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Committee on Banking Regulations and Supervisory Practices at the BIS, the Cooke Committee. One outcome of this is the agreement to introduce consolidated balance sheets, that is to say the banking authorities supervise their domestic credit institutions, including not only their domestic and foreign subsidiaries but also their Euro-currency establishments, on the basis of a consolidated balance sheet for the group as a whole. The banks' compliance with own funds and liquidity ratios is examined on the basis of this consolidated return. In Germany the legal framework was created by amending the Banking Law with effect from 1st January 1985.

Many banks found initially that supervision on a consolidated basis restricted their scope for expansion. The rapid spread of Euronotes may therefore have been stimulated by the fact that they do not affect the balance sheet. How effective the co-operation among the supervisory authorities has now become may be seen in their reaction to the expansion in Euronotes. Following

discussion in the Cooke Committee, the Bank of England classified Euronotes as potential risks at the beginning of April 1985 and instructed banks in the United Kingdom to give Euronote credit lines to non-banks half the weight of traditional credits to such borrowers and those to banks the same weight as traditional lending when calculating their risk asset ratios. The authorities of other countries will probably follow suit in the near future.

The Euro-currency market will continue to play a central role in the international financial arena, largely because of its undiminished ability to innovate, which has enabled it to be in the vanguard of numerous new developments in the past. The blurring of the traditional demarcation between the money and capital markets and between the domestic and Euro-currency markets for a particular currency may lead to closer integration of the international financial markets and strongly influence the character of the Euromarket, but it cannot jeopardise its future.

ISLAMIC BANKING

Principles, Problems and Perspectives of Islamic Banking

by Volker Nienhaus, Bochum*

Since the late 1970s, financial institutions (banks, investment companies, insurance companies) have grown up in many countries in the Moslem world with the intention of conducting their business in accordance with Islamic, or Shariah, law. Above all else, this means business involving no interest payments. The following article explains the most important principles of Islamic banking and outlines some of the problems which appear to be most central to this sphere.

Islamic financial institutions competing against, or offering an alternative to, conventional banks now exist in Egypt, Jordan, Kuwait, Guinea, Bangladesh, Malaysia and elsewhere. Saudi Arabia will shortly join this list (unless one chooses to include it already by virtue of the internationally oriented Islamic Development Bank in Jeddah – this was founded in 1975, but as a development bank does not pursue commercial aims). The governments of Pakistan and

Iran are working towards the complete Islamisation of the financial system (the former since 1979, the latter for practical purposes only since 1984), and Sudan embarked on this course at the end of 1984, but it came to a standstill after the overthrow of Numeiri. Apart from Turkey, which also counts as part of the Moslem world, the only European country which has so far granted an unrestricted banking licence to an Islamic financial institution is Denmark. In contrast, such a licence was clearly turned down at the end of 1984 by the Bank of England, whose main reservations concerned the

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protection of depositors under Islamic banking procedures. One could expect central banks in other Western countries – at least for the time being – to have similar misgivings, meaning that the establishment of an Islamic bank in Europe or North America is hardly likely within the near future. However these reservations – which will be discussed later – do not apply to non-deposit-taking Islamic financial institutions, and there are indeed quite a number of Islamic investment, insurance and holding companies operating in the United Kingdom, Luxembourg and Switzerland, among other countries.¹

Many Islamic banks have achieved persistently high growth rates both in deposits and in balance sheet totals over the past few years. Even so, the majority of these banks, by now more than 30 in number, are relatively small even by national standards, and not just in international terms; their financial power does not in any way approach that of the conventional Arabian banks founded, or considerably strengthened with regard to their capital base, around the same time – the banks through which the oil states seek to channel the greater part of their petro-capital into remunerative employment. However, a boost to growth in the Islamic banks' balance sheet aggregates can be expected in the near future, not only because a number of the more significant financial institutions have considerably increased their capital base, but also because two strongly capitalized Saudi financial groups (Al Rajhi and Al Baraka) aim to commence activities in the Islamic banking field.

