

**The Relationship between Islamic Banking
Theory and Practice**

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ABSTRACT

This thesis is designed to investigate the practice of Islamic banks within different economic, financial, social, legal and religious environments, with a view to determining whether or not the Islamic banking theory is reflected in practice. It covers three Islamic banks working in different environments: in London where Al-Baraka International Bank Limited works as an Islamic bank in a non-Islamic country; in Jordan where Jordan Islamic Bank works as an Islamic bank in an Islamic country and in Turkey where Al-Baraka Turkish Finance House works as an Islamic bank in a secular country with a predominantly Muslim population.

The major findings are:

- 1 The study shows that while P.L.S. is central to the theory of Islamic banking, in practice it is peripheral. None of the banks studied looked at P.L.S. contracts as a contract which should dominate their transactions because it was perceived to be too risky to be adopted and it had too many loopholes from a commercial point of view. *Morabaha* was the main type of transaction adopted by all three banks.
- 2 Islamic values do shape strategic goals and determine the priorities of the Islamic banks. Islamic banks do not violate Islamic law, even for guaranteed profitable deals. The three criteria by which Islamic banks assess a possible financial project are: (i) that it does not violate Islamic law; (ii) that it should maximize the bank's profit; (iii) minimize perceived risk.
- 3 Whether the Islamic banks are operating in an Islamic banking system is not a decisive factor in their success or survival, what is decisive is that the peculiar nature of Islamic banks is to be secured by specific legislation.
- 4 One of the major problems facing Islamic banks is to find long, medium and short-term investments which are at once commercially effective and Islamically acceptable. In particular, Islamic banks will, at least in the foreseeable future need to focus on a complementary role, providing an avenue for Muslims to save and invest in an Islamically acceptable way.

Dedicated:

To my loving parents

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Part One

Review of Literature

Chapter 1

The Introduction

1 Introduction

1.1 Statement of the problem

Islamic economics are regulated by *sharī'a*, the laws derived from the Qur'ān (the holy book of Muslims) and *sunna* (the practice and sayings of Prophet Muḥammad, *ṣalla-llahu 'alaihi wa sallam*) Islam makes no distinction between secular and religious law. It follows that the economic and financial practice of Islamic banks must abide by guiding principles contained in the *sharī'a*. One of the most important central tenets of Islam and of its economic system based on Islamic principles is the unequivocal prohibition of payment and receipt of interest.

There is a consensus among Muslim scholars that *ribā* is interest (Faruqio, 1985). The Qur'ān explicitly declares that taking *ribā* is tantamount to declaring war with Allah and His Messenger (Prophet Muḥammad, *ṣalla-llahu 'alaihi wa sallam*); the offence is so great for any economic system to allow interest-based transactions to be practised. The Qur'ānic statements are as follows:

- Those who devour usury will not stand except as stands one whom Satan by his touch hath driven to madness. That is because they say trade is like usury. But Allah hath permitted trade and forbidden usury (2: 275).
- O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Messenger. And if ye repent, ye shall have your capital sums: deal not unjustly and ye shall not be dealt with unjustly (2: 278-79).

Historically, early Islamic societies were able to develop financial instruments and institutions that were consistent with religious stricture and yet economically vigorous and effective (Ahmad,

1987a). Traditionally Muslims have always believed that banking and financial operations must be conducted in the absence of interest. Accordingly, they are not contented with the conventional banking system which is based on charging interest. In recent decades they have sought to establish banks and financial institutions which do not charge interest in their transactions.

1.2 Some basic points related to the subject

- a) The Qurʾān prohibits interest.
- b) For centuries Muslims had a thriving economy which was not based on interest.
- c) Muslims now seek economic success on the same principle, namely elimination of interest.
- d) In recent decades Islamic banks have been set up claiming to perform most banking functions without any dependence on charging interest.

1.3 Aims of the thesis

The aim of the thesis is to test the following hypotheses:

- a) Islamic banks are profit seeking organisations within the framework of a social developmental role based upon Islamic law regardless of the environments in which they operate.
- b) The operations and performance of Islamic banks differ in accordance with the economic, financial, social, legal and religious environments in which they operate.

- c) Profit-and-loss-sharing i.e. *mudarabah* and *musharakah* is the concept which underlies Islamic banking theory and practice.
- d) Islamic values determine the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.

