultural and research centre, the largest Paris Mosque is a centre for Muslims and non-Muslims alike with its famous tea-room, and a number of Arab banks have a base in the city.

Despite this, Islamic bankers are nowhere to be seen. The common perception amongst Islamic bankers is that the Muslim population in France is largely working class, or blue collar, and is therefore best served by the domestic French banks. French Muslims tend to be from the Maghreb (especially Algerian, Moroccan and Tunisian) and Turkey, and are often, but not exclusively, migrant workers.

It appears both sad and myopic that Islamic bankers are able to jump to such conclusions so rapidly, and be so dismissive of this market. However, one cannot totally blame them, since a considerable barrier to offering services in France is the persistent refusal by the central bank, Banque de France, to licence an Islamic bank because they are so different from
conventional banks. Recent unrest in the country, due to the situation in Algeria, is hardly like to endear French authorities to Islamic banks in the foreseeable future either.

However, this does not prevent banks and investment institutions from offering investment products in France. Indeed, there is a fairly cheap delivery platform for retail investors in the form of Minitel, the home screen-based system connected to the telephone lines. Minitel is in the majority of French homes and a number of banks have been offering investment products and home banking services in this way to both retail and small business customers. The last time anything truly significant occurred in France was in June 1988, when a colloquium was arranged in Paris. The Association Islam et Occident invited Dr. Ahmad Mohammed Ali, the President of the Islamic Development Bank (IDB), to participate in a conference organised by the Union of French banks on the role of Islamic banks.

Ahmed Mohamed Ali held discussions with the then French economic and finance minister Perre Beregovoy, who was later to become Prime Minister, and Philippe Lagayette, director of the Banque Francaise de Developpement.

The IDB President informed the colloquium that the French banks were managing 11% of IDB assets, and that the Bank had at the end of 1986 signed two management conventions with the Societe Generale and BNP banks to handle Islamic projects. The first placement comprised $136 million, which Mohammed Ali said represented "a new stage in the co-operation between the IDB and the French institutions".

Fifteen of the 45 IDB members are French-speaking, and there had been much interaction between the IDB and all sorts of French institutions, especially in the African countries. In the early 1980s some fifteen projects mobilised funds of $340 million, with the major activities being in places as diverse as Bangladesh, Cameroon and Jordan.

With a large immigrant Muslim population in France this is obviously an attractive market to service. One area where there
has been much debate has been the issue of financing the construction of mosques throughout the country. These may not be vast projects, but they may well be of interest to Islamic bankers.

As stated, there are 900 mosques and more are being planned or upgraded, but funding is needed. There is also a significant wealthy layer within the Muslim population to be serviced, even if they are outweighed by the less monied classes.

Finally, there is the opportunity to deliver cheaply a range of investment products to those who would like to put aside savings. There is an obvious and huge market and it is being totally ignored. So long as this situation continues, then it can be argued that Islamic banking is merely a niche market for the wealthy and the businessmen. Yet surely this is not the ethos of the Qur’an? Neither is it the message of the Prophet. If France changes, then so perhaps will Islamic banking.

David Cowan
Institute of Islamic Banking and Insurance

Aims and objectives of the Institute of Islamic Banking and Insurance include:

Promotion of knowledge and understanding of Islamic Banking and Insurance.

Education of personnel in Islamic Banking and Insurance to fill the rapidly growing demand for qualified personnel by financial institutions. For this purpose, the institute runs a Diploma Course in Islamic Banking and Insurance on distance learning method.

Conducting research and development to develop new Islamic financial instrument and to tackle issues and problems relating Islamic Banking and insurance.

The Institute publishes a monthly magazine -The New Horizon- devoted to Islamic banking and insurance.

The institute's standing programmes include holding of meetings of Professionals using Islamic financial instrument, organising workshops to address various issues concerning Islamic banking and insurance.

The institute offers its membership to organisations and individuals who satisfy the prescribe conditions.

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London has emerged as a leading centre of Islamic banking.

EDDY GEORGE, GOVERNOR, BANK OF ENGLAND

The positive trends in Islamic banking are much stronger than the problems.

R.T. FOX, VICE CHAIRMAN, KLEINWORT BENSON GROUP

It might be fair to say that Islamic banking is no longer an experiment.

MICHAEL AINLEY, SENIOR MANAGER, BANK OF ENGLAND

In the last 20 years, Islamic banking has made a significant impact and it does have a unique contribution to make to the economic debate not just in Muslim world but to all the nations.

DAVID COWAN, WRITER ON FINANCE

It is clear that Islamic banking is no mere passing phenomenon. ...The substitutions of equity for debt finance is advocated by many development agencies. There is clearly considerable scope for expansion, both in countries with majority Muslim populations and in financial markets of the West.

DR. RODENY WILSON, UNIVERSITY OF DURHAM

The very rapid expansion of Islamic banking has surprised many. It is not on the verge of further advancement that should make it well placed to compete and prosper as an efficient market.

STELLA COX, DIRECTOR, KLEINWORT BENSON GROUP

The development of an Islamic Capital market, where long-term risk are exchanged for liquidity, is an extremely important requisite for co-operation between conventional and Islamic banks.

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