Western bankers and observers initially adopted a sceptical, wait-and-see posture vis-à-vis the Islamic financial institutions. In the meantime, though, they have become familiar with the practical application of the principles of interest-free banking (these will be discussed below), and for most of those who have gained practical experience by doing business with Islamic banks² scepticism has given way to a greater openness and willingness to continue cooperating in the future. Nevertheless in the past two years or so there has been an increasing number of negative headlines and commentaries in the press. Evidently many of the authors believe their original misgivings (and

prejudices) have been borne out by the problems individual banks have suffered; there has already been talk of a crisis of credibility.³

Three examples may serve to outline the nature of the problems facing Islamic financial institutions:

- The largest Islamic bank holding concern, Dar al-Maal al-Islami (DMI) in Geneva, was saddled with substantial losses in each of its last two financial years, because a large portion of its liquid financial assets had earlier been used to acquire gold, the price of which fell heavily instead of continuing to rise as had been hoped.
- The largest of the Islamic banks in balance sheet terms, Kuwait Finance House (KFH) ran into difficulties through loss of earnings and essential asset-revaluations in 1983 and 1984: because its portfolio was concentrated very one-sidedly in real estate, the price collapse in that market in Kuwait left KFH having to make substantial write-downs.
- At the beginning of 1985 a regulation was issued in Sudan requiring private-sector banks to invest at least a quarter of their funds in agricultural and industrial projects contributing to development, rather than confining themselves to trade financing (which is both safer and more profitable). A negative example cited by the press as having too low a proportion of project finance which would aid development (6 % in 1982) was the country's first Islamic bank opened in 1978, the Faisal Islamic Bank (Sudan).⁴

Reports such as these, particularly if they are commented on in that light, can combine to give the impression that Islamic banks, with their unconventional and seemingly dubious interest-free business practices, are despite their apparent initial successes more than likely to fail because of a concept which is tied to "mediaeval" norms felt to be inappropriate to the modern age.

Such a negative verdict, however, is based on an unjustified generalization from individual cases which all involve individual management errors (mis-forecasting of the gold price at DMI, lack of portfolio diversification at KFH) or special environmental circumstances (the generally limited attractiveness of agricultural and industrial projects in the Sudan because vital raw materials, equipment, spare parts etc. cannot be imported due to the acute and permanent shortage of foreign exchange). These first setbacks, then, should

¹ For a summary and characterization of existing Islamic financial institutions, cf. in full Volker Nienhaus, Traute Wohlers-Scharf: *Arabische und islamische Banken*, Cologne (Al-Kitab Verlag) 1984.

² This is expressed at frequent intervals in speeches and statements made at international conferences on Islamic banking in which Western companies and advisors participate; cf. for example the Conference Report "Islamic Banking – Its Impact on World Financial and Commercial Practices" by Monadnock International and The Middle East Association, London 1984.

³ Cf. the cover story "Islamic Banking – A Crisis of Credibility" in: *The Middle East*, July 1984.

⁴ Cf. Alfred T a b a n : Sudan's banks get loan quotas, in: *African Business*, April 1985, p. 81.

not be accepted as proof that the concept of Islamic banking (which will be described in more detail below) is a failure.

Prohibition of Interest and Profit-and-loss Participation

Proponents of Islamic banking are all agreed that the two primary sources of Islamic law, the Koran and the Sunna (the tradition of the Prophet) both prohibit any kind of interest charge on loans, regardless of the loan's use (consumptive or productive), and that the prohibition is not confined to usurious rates of interest.⁵

□ If a person gets into difficulties through no fault of his own and needs a loan to support himself and his family, it is meritorious conduct to provide him with an interest-free loan; for the lender to try and extract some other advantage from the debtor beyond the repayment of the loan would be an immoral act. Conversely, the debtor is morally obliged to pay back the loan in full as quickly as possible.

□ If, on the other hand, a person takes out a loan to finance a commercial venture, there is certainly no moral constraint preventing the lender from sharing in the results of the venture he has financed, providing that he not only participates in a positive result (profit), but also helps carry a negative one (loss). Were the lender to participate only in the profits of the enterprise, all the entrepreneurial risk would be concentrated on the borrower, which is not only felt to be unjust but is also believed to be inadmissible under Islamic law.

Islamic jurists therefore began at an early stage to recognize and develop contractual forms already known in Arabia in pre-Islamic times, forms which replace the creditor/debtor relationship where interest is payable regardless of a venture's results by a partner relationship in which both partners (each of which could also be a group of persons) are rewarded in proportion to those results. There are two forms of partnership which have been established as the basis of Islamic banking by the academic literature on the subject, namely *musharaka* (also known as *shirkat*) and *mudharaba*.⁶

□ Partnerships known as "musharaka" involve the bank and the entrepreneur jointly providing the capital for a given project, or the bank putting up additional funds for an enterprise already in operation. The bank is entitled to a pre-agreed percentage share of the project's or enterprise's profits, the absolute amount of which is as yet unknown. Losses must be carried by the capital-owning partners in proportion to the size of their shares in the venture. Both the bank and the

entrepreneur have the right to manage the venture, though the bank may elect not to exercise that right.

