On Islamic Banking, Performance and Financial Innovations

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Edited by

Mondher Bellalah

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This book is written to better the understanding of the Muslim community around the world of Islamic economics and its importance, especially in these days of crisis. The book is also intended to be a reference manual for teaching the theory and practice of Islamic banking and Islamic financial innovations around the world. Islamic finance courses at universities are highly important since Islamic financial innovations remain very limited, and additional efforts have to be made in this area.

It is very important therefore to mention the unique efforts of the Tunisian Private Universities to enhance Islamic studies and in particular www.umlt.ens.tn.

Such efforts cover all fields in Islamic studies, including economics. No award will ever be given that denotes excellence in Islamic studies better than the award for Best Study in Field.

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FOREWORD

Despite the consequences of the latest global financial crisis, the slow process of international economic recovery, as well as the cautious positive outlook of recent international economy performance, Islamic Finance was able to maintain its position as one of the most growing sectors of financial services in the globe. Islamic Financial Services are actually shifting from the creation phase to widely and internationally tangible prevalence, constituting an integral part of the financial systems of many countries. By the end of 2013, total assets of Islamic Finance exceeded $ 1.6 trillion with apparent domination of Islamic Banking which amounted to “75-80” % of total Islamic Finance assets. By the end of 2014, total volume of asset is expected to exceed $ “2” trillion maintaining the growth pace seen in the last few years which was approximately “15-20”% per annum, so that total assets of Islamic Banks will be around $ 1.6 trillion. These positive prospects are enormously fostered by the positive economic outlook of the GCC and other emerging markets’ Countries.

The process of transformation and restructuring implemented by many of the large Islamic financial institutions recently, as well as recent developments on the operational environment have contributed to the reduction of the profitability gap amongst Islamic and conventional banks. In addition, the continued positive outlook of the Islamic banking industry, encouraged many international banks to enter (or plan to enter) Islamic banking market. This, of course, in addition to the regulatory rules imposed by Basel III, increased competition and sophistication of Islamic Banking market. Therefore, it has become imperative to develop performance measurement and risk management techniques in light of an international economy overwhelmed by uncertainty. Furthermore, operational transformation has become a must in order to ensure responsiveness to a growing number of Islamic banking customers and their uninterrupted aspirations while taking into account cost cutting and to remain abreast with state-of-the-art technologies. Likewise, market sophistication imposes Islamic Banks to consider Shariah-complaint regularity clarity and governance regulations which performed a basic role in polishing the image of Islamic banking globally.

In light of all of the above, comes this book, with a solid scientific approach which practically clarifies Islamic banking systems, tools as well as methods for assessing performance in comparison with conventional banks. Using empirical evidences, the theoretical and practical foundations of these two banking types are also elaborated. In addition, the book illustrates the experience of smaller Islamic Banks growth in the last decade, the challenges they faced in terms of profitability and growth as well as up-to-date advanced mechanisms used in operational environment risk management.

We in **Kuwait International Bank (KIB)** deeply praise the efforts exerted in drafting this book in its current form. This book will eventually assist Islamic banks' staff; policy-makers, decision-makers as well as all those concerned with Islamic Banking in both Islamic and non-Islamic countries in the formulation of a clearer understanding of Islamic Banking in a systematic approach. This book can be used as an academic reference all over Arabic and Islamic universities.

—Mohammed Jarrah Al-Sabah
Chairman of Kuwait International Bank

PREFACE

Islamic banking has seen rapid growth during the last two decades. This is a result of the liberalization of financial regulation, the globalization of financial markets, technological changes, product innovation, the birth of several new Islamic States, and a growing Islamic presence in the West, among other factors. New innovations have allowed economists and religious scholars to bring new products to almost all areas of banking and insurance, products which would previously have been extremely controversial. There is no accurate data on the exact extent and volume of Islamic banking, but it is currently estimated that Islamic Banks' assets are between 500 and 800 billion U.S. dollars, and there are nearly 300 Islamic Financial Institutions worldwide, including "Islamic Windows" of conventional banks. The Islamic *sukuk* (bond) is the fastest growing product, estimated at USD 40 billion outstanding. In Pakistan and Malaysia, Shariah compliant funds have exceeded 50% of total market capitalization. Today, Islamic banking is growing at approximately 15% per annum. The growth of Islamic banking is a result of economic growth in the Islamic world, fuelled primarily by oil wealth. This growth created a large population of people with medium wealth, and hence made banking a necessary service for a large segment of the population rather than for just a few, as had been the case some 10 to 15 years earlier. The Islamic banking system is not only popular within Islamic banks, but also in international and other conventional banks. Nowadays, the majority of international banks are adopting Islamic banking in order to serve the specific needs of their new clients. Examples of such banks are Citibank and HSBC, both of which started up Islamic operations worldwide in order to expand their businesses.