The terms used in the statement of the aims of the thesis are fairly familiar but not necessarily clear. We can assume (because there is a universal consensus among Muslim scholars) that prohibition of *ribā* in the Qur'ān is prohibition of interest, i.e. lending money at a fixed rate of return over a specified period. The Qur'ān prohibits *ribā* in the most vigorous terms (Qur'ān, Chapter 2). However, it is important to note that the Qur'ān also permits and encourages commerce. This is a characteristic of Islam that *ḥalāl* (what is permitted) is encouraged alongside the prohibition of what is *ḥarām* (prohibited). Ideally, Muslims should not only fight against *ribā* but must also actively promote legitimate business so as to succeed commercially in this world. This is the example of the Prophet Muḥammad himself and of his companions. Islamic banks cannot be judged to be successful and sufficiently Islamic simply because they have (at least formally) eliminated interest from their transactions, but rather they must show that they are profitable and that they have contributed to the economic vigour and prosperity of the society in which they operate.

This thesis is divided into three parts, as follows:

Part One - Review of Literature

Part one is made up of three chapters: Chapter 1 presents the background to the thesis (or general introduction) while Chapters 2 and 3 identify the general theoretical frameworks of Islamic economics and Islamic banking theory.

Part Two - Research Methodology and Case Studies

Chapter 4 develops the research methodology. Chapters 5-7 study the *modus operandi* of Al-Baraka banks working in a Western environment, in an Islamic environment and then in a secular environment (with Muslim communities) in the light of existing theory and further ideas and proposals developed in this thesis. Attention shall be restricted to three organisations in this study, namely, Al-Baraka International Bank Ltd (London, UK), the Jordan Islamic Bank for Finance and Investment (Amman, Jordan) and Al-Baraka Turkish Finance House (Istanbul, Turkey).

Part Three - The Results

Chapter 8 is the comparative analysis chapter which compares the three case studies in the light of the hypotheses which the thesis promises to investigate. Chapter 9 is the conclusions and recommendations. Chapter 10 - Future of Islamic Banks: the evidence tends to suggest that Islamic banks have a great deal to learn from conventional banks as regards techniques (accounting, auditing procedures, management, etc.) which would make their operations more viable. Equally, conventional banks (whose operations for a number of reasons are increasingly coming into question) have much to learn from Islamic banking, in particular the relevance of ethical investment, socially responsible decision-making, and greater preference for trading in actual assets and actual wealth.

Chapter 2

General Theoretical Framework of Islamic Economics

The aim of this chapter is to explore the philosophy which lies behind the theory of Islamic banking, and to explain how the Islamic banking system operates.

1 Background

Any research in this field requires some familiarity with the ground rules and essential norms of Islam and how these relate to the principles and practice of Islamic economics. The rules and norms of Islam derive from the Qur'ān and the *sunna* (the living tradition of the Prophet Muḥammad, *ṣalla-llahu 'alaihi wa sallam*).¹ The *sunna* is known to us from written collections of sayings and precepts attributed to him and of records of his decisions and actions in a wide variety of situations.

The most important of the rules and norms are axiomatic for Muslims, that is, above question. The ones relevant to our subject are that:

- a) The Qur'ān is the revealed word of Allah, transmitted *verbatim*, and this Qur'ān is authoritatively explained through the teaching and example or *sunna* of the Prophet.
- b) The *sharī'a* is the Divine Law, derived directly from the words of the Qur'ān or from the *sunna* of the Prophet, or indirectly from the same sources through reasoned deduction or analogy.
- c) Human reason has a limited sovereignty within the Law; it has no sovereignty over the Law. In other words, what Allah has permitted cannot be unconditionally prohibited, nor can what He has prohibited be made unconditionally permissible (Qaradawi, n.d.).
- d) The Law includes the general principle that if nothing is specifically prohibited, it is in principle (and practice) permitted.

¹ This prayer is normally recited by Muslims after mention of the Prophet's name; it is usually translated: "May peace and the blessings of Allah be upon him."