□ Partnerships known as "mudharaba" involve the bank alone providing the capital in return for profit participation, and the partner simply providing his entrepreneurial effort, for which he too receives a share of the profit. Any losses must be met entirely by the provider of the capital, though the entrepreneurial partner will also receive no payment. Only the entrepreneurial partner has the right to manage the venture.

Both because the bank is required to share any losses occurring, and because the absolute return to which it is entitled on the capital it provides is not known at the outset, the bank is said to share the economic risk with the entrepreneur in these financings involving profit-and-loss participation, thus relieving some of the burden on the active partner. This is also taken as an essential point in any attempt to demonstrate the allocative and distributive superiority of the Islamic banking system compared to the conventional system.

In practice, however, the Islamic banks' lending operations are by no means confined to these forms of financing. Other forms apart from profit-and-loss participation which are both admissible and used in practice fundamentally involve the bank providing the entrepreneur not with the funds he needs to acquire a given asset, but with the asset itself. In the case of capital goods such as machinery, it may do this by way of hire purchase or leasing; in the case of raw materials or trade merchandise a possible route is a double purchase agreement with a fixed profit mark-up (*murabaha*) for the bank: first the bank purchases the goods required, then the entrepreneur buys them from the bank at an augmented price. Such transactions are fully admissible under Islamic law, as they do not involve the pure lending of money but represent special ways of conducting the financial side of the real transfer (purchase) of goods by making use of the right to demand a higher price for delayed or instalment payment than for immediate cash payment.

Divergence between Ideology and Practice

To the extent that it is possible to analyse the Islamic banks' lending business according to different types of finance on the basis of their annual reports, it is clear

⁵ Cf., for example, M. Umer Chhapra: *Towards a Just Monetary System*, Leicester (The Islamic Foundation) 1985, p. 55 ff.

⁶ Cf., for example, Muhammad Nejatullah Siddiqi: *Partnership and Profit-Sharing in Islamic Law*, Leicester (The Islamic Foundation) 1985.

that for most of the banks by far the greater part of their earnings are not actually made – as one would expect by reading the theoretical and ideological texts on the subject – from profit-and-loss participation financings at all. In terms of quantity they have no more than a subsidiary role, and in terms of quality one should also add that *mudaraba* and *musharaka* partnerships are hardly concluded for agricultural or industrial projects, but apply mostly to trade financing deals. The majority of Islamic banks' earnings are derived from leasing, mark-up and similar transactions which – in contrast to profit-and-loss participation – carry practically no risk. Many of the banks derive additional earnings from trading and foreign exchange deals or property transactions, all of these involving not only financial assistance for customers, but also own account transactions.

Thus there is a marked discrepancy between the theory or ideology of Islamic banking, centred on profit-and-loss participation, and the practice which shows the preference for transactions bringing set earnings for the bank. Of course there are a number of quite obvious business reasons for this discrepancy. Among the factors militating against profit-and-loss partnerships are the uncertainty of the bank's future earnings in absolute terms, the danger of accumulating bad risks, the problem of identifying and judging market opportunities from among the proposed entrepreneurial projects, problems of evaluation and profit assessment, supervision of the partner's management of the enterprise, etc. Moreover, a factor working against quantitatively greater financial support for agricultural and industrial projects on a profit-and-loss participation basis is that Islamic banks too, especially newly established ones, also need to be able to show financial success as quickly as they can to their shareholders and depositors – the latter also do not receive any fixed interest on their deposits but receive a share of the bank's profits – whereas the investments given financial support often need a period of several years before they begin to show a profit. Transactions such as trade financings, on the other hand, yield earnings in the short term.⁷

In the light of problems such as these, particular Islamic banks have in a sense imposed restrictions on themselves with regard to the amount of profit-and-loss participation business they can undertake. On the other hand, though, the fact that they have to a large extent steered clear of profit-and-loss participations should not entice the banks to then further extend their own-account business activities which are frequently regarded as uncharacteristic of banking. Rather, a report endorsed as long ago as 1981 by the governors of

the central banks and monetary authorities of the Islamic countries recommends that these uncharacteristic own-account operations should be renounced altogether, and a rule to this effect can be found, for example, in the statutes of the Islami Bank Bangladesh, founded in 1983.