Although interest in Islamic banking has grown considerably during the last decade, it is still an evolving industry today. The financial world has set conventional banking, driven mainly by the profit maximization principle, as standard practice. However, Islamic banking principles have been attracting increased attention from academic researchers and regulators, both in developing and developed countries, as a result of their distinctive micro-operating fundamentals. The prohibition of interest payments by Islamic Shariah (Islamic law) has made equity and profit sharing the cornerstones of its operational structure. This ban on interest does not mean that capital is free in an Islamic system. In fact, it recognizes funds as a factor in productivity, but it does not allow the providers of those funds to make a prior or pre-determined claim on any future interest. Theoretically, this risk sharing principle provides better long-term allocation of funds to investments with higher risk-return profiles, and subsequently, greater economic growth.

This book addresses the main issues of concern within Islamic banking (the conceptual framework and viability of interest-free banking) and provides an assessment of its performance and future. In a world where conventional interest-based finance is the dominant framework, Islamic banking faces many challenges that must be addressed. This book provides an excellent read for both researchers and practitioners globally, as it analyzes the past experiences of Islamic banks world-wide, and moreover, provides an objective assessment of their successes and failures, and discusses the contemporary issues and challenges confronting them.

—Adnan Ahmed Yousif
President & Chief Executive, Al Baraka Banking Group
President of Union des Banques Arabes.

INTRODUCTION

Islamic financial practices are founded on the belief that money is not an earning asset in and of itself, and therefore cannot earn interest. Unlike a conventional bank, which is basically a borrower and lender of funds, an Islamic bank is essentially a partner, in partnership with its depositors on the one hand, and also with entrepreneurs, employing depositors' funds in direct, productive investment. Islamic religious law – that is, Shariah – emphasizes ethical, moral, social and religious factors to promote equality and fairness for the good of society as a whole. Principles encouraging risk sharing, individual rights and duties, property rights, and the sanctity of contracts are all part of the code underlying the Islamic banking system.

Islamic banking has emerged as one of the most important industries worldwide. It is known for its interest free model and operates in many countries including Bahrain, Pakistan, Jordan, Iran, Sudan, the United Kingdom, Singapore and Malaysia. Islamic banking and finance have undergone rapid transformation and growth, from an industry striving to satisfy the needs of Muslim communities alone to a multibillion dollar industry upholding Islamic principles. Over recent decades the Islamic banking industry has emerged as one of the fastest growing and has spread to all corners of the globe, receiving wide acceptance from Muslims and non-Muslims.

The market for Islamic banking has grown rapidly over the past few years and is expected to continue to exhibit robust growth for the foreseeable future. In many markets, Islamic banking has evolved from being a niche offering to part of the mainstream financial services landscape. At the same time, the competitive landscape is being re-drawn, with more Islamic financial services institutions present in the marketplace than ever before. Incumbent banks and new market entrants are facing vastly different market conditions and need to develop new, unique features, beyond Shariah compliance, to compete successfully in the future.

Any future unique selling points that Islamic banks promote will likely revolve around the areas of product development and innovation.

Rapid innovations in financial markets and the internationalization of financial flows have changed the face of conventional banking, particularly since the recent financial crisis. Financial innovations led to increased market orientation and encouraged the use of financial products such as mortgages, automobile loans and export credits as backing for marketable securities; this is known as the securitization process.

As financial instruments and markets have become more complex and processing has been automated, the treasury function has also been made more complex. The conventional financial system focuses primarily on the economic and financial aspects of transactions. The Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions, and seeks to enhance equality and fairness for the good of society as a whole.

This book discusses some conceptual features, and highlights the approach of Muslim economists on issues as controversial as the status of credit money, bank money and deposit money, the principle of compensation, etc. It studies the determining factors and measurement indicators of the performance of Islamic banks. It presents an overview of literature that deals with the concepts and determinants of banking performance. It investigates the different approaches and methodologies, as well as the main models, used by researchers when dealing with conventional banks.

The book draws attention towards the rapid development of Islamic finance and banking, their infrastructures and their supporting institutions in recent years. It sums up the different Islamic financial contracts and basic structures, and the derivative Shariah-compliant products used to offer a wide array of innovatively structured financing and investment banking products and services. Islamic banking intermediation lays out specific protocols both for the mobilization and the allocation of funds, and hence the balance sheet structure differs completely from that of conventional banks. Moreover, the current global crisis, which grew in the United States out of the subprime crisis, driven by an unethical attitude of greed and excessive speculation, has gradually engulfed the world. The financial crisis started with the development of an environment where the quantity of loans grew considerably, much more than the quality of those loans, and hence excessive risks were taken. In fact, the debt-based nature of interest delivery that has developed over the previous years, as well as poor and inadequate regulation and lax lending standards, have contributed massively to the augmentation of the gap between the real-world economy and the financial sphere. This book introduces some deregulated power markets by explaining the structure of these markets and the market products that can be used to sell the output of a power generator.