- e) The Law prohibits *ribā* (which we define as taking or lending money on a fixed rate of interest, or financing an enterprise with interest-accumulating capital).
- f) The concept of prosperity (Kahf, 1981) is defined in *sharī'a* in terms of the pleasure of Allah and not in terms of accumulation of surplus wealth. Virtue, righteousness and fulfilment of servanthood to Allah are the keys to His pleasure. Virtue and righteousness can be achieved through good actions and purification of human behaviour from evil and vice.
- g) The concept of wealth and income is unique in Islam (Kahf, 1981). *Māl*, whether looked at as wealth or income, is a bounty from Allah; it is not evil. Heaven is not open only to the poor, it is also equally open to the rich. *Māl* is a means that may be used for good or for evil. Poverty is in some instances associated with disbelief and riches are considered a gift from Allah (Ahmad, 1991). So the most important point is not whether you have money, but how you earn and spend it.

2 The problems associated with research into Islamic economics

Can there be specifically Islamic economics? Economics, it is often emphasized, is a positive science, or at least has pretensions to be one. Islam, on the other hand, is a religion which has to do with general values, normative judgements and so on. One might suppose that there can no more be an Islamic economics than Islamic atomic physics, or Islamic mathematics.

However it can be argued that a distinct and meaningful Islamic economics is possible and indeed necessary. Zarqa (1981) stated that, to begin with, conventional economics is not as innocent of value judgement as we are often led to believe, nor can it ever be so. Equally, Islam is not devoid of positive assertions about economic reality. It follows that one can replace non-Islamic value judgements with Islamic ones, and add to the economists' stock of positive assertions Islamic

assertions, and then work out the consequences. However, there are substantial problems associated with research in this field. Most of them have to do with the fact that Islamic economics is a new discipline with uncertain boundaries and without the conceptual and analytical sophistication of conventional economics:

- a) Because Islamic economics has only recently come to be used as a rationale for determining policy objectives and implementation, the data available for analysis is, relatively, limited (Yalcintas, 1987).
- b) There is a shortage of scholars sufficiently qualified in both the relevant disciplines, namely Islamic jurisprudence (*fiqh*) and modern (conventional) economics (Zarqa, 1987).
- c) There is, as a result of the shortage of relevant data and qualified personnel, a retardation of the theoretical development of the discipline, i.e. in consequence, theoretical analysis of the practical implementation of Islamic economics lacks the methodology, the tools (concepts, specialist terms) needed to proceed confidently and at a pace (Ahmad, 1987b).
- d i) A symptom of the theoretical naiveté of the discipline is a common confusion between a ruling on a particular issue given by a particular scholar working within the principles of the Law, and the principles of the law. The authority of the principle(s) from which the ruling is derived is accorded, without the proper reservations and qualifications, to the ruling itself (Yalcintas, 1987).
- ii) A second symptom is the failure to establish modes of reasoning which will allow the individual to determine, for a particular problem, the relevance of arguments from *fiqh* or from conventional economics (Zarqa, 1987).
- iii) A third important symptom is the lack of criteria for determining whether a whole theory of all possible economic relations or transactions is needed, or if Islamic economics could or should confine itself to particular sectors of the economy or to particular sorts of transaction (Abdul-Jabir, 1987).

- e) Conventional economics is not irrelevant to either the theory or the implementation of Islamic economic policy, and may, in some ways, be of great service (Abdul-Jabir, 1987).

3 Key elements of Islamic economic thought

3.1 Ownership

An understanding of the concept of property in Islam is one of the foundations of behaviour for both the consumer and the firm. Absolute or pure concepts of property are important in shaping the psychological environment within which economic activity is motivated and preferences between kinds of relationship and transaction are made. The following points are particularly relevant (Abbadi, 1977):

- a) Property is unconditionally owned only by Allah (Qur'ān, 24:33 and 57:7).
- b) Property among human beings is a form of stewardship or care-taking, that is, it is conditional, and for the use of every property the person is answerable to Allah.
- c) Conditional ownership is either (i) collective or (ii) individual.
 - i) Collective ownership extends to such fundamental, natural resources as water, air and fire. Ownership of such resources cannot be held by an individual. The actual use of such resources by individuals may be recognized provided such use does not adversely affect rights of use (e.g. access) by other individuals.
 - ii) Individual ownership extends to goods, buildings, livestock, etc., and includes rights to lease, rent or re-sell. Restrictions on such ownership will be considered by the authorities only if they fear abuse of certain resources by the owner or encroachment by him on the rights of others.