Working on the assumption that the Islamic banks, on the one hand, restrict or renounce these activities which are uncharacteristic for banks – whether on their own initiative or under appropriate pressure from national central banks and/or monetary authorities – and that, on the other hand, they do not undertake any massive expansion of profit-and-loss participation financings, their business activities will be concentrated on contractual forms such as mark-ups in trade financing and equipment leasing, which in their ultimate economic effects are practically identical to those of conventional, interest-related forms of financing. If these assumptions are correct, the notion propounded in the theory and ideology that Islamic banking is allocatively and distributionally superior can undoubtedly be shelved until further notice by referring to banking practice.⁸ Does this then also mean, given that the economic consequences are identical, that the Islamic banks are carrying out a particular kind of trade descriptions fraud, i.e. by giving themselves the evidently catchy label of "Islamic" whilst in reality failing to distinguish themselves sufficiently clearly in their business policies from conventional banks?

The Search for New Techniques

If one homed in primarily on the economic differences one might indeed come to such a conclusion, but this would not do justice to the aims and objects of the Islamic banks. As far as they are concerned, adherence to the prohibition of interest charges is a *legal* problem first and foremost, and any *economic* implications this has – which will vary according to the solution chosen to that legal problem – are only a secondary consideration. The Islamic banks' prime concern is to develop contractual forms capable of achieving particular

⁷ In the West the expectation has not infrequently been expressed – presumably following impressions gained from academic literature on Islamic banking as reinforced by the public relations activities of some of the banks themselves – that such banks operating in Europe could be a source of urgently needed venture capital, on a profit-and-loss participation basis, especially for smaller and medium-sized innovative companies with good growth prospects. However, as familiarity with the actual business policies of the Islamic banks has grown it has become clear that the expectations in this field, often rather too hopeful, will have to be substantially toned down.

⁸ However, what is not yet clear is how banking practice will evolve in countries in which the entire financial side of the economy has been, or is due to be, islamised. Pakistan should prove to be an interesting object for study in this respect.

financing aims without coming into conflict with the interest prohibition as laid down by the judiciary and defined under formal (not material or economic) criteria. One can hardly hold it against the banks that, having first subjected them to legal examination, they have had recourse to known financing techniques such as leasing. A clear distinction should be drawn between the two criteria of *originality* and of the *admissibility* of financing techniques. The most important point for the Islamic banks is that a technique is legally permitted, whereas Western observers and theoreticians concerned with Islamic banking frequently expect above all else that new techniques will be applied which can stand in their own right.

The Islamic banks cannot at present fulfil such high expectations. Even so, one should not disregard the fact that many of those practically involved in the Islamic banking business are not prepared to accept that the present set of financial instruments available to them is the last word on the matter, as some of the techniques regarded as permissible – marking up, for example – cause them much discomfort because of the great economic proximity to interest transactions. Thus all sorts of banks are considering new concepts and seeking new interest-free financing techniques mainly oriented towards the ideal of profit-and-loss participation, yet without saddling the bank with an incalculable earnings risk. Another problem for which a solution is also being sought is how liquid funds can be placed on a very short-term basis and earn a return; the conventional money market based on interest-bearing bonds is, of course, out of bounds for the Islamic banks.

It appears that problems of this nature can only be solved with difficulty, if at all, by individual Islamic financial institutions carrying out their own business in isolation. In Pakistan, the Islamisation of the financial system is proceeding on the basis of conceptual preparatory work carried out by consultative bodies involving not only theologians and legal experts but also economists and bankers. The aim is to create a national interest-free capital market where fixed-interest securities are no longer traded, but which will include, as well as traditional dividend-yielding shares, the main new addition of a type of debt known as participation term certificates (PTCs) designed to supersede the old interest-bearing industrial debentures and to provide the certificate's owner with a percentage participation in the results of the issuing company. Though this does not as yet solve the problem of the short-term placement of liquid funds, it does at least suggest a direction in which Islamic financial institutions outside Pakistan could also address their considerations on the overall perspective

of their activities, namely towards the creation of an international market for interest-free bonds with different maturities. Apart from manufacturing and commercial companies interested in raising funds from Islamic sources, such bonds might also be issued by the Islamic banks themselves. Admittedly the establishment of an Islamic capital market is still a long way off, but as the Islamic banks increase in number and in financial strength the relationships between them could, for example, intensify and then be more strictly formalised to ultimately form the core of a kind of interbank market, into which in turn interest-free bonds issued by individual non-bank organisations could later flow, and so the process could go on.