The book determines the potential economic benefits that an Islamic investor can enjoy through investment in power assets. It also presents the Islamic mechanisms that can be used to invest in power generation.

The book is organized as follows:

Part 1 describes the characteristics and performance of the Islamic Banking System.

Chapter 1 presents the fundamentals of the Islamic financial system and financial instruments.

Chapter 2 explains Islamic Banking Intermediation and financial instruments. This chapter also explains risk management issues and the capital adequacy regulations of Islamic Banks.

Part 2 deals with the Islamic banking system and financial Instruments. It provides some empirical results regarding performance measurement.

Part 3 compares conventional versus Islamic banks: Theory.

Part 4 is interested in the concepts of interest rates and profitability and the capital structure of Islamic institutions. Islamic finance has failed to capture the interest of Western writers. This deficiency is explained by references to Western literature regarding the prohibition of interest.

The Koran permits trade but forbids usury. This fundamental principle differentiates the Western from the Islamic banking system.

Islamic banks are involved in the process of implementing government monetary policy in addition to their important role in mobilization and allocation of resources.

Islamic teachings provide a better organizational system for bank operation. The practice of interest is condemned by many thinkers, like Aristotle, who described it as a “birth of money from money”.

This part includes three chapters.

Part 5 is about advanced risk management techniques. The advanced analysis of the risk and return profile of Islamic products constitutes a challenge to Islamic financial institutions. Islamic financial institutions are obliged to keep a portion of their assets in equity investments. This part of the book talks about the dynamics of the specific risk profile that is central to Islamic equity investment in a Shariah compliant stock market. Therefore we investigate three Islamic equity indexes as classified by economic hubs (the Dow Jones Europe, Asia-Pacific and USA) in comparison to their conventional peers. Our risk profile analysis is based on the estimations of two well-known advanced risk measures, namely the Value at Risk and the Expected Shortfall.

PART I

THE ISLAMIC BANKING SYSTEM AND FINANCIAL INSTRUMENTS: DEFINITIONS, CHARACTERISTICS AND PERFORMANCE MEASUREMENTS

An Islamic bank is a financial intermediary institution which typically performs the functions of resource mobilization and revenue generation in compliance with Islamic Law. The Islamic banking system carries out two kinds of financial intermediary actions. The first is a payment action, where current deposits remain highly liquid and the aim is the safekeeping of money, and the second is an investment action whereby investments and saving deposits are treated as medium- and long-term savings. Unlike Western commercial banks, which pay interest on current and saving accounts, Islamic banks are prohibited from paying interest on any kind of financial product. Islamic banking converts the interest based banking system to an interest-free system, and the bank's conventional status of borrower and lender changes to become more of a partner status. In fact, the relationship between depositors and financial intermediaries becomes one based on the profit and loss sharing principle. Thus the terms of financial transactions reflect an equitable risk-return, shared between parties.

Along with the prohibition of interest and the upholding of the profit and risk sharing system, another unique feature of Islamic banks is that they are not allowed to invest in activities deemed illicit or featuring any kind of speculation or gambling, which provides a level playing field and protects the interests of all parties.

For the mobilization of funds, Islamic banks have developed two basic deposit products. Each of them is based on a Shariah-compliant intermediary contract. These deposit products are: current accounts, based on *Wadia* or *Amanah* contracts, and investment and savings accounts, based on *Mudaraba* or *Wakalah* contracts.

The assets division of an Islamic bank can carry a more diverse portfolio of heterogeneous asset classes than the liabilities division, representing a wider spectrum of risk and maturity profiles.

The growth of sukuk, or Shariah-compliant debt securities, is among the most significant developments within Islamic finance in recent years. Banks are subjected to a wide array of financial, operational and business risks in the course of their operating within the stipulations of the various Shariah-compliant financing and intermediation contracts, many of which involve highly complex interdependency between, and overlapping of, different kinds of risks.

Islamic finance features another component additional to those of conventional finance: the willingness to consider social welfare in the financing of a project. This links the investor's return to the performance of the underlying asset.

Islamic finance contributes to the funding of green energy projects throughout the world such as low carbon emission coal plants, gas power plants, wind and solar power plants.

Islamic financing can be brought into power asset developments worldwide by presenting the opportunities offered by different important markets (the US, Europe, Australia and India).

In this part of the book we will be dealing with the various issues related to the power generation industry, such as the different types of power assets and their investment risks, the structure of liberalized power markets in the US and Europe and finally, the Islamic financing mechanisms which can be used to finance power assets through investment deals.