In sum, Islam recognizes the right to own property for consumption and for production (14, 32-34):

- It is God who has created the heavens and the earth and sends down rain from the skies and with it brings out fruits wherewith to feed you; it is He who has made the ships subject to you, that you may sail through the sea by His command; and the rivers (also) has He made subject to you - And He has made subject to you the sun and the moon, both diligently pursuing their courses, and the night and the day has He (also) made subject to you. And He gives you of all that you ask for. But if you count the favours (gifts) of God, never will you be able to number them. Verily, man is given up to injustice and ingratitude.

This indicates clearly that God has made practically unlimited resources available to mankind. Thus the economic problem of man in Islamic philosophy does not stem from scarcity, as claimed in capitalism, or from exploitation of production relationships, as the marxists claim, but from the utilization of these resources in accordance with God's dictates.

Three basic principles are accepted in the *sharī'a* as to the way this should be done:

- a) Ownership of resources by man is not absolute. It is a social obligation to be undertaken within the limits set for it. Allah owns the resources and man is only a trustee in their use.
- b) The way to pursue the acquisition and development of resources, i.e. the economic aspect of man's life, is likewise not completely free; there are moral and legal constraints.
- c) Although individuals are allowed to own wealth in the normal way, the final aim is that this wealth should be of use to the community as a whole: social solidarity is the justification

and aim of the Islamic economy. Wealth can come into the possession of any individual through his or her work, or through inheritance and grants but these too are conceived of as, originally, the results of work.

All forms of activities that allow an individual to acquire wealth in a *ḥarām* way are strictly prohibited. These include (Hamidi, 1986):

- a) Monopoly in all forms².
- b) Hoarding.
- c) Gambling and betting in all forms.
- d) Cheating in quality, quantity, weight or any specifications of the goods and services traded or acquired or disposed of.
- e) All trade malpractices (e.g. creating artificial scarcities, etc.)
- f) Speculation in all forms that might be used to scoop windfall profits, not justified by the real value of the assets traded or being developed. (These might include modern practices of closed deals in forward sale of currencies, commodities, shares etc. Spot sales or open deals subject to risk are another matter.)
- g) All types of fraudulent sale or sales used as an excuse to charge interest.

² For example if the dealers in a commodity refuse to sell it, despite the fact that people are in need of it, unless they secure a price higher than its known value they must be compelled to sell it at a price equal to the price of an equivalent commodity (Qaradawi, n.d.).

h) Interest in any form and at any rate is strictly prohibited in Islam.

3.2 Contracts

A number of contracts are recognized in Islamic law. Detailed descriptions of many of them, since they recur in Islamic banking, will be given later (See Chapter 3).

3.3 Prohibition of *ribā*

Ribā is a crime as well as a sin, and even those hired to write the contract or who witness (and thus confirm) the contract are a party to the sin. The relevant saying of the Prophet is: “Allah has cursed the one who takes *ribā*, the one who pays, the one who writes the contract, and the one who witnesses the contract”. There is a consensus among Muslim scholars that this prohibition extends to any and all forms of interest and there is no difference between interest-bearing loans for purposes of consumption or investment (M.F.I, 1986). The original ban on interest charges stemmed from the fact that money lenders were exploiting the poor by charging usurious rates (Wohlers-Scharf, 1983).

Prohibition of *ribā* means that money can only be lent lawfully either for charitable purposes—that is, without any expectation of return above the amount of the principal—or for purposes of doing lawful business—that is, investment on the basis of profit and risk sharing. Investment of the kind that seeks profit while sharing the risk is encouraged in Islam, and indeed commended (2:275; 57:10; 6:29).

The clear distinction between trading and *ribā* in Islam needs emphasis, the former being not merely permitted but encouraged. Economic activity and prosperity are not reluctantly tolerated as

this worldly necessity, but viewed as a religious virtue or even as an obligation, provided the activity conforms to *sharī'a*. Thus, while both trading and *ribā* generate an increase in capital, the increase generated by trading is welcome, and only that generated by *ribā* is forbidden. *Sharī'a* does not consider money as a commodity such that there should be a price for its use. Money is a medium of exchange in an asset-orientated economy; money is just a means of exchange and store of value. It is not allowed to be a commodity (