Deposit-taking Business

Islamic banks are not only required to conform to the prohibition of interest on the asset side, i.e. in their lending and financing business, but also on the liability side, in their deposit-taking business.

- Deposits at call are treated by the bank virtually as interest-free loans from the depositors: the latter do not receive any return on their deposits, but are entitled to be repaid in full at any time. If the bank uses deposits at call to finance projects which result in a loss, the bank must bear the losses alone.
- By contrast, deposits placed in what are known as investment accounts, with notice of withdrawal required of, say, one month, three months or one year, can be regarded as analogous with profit-and-loss participation financings. In this case the depositors leave their funds in the bank's hands in order for it to be put to remunerative use. As in the case of *mudaraba* and *musharaka* partnerships, investment account holders participate in the results obtained by the bank by deploying their funds. If losses occur, these are not carried by the bank alone, but also shared with investment account holders. Thus the accounts differ from deposits at call in that an Islamic bank cannot give a direct and unconditional guarantee that funds placed in investment accounts will be repaid. As far as Western central banks are concerned, which give the highest priority to protecting depositors, this risk pertaining to investment accounts is a key reason for refusing deposit-taking or primary banking licences to Islamic financial institutions.

Islamic financial institutions are therefore looking for workable schemes which, though they do not guarantee the return on investment accounts, do at any rate protect the sum initially invested. At least in theory, one feasible method could be the insurance of the sums deposited by an institution unrelated either to the bank or to its

customers. In return for the payment of appropriate premiums, the insurance institution guarantees the full repayment of the funds invested, even if their deployment by the bank generates losses. This type of insurance cover does not appear to collide with Islam's prohibition on gambling;⁹ what is doubtful, however, is whether an independent institution prepared to offer investment insurance of this kind could actually be found.

Within one particular Islamic bank, i.e. without recourse to any third-party undertaking, one could conceive of another structure as follows: the depositor and the bank agree that funds in a particular account should fundamentally be treated as a (secured) call deposit unless the bank is in a position to use them in transactions with contractual structures which do not involve any risk on the extent of the return (e.g. leasing or mark-up deals). If the bank does use funds for types of business other than those agreed, i.e. where the rate of return is at risk, and incurs losses, then it will have to meet them from its own reserves as the customer deposits would in this case have to be treated as call deposits. Any profits achieved, on the other hand, have to be shared with depositors. A structure such as this would greatly reduce the risk on depositors' principal, or indeed practically rule it out: certainly leasing and mark-up transactions might give rise to occasional defaults which the bank would have to write off, but if a sufficient volume of such business is conducted these cases could most probably be (more than) compensated for by earnings made on the remaining transactions. Also, it would presumably be considerably easier to find an independent underwriter willing to cover this minimal residual risk than it would to obtain cover for the entire risk which would flow from the bank deploying its depositors' funds just as it chooses.

It seems there is some chance, then, that structures will be able to be found in the medium term whereby both the requirements of Islamic law and those of the Western central banks regarding the protection of

depositors can be fulfilled. However there is still another problem which this will not solve, and may indeed exacerbate, namely the term differential between lending and deposit-taking activities. The overall economic function of banks is to use predominantly short-term deposits to fund longer-term financings. A precondition for this to work properly is a functioning credit and capital market, involving other organisations besides the banks themselves. Interest payments play a crucial role in the currently existing markets, and on an international level there are no signs of an Islamic alternative in evidence. The fact that the Islamic banks have yet to satisfactorily fulfil the function of bridging shorter and longer-term investments is likely to call forth critical comment from the Islamic countries' central banks and currency authorities, who can be expected to seek stricter controls over the Islamic financial institutions in future.

Conclusions

In the short term, the Islamic banks need to try and avoid management errors, and to solve numerous sets of practical, technical and administrative problems – for example, how to assess their lending business sufficiently early and continually, how to establish the profits earned and apportion them in the accounts, or the tax treatment of the profit shares which the entrepreneurial customers are required to pay over to an Islamic bank, but which cannot generally be set against income taxes as can conventional debt interest. In parallel, however, it is in their own long-term interests for them to seek out feasible means by which, step by step, an international Islamic capital market can be established which also includes non-banks. This is the crucial point in determining whether the Islamic banks can offer a genuine challenge to the conventional banking business or whether they will simply occupy one market niche within the established system.

⁹ Cf. Muhammad Nejatullah Siddiqi: Insurance in an Islamic Economy, Leicester (The Islamic Foundation) 1985.

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