CHAPTER ONE

FUNDAMENTALS OF THE ISLAMIC FINANCIAL SYSTEM AND FINANCIAL INSTRUMENTS

MONDHER BELLALAH AND RACHA GHAYAD

Introduction

Interest is prohibited by Islam, and it was the aspiration of Muslims to make this ban a reality in their economies that, over time, led to the creation of a number of Islamic financial institutions worldwide. These institutions included Islamic commercial banks, Islamic investment companies, Takaful (Islamic insurance) companies, leasing and Mudaraba companies, and other non-banking financial institutions.

This chapter discusses some conceptual aspects of Islamic banking and highlights the approach of Muslim economists on controversial issues such as the status of credit money, bank money and deposit money and the principle of compensation.

We will study the fundamentals of Islamic banking, the key feature being the non-recourse to the application of interest without waiving the return on capital. The purpose of Islamic banking should in no way deviate from the objectives of Islamic economics, which seek consistently to achieve the values of justice and charity: "Yes, God commands justice and charity."

Section 1. Currency in the Islamic economic concept

1.1. Revitalizing the normative branch of economics

The unique system of Islamic economics, as observed by Muslim economists, works in a way which allows for the prospect of revitalizing the normative branch of political economics. The idea that prevails nowadays, of economics as a positive science, detached from values, is in fact a recent phenomenon. If the distinction between positive economics and normative economics dates from the second quarter of the 19th century, theoretical developments since that time have focused specifically on positive economics. Nowadays, when social economy movements, which have traditionally supported the normative branch in debates over the economy, are faltering, Islamic economics purports to be the main cause of the revitalization of this branch of the economy.

1.2. The theoretical religious base for prohibiting interest (Riba) in Islam

Islamic banks have developed their specific, interest-free systems by applying the rules of the Koran, the holy book of Muslims. All Islamic banks, wherever in the world they operate, work on the clear basic principle of the prohibition of interest, based on verses of the Koran, for example The Sura Al-Baqarah (Cow Sura), verse 275: "… Those who live on usury will not rise up before Allah except like those who are driven to madness by the touch of Satan." That is because they claim: "Trading is no different than usury, but Allah has made trading lawful and usury unlawful." This prohibition of interest also includes any purely financial speculation. Islam considers money a mere means of exchange, without intrinsic value. Since its circulation does not reflect a real economic activity, therefore, it would be immoral for it to yield any premium whatsoever. Islam does not distinguish between secular law and religious law. It follows that the economic and financial practices of Islamic banks must comply with these guidelines, while retaining some flexibility in order to adapt to new economic situations.

1.2.1. Riba (usury) and hoarding

The Islamic approach has its own conceptions of the value of capital and labor. Instead of a simple lender and borrower relationship, the Islamic financial system is based on a more equitable sharing of risk between the lender and the business owner. This practice follows a central tenet of the Koran, which forbids *Riba*, that is to say the charging of interest payments.

As with the vast majority of precepts of Islam, there are historical explanations for this prohibition. The economy of the Arabian Peninsula in the seventh century was based, in effect, on merchant city-states in a hostile environment. Because of their isolation, they often suffered from a lack of liquidity that meant usury and hoarding were favored. Islamic teachings were aimed at curbing these undesirable social phenomena, because if the interest rates charged to dealers moving from city to city were too high, it discouraged trading and considerably increased the cost of goods. Islam had to create the moral obligation to use money only for the purposes of production, for oneself and for the good of the community by investing in profitable businesses. What is meant by "profitable" in this case, though, is something which makes an indisputable positive contribution to the community, and does not depend solely on the capital market for resource allocation. Muslim economists have noted that, in the Western system, available funds go mostly to the borrowers with the best financial guarantees and do not necessarily benefit the projects that do the most for the welfare of the community. In other words, when investing, one should at least consider the communal value of the project rather than just the economic gain. Finally, charging interest reduces the supply of venture capital and thus hampers growth.

1.2.2. The role of profit

There are also other arguments that justify the principle of prohibiting interest. Thus, there is no question of financing loans, but rather, lenders are offered an active involvement in the petitioner's company, which, in turn, offers a share of future profits. This is typically an equity investment in the form of allocations or shares. The economic rationale of profit is therefore not only that it is an opportunity for redistribution, but also that it is an opportunity for the efficiency, economic stability and company growth of which profit is just a reflection. Simply funding with interest may be very unfair if only the entrepreneur suffers loss, or conversely, reaps a disproportionately large profit.

The principle of compensation: Regarding "the *foulous"* (the money), we find in two Hanafi jurists, Abu Yusuf and Muhammad bin al-Hassan Chibani, the principle of compensation. Indeed, after the introduction of foulous (based on copper), they lost much of their value, while gold and silver retained some stability. Turning to the issue, the two jurists have accepted the principle of compensation by offering to link to the debts contracted in foulous with their equivalent in gold on the day of the transaction. In this case, the debtor will repay the equivalent in gold of the borrowed foulous. Thus we can deduce that the compensation is in line with the spirit of justice and fairness commanded by the Holy Koran Although contemporary jurists acknowledge the principle, the fact remains that they refuse to use this verse in deductive analogy (*qiyas*), with the justification that the context differs. They believe that as today's paper currency has totally replaced gold and silver, no compensation is therefore authorized by an analogy about a bimetallist society. This position seems to us inconsistent with the principle of justice stated in the verse quoted above. In the system of the gold standard, the creditor is not financially harmed. In the current system, however, he can be jeopardized to the extent that paper money loses its value entirely, especially in underdeveloped countries. In addition, the difference in context mentioned by contemporary jurists seems very insignificant. In fact the foulous, just like paper money today, is already a substitute for gold and silver. The changing nature of the monetary system is not a valid argument for disregarding the principle of compensation. It certainly has not prevented some scholars of Islamic economics from accepting it, if under two conditions: that the proposed compensation is as fair as possible, and that it should in no way resemble the application of interest. The principle of justice applies in all cases; inflation, deflation or stability.

In the first case, the compensation must take into account the inflationary phenomenon: the creditor receives more monetary units than he has lent.

In the second case (although very rare in modern economies), he will receive less. In case of stability in the value of the currency, the creditor will receive exactly the same as the amount of the original loan. When we talk about compensation, no reference is made to the interest that is received by the creditor, regardless of the level of inflation. Research studies in this area are still in their infancy, so here we will simply present previously issued proposals.

A. Using the Islamic Dinar

This proposal suggests the use of a constant unit, conventionally called the Islamic Dinar, for futures and loans without interest (Qard Al Hassan). This unit is equal to one gram of gold. Issa (1985) proposes that debts are contracted on the basis of this monetary unit, linked, of course, to a certain quantity of gold, and that repayment is made on this basis. This proposal may extend to wages, salaries and pensions. It should be subject to intervention by monetary authorities to determine the value of the Islamic Dinar, although it does not materially exist.

B. Using a (strong) reference currency

The second proposal is to take as a reference not, as previously suggested, an Islamic Dinar, but an international currency that is as constant as possible (Issa, 1985). Then the same scenario is repeated as in the previous proposal. In place of the Islamic Dinar, the unit used by this institution (which would comprise 45 Muslim countries) is equivalent to one Special Drawing Right (S.D.R.) of the International Monetary Fund. To guard against fluctuations in the currencies of member countries, the granted loans would be denominated in Islamic Dinar and refundable.

However, the two proposals we have just described have some drawbacks. Gold and hard currencies are themselves subject to fluctuations. Sometimes, strong variables in decline may ultimately jeopardize the creditor even when inflation is above zero. Therefore, our proposal consists of taking as a reference not the price of gold, nor a single hard currency, but a set of international currencies; a change upwards in one of them will be offset by falls in others. We would use the median price, which would be relatively stable. The fact is, though, that however good one's intentions, it is almost impossible to create a perfect compensation system. In this regard, the Koran is clear: "Therefore, fear Allah as much as you can." (Holy Koran, 64, 16)

Finally, it is worth mentioning that the best remedy for the deterioration of the value of money is balanced economic development coupled with a sound and effective monetary policy. If these two objectives are not achieved, inflation will continue to eat away at the values of national currencies, and any proposed compensation will be merely a soothing ephemeral which does nothing to improve the fate of the economy in question, nor that of creditors.

Having presented various aspects of the Islamic concept of currency, we will now discuss how funds are mobilized and allocated to different sectors of the economy in the absence of interest rates.

1.2.3. Financial intermediation in the Islamic system

In the absence of interest rates, how does the remuneration of financial capital occur? What is the nature of financial intermediation in the Islamic system?

To answer these questions, it is necessary to introduce the famous principle of the sharing of profit and loss, or Profit and Loss Sharing (PLS).

This principle bases itself on very simple logic: since nobody can predict the future, why should financier and entrepreneur not agree on the sharing of the outcome? In the Islamic system, and in order to be fair, both parties are paid downstream. This principle, of sharing the results of the company, positive or negative, is at the root of the Islamic financial system. Financial intermediation in the Islamic system, whether on the part of the depositors or the borrowers, is guided by the application of the PLS principle. Depositors are treated as if they were shareholders of the bank and are therefore assured neither of any par value guarantee, nor of any predetermined return on their deposits. If the bank makes a profit, the depositor receives an allocation under the Mudaraba contract; on the other hand, if the bank suffers a loss, the depositor is required to share that loss, also in accordance with the Mudaraba contract, and will therefore receive a negative return.

In terms of deposits made singly or for non-investment purposes, the bank guarantees the nominal value of the deposit, but does not pay liabilities. Thus they are considered equivalent to demand deposits or sight deposits in a conventional banking system.

Deposits for investment purposes are the main source of funds for the Islamic bank, but they are more like shares in a company than term deposits. The only contractual agreement between the depositor and the bank is about the manner in which losses and profits must be distributed. The ratio of sharing profits or losses should be discussed between the bank and depositors at the start of the operation, and may be modified by mutual agreement during the operation. The same principle of sharing of profit and loss applies to the use of funds. There are two contracts that fully meet the requirements of Shariah law in this area; Mudaraba and Musharaka contracts.

Under a Mudaraba contract, the bank finances an entrepreneur who invests effort and knowledge, as well as bank funds, in a productive activity, in exchange for sharing a percentage of the achieved profits. The losses are borne exclusively by the financier (lender), while the entrepreneur (borrower) only loses the time and effort invested in the company. This type of contract is equally concerned with human capital and financial capital.

Section 2. The Islamic Banking System

2.1. Definition of Islamic bank

In the relevant contemporary literature, there are no specific definitions of Islamic banking terms or Islamic banking activities. Instead, there is a flexible approach to defining such establishments and their business. For example, the International Association of Islamic Banks has described Islamic banking as follows:

> "The Islamic bank implements, basically, a new banking concept because it rigorously abides by the rules of Islamic Shariah in the field of finances and other business transactions. Moreover, the bank operated in this way

should reflect Islamic principles in its operations. The bank should seek to establish an Islamic society; therefore, one of its primary goals is to deepen the religious spirit among the people."

This description does not provide an accurate definition of "the Islamic bank"; it is more focused on the objectives of an Islamic bank than anything else. Based on this, however, we can say that an Islamic bank is a company that acts as a financial intermediary between depositors or investors, depending on circumstances, and users of funds, as well as providing various other banking services. Therefore the functions of this bank are parallel to those of a conventional bank or one based on the interest rate, because both act as financial intermediaries. However, in conducting banking activities, an Islamic bank must adhere to certain Islamic standards as well as to prudent standards for banking operations. Thus it is now appropriate to examine the meaning of the term "Islamic banking activity". Again, in this context, there is no clear definition. The Islamic Law of Malaysia, promulgated in 1983, defines Islamic banking operations as "banking activities whose aims and operations do not involve any element which is not approved by the religion of Islam." It turns out that the term "Islamic banking activity" has not been properly defined and perhaps has even been rather neglected. However, a recent Malaysian law dealing with conventional banking provided a more complete, albeit somewhat open, definition of banking operations.

The previous discussion has led us to try in this chapter to provide definitions of the terms "Islamic banking" and "Islamic banking activity". In this regard, we can define an Islamic bank as a company or corporation authorized by the necessary authorities to carry out Islamic banking activities under the rules and principles of Shariah law.

Islamic banking activities, on the other hand, comprise the acceptance of deposits or investments from clients and the provision of financing facilities to customers (financial intermediation) as well as the provision of other services for clients within the framework of banking practices. Nevertheless, all these activities must conform to Shariah law.

This definition, as it appears in existing laws and statutes, does not explicitly cover the activities of an Islamic bank as an investment bank or as an institution involved in fund management. However, the recent developments in Islamic banking operations seem to suggest that Islamic banks will assume a broader role as universal banks in the future. This means that they may be involved in fund management, as well as in the production of paper money or commercial paper, due to the process of securitization. So it would be appropriate for an Islamic bank to take on the role of a universal bank, covering most of the financing and investment contracts.

In conventional banking operations, the intermediation function has become more limited because of disintermediation, and we can expect this trend to be followed in Islamic banking activities. In contrast, the undertaking of universal banking functions would be of great significance. Modern statutes on Islamic banking operations must therefore address the issue of defining and redefining Islamic banks as their roles and functions change.

The one element that is made explicit by this definition is that compliance with Shariah is the essence of an Islamic bank and its activities.

Before the actual creation of the first Islamic bank, they existed only as theoretical models developed by a number of thinkers and intellectual Muslims. Today, both theoretical contributions and their practical implementations have clarified the picture of Islamic banks. So what is an Islamic bank? How does it differ from a conventional bank?

Before defining an Islamic bank, it is best to give a brief description of conventional banking. This differs from one country to another. In Anglo-Saxon countries, commercial banks are dominant, while in Germany, Switzerland, the Netherlands and Japan, it is the universal bank that prevails. Consequently, a comparison between these two banking models becomes inevitable.

The commercial bank model is based on the pure financial intermediation model, in which banks mobilize savings for lending to businesses and individuals. They profit from the difference between the interest rates payable and receivable. They offer a range of banking services such as letters of credit and bonds. A portion of their profit comes from cheap money that they collect in the form of demand or sight deposits. They are prohibited from doing business, and their own capital is limited to a restricted part of net assets.

This partial reserve system authorizes them to create derived deposits, thus allowing them to multiply their resources inexpensively. However, the process of offering bank loans is subject to some problems that render it ineffective. Borrowers are generally better informed about their own operations than funders, so when acting as creditors, banks often face a high level of information asymmetry. Borrowers are in a position that allows them to hide information from banks; therefore, they can use the loaned money for purposes other than those reported to the bank, thus exposing the bank to unforeseen risks. They can also provide erroneous figures or fraudulently declare a state of bankruptcy. These problems are described as moral hazards. The fulfillment of guarantees given to banks that they will be repaid depends primarily on the effective use of funds loaned for the agreed purposes in order to produce sufficient cash flow for covering debts. Even at a government level, several countries have been known to borrow billions of dollars and use them for unproductive purposes, leading to serious debt problems. Banks may ensure proper use of loaned funds by timely controls, but this does not appeal to customers and often results in additional expenditure, which goes against the goal of profitability. Therefore, the purpose for which the credit is allocated is of minimal importance to commercial banks. It is the credit rating or creditworthiness of the debtor which plays the most important role.

In contrast, universal banks are allowed to take equity capital, and to conduct business and insurance transactions, that go beyond the operations of a commercial bank. In comparison with commercial banks, universal banks are better equipped to overcome the asymmetry of information. They finance their customers through a mixture of *prêtage* (lending) and preferred equity. The equity stake enables universal banks to take places on the boards of directors of the funded companies, allowing them to monitor closely the use of funds which, in return, are offered at a lower cost. Reduction of control costs mitigates business failures and improves the efficiency of the banking system.

Adhering to this logic, many economists have shown their preference for universal banking because it is more efficient. Commercial banks are allowed to trade only up to their net worth. However, we cannot apply the same rule to Islamic banks, because as discussed above, several modes of Islamic financing are suitable to trading activities. It is possible for Islamic banks to fund business ventures involving the purchase of goods on credit or with fixed assets. These companies will buy these goods and assets to be sold on agreed terms to their customers. As such, this results in an equity stake. Thus we can say that Islamic banks resemble much more closely the model of universal banking than that of commercial banking. They are required to have a variety of ways to provide funding, including equity stakes. They can also develop financial packages by combining a form of equity participation with other modes of Islamic financing. Even when the formulae of trade or indebtedness are used, financing remains closely related to the real sector. The customer's creditworthiness remains relevant, but it is the productivity and profitability of the project that prevails in importance.

The comparison mentioned above leads us to the following definition of an Islamic bank: an Islamic bank is an institution which receives deposits and carries out all banking activities, with the exception of loan transactions and loans with interest. Its liabilities consist of funds raised in the form of Mudaraba or Wakala (agent contracts). It also accepts deposits on demand/at sight that are considered interest-free loans, from customers to the bank, and therefore they are guaranteed. Assets are constituted by funds offered on the basis of sharing profits and losses, or on the basis of indebtedness, in accordance with Shariah principles. These assets belong in the category of investment deposits. Furthermore, equity stakes and the financing of current assets (merchandise stock) and fixed assets also constitute an integral part of Islamic banking operations.

The Islamic bank shares its net earnings with its depositors depending on the date and in proportion with the amount of each deposit. Applicants must be informed from the outset of the profit sharing agreement they are entering into with the bank.

2.2. The history and development of Islamic banks

There are numerous indications of the current importance of Islamic Finance (IF). The value of the assets of Islamic Finance Institutions (IFI) was about five billion U.S. dollars in 1985 (Iqbal, 1997). Now, at the dawn of the third millennium, it is estimated at 100 billion U.S. dollars, which, for comparison, is equal to nearly a quarter of the external debt of developing countries (World Bank, 2000).

More than one hundred Islamic Finance Institutions are in operation (Khan, 1986). Most were created in the second half of the 1970s, predominantly in Muslim countries such as Saudi Arabia, Bahrain, Bangladesh, Brunei, Egypt, the United Arab Emirates (UAE), Jordan, Malaysia, Senegal, Sudan, Turkey and Lebanon. Although oil capital supports economic activities, and hence banking and financial operations, the structure of capital in Islamic banks does not depend on public initiative, but on private initiative.

2.2.1. The first experience of a rural savings bank

The idea of an Islamic bank dates back to the 1940s. The first Islamic bank was founded in 1948 in Pakistan; this was the Muslim Commercial Bank, an enterprise which was quickly extinguished (Quershi, 1967).

The second attempt at founding an Islamic bank took place in 1963 in Egypt with the establishment of the Mit-Ghamer rural savings bank in the Nile delta, inspired by a German savings bank. The operation of this bank had been adapted to the environment and the population; basically, rural and religious. Created by Al Nagar, the Mit-Ghamer was a savings bank that used financial techniques with particulars based on the principle of dual partnership; partnership between depositors and the bank and partnership between the bank and entrepreneurs. This principle was a result of the need to conform to the Islamic principle of avoiding usury. The funds, collected by the bank and corresponding to liabilities, were deposited either in savings accounts, opened with a minimum of five *piaster*, which received no interest and could be withdrawn at any time (Arab Republic of Egypt, 1972), or in investment accounts, opened with a minimum of one Egyptian pound, which produced a revenue proportional both to the size of the deposit and the profits made by the bank.

As for loans related to balance sheet assets, these were also of two kinds: common interest-free loans, granted to poor and middle class people, each of which was capped at two hundred Egyptian pounds and repayable in two years, and association loans that allowed the bank to join in a contractor's plans and subsequently to receive between 10% and 50% of the profits (and losses) achieved. These loans could be worth up to two thousand Egyptian pounds, and also had a maturity of two years.

Something which helped give the bank a reputation for legitimacy was the creation of the Social Fund for Alms, the *zakat*[1], contributions to which were calculated at 2.5% of the capital, and donations from which were given to the most needy amongst the general population through channels identified by various criteria specific to Islamic law (Seddik, 1986).

2.2.2. The institutionalization of the Islamic bank

2.2.2.1. The creation of the Nasser Social Bank in Egypt

The Nasser Social Bank in Egypt, which was the first State Islamic bank, was created in 1972. The bank was placed under the supervision of the Egyptian Ministry of Social Affairs; its activities did not follow the logic of profitability of the type generally used in banking. It escaped the control of the Central Bank and the various preventative rules imposed on other banks. Its goal was to help establish an Islamic microeconomy, in close coordination with the State and its other institutions. It had to be a practical instrument of state policy vis-à-vis the urban poor and small

[1] Zakat, or alms, constitutes the third pillar of Islam. It is a deed of worship of the financial category which purifies the soul and heightens its merits, as it purifies assets and increases wealth. It is not a morsel offered to the poor by the rich, but a right due to the poor from the assets of the rich: "Deduct a part on their assets for their purification and uplift their souls," says the Koran. It also says: "Perform prayer and pay Zakat."

entrepreneurs who were looking for means of production. In order to become that, it had to promote the two symbolic elements of such a policy, i.e. free social loans and alms. Unlike the Mit-Ghamer bank, the Nasser Social Bank did not set a minimum amount for opening accounts. The success of the Nasser Social Bank in terms of its social base, its amount of savings and the development of a small private sector allowed the Egyptian state to make a successful recovery from the experiences of the time of the Mit-Ghamer bank. This recovery took place in the context of a growing influence of religious discourse on civil society.

2.2.2.2. Generalization to the Gulf countries

The idea of Islamic banking attracted several economists and businessmen from Saudi Arabia, and we mention to this effect Prince Muhammed El-Faisal and Saleh Kamel. The first, considered the great promoter of Islamic finance, gave his name to the first private Islamic bank in Egypt.

Immediately, the ministries of foreign affairs and finance in Gulf countries and the peninsula formed a special committee, responsible for the preparation of joint agreements on the establishment and operation of Islamic banks. These agreements made possible the launch of the Islamic Development Bank in 1974/1975, which is the only Islamic bank supported by public authorities.

In the same year, 1975, the Dubai Islamic Bank (DIB) was established in the United Arab Emirates (UAE) on the initiative of businessman Said Loutha[2]. Its capital is primarily private, with the authorities in Dubai and Kuwait having taken just a minority stake in it. The bank operates primarily as a merchant bank, offering its depositors/investors equity investments in industrial and real estate projects, and remuneration based on the principle of sharing profits and losses as required by Islamic law.

In 1981, Muhammed El-Faisal founded the Dar Al Mal Al Islami (DMI) group, the first international network of Islamic banks. The Faisal Banks of Egypt and Sudan belong to this group. The Faisal network banks did not want to be confined to the role of merchant bank; they wanted to target a more diversified clientele, to whom they offered a range of operations and services comparable to that offered by conventional banks.

During the same period, the Saudi businessman Saleh Kamel created several Islamic investment banks. Later, these banks were part of what became the Al-Baraka Investment and Development Company group,

[2] The founder of the Islamic Bank in Dubai; he is among the people interviewed in Dubai as part of our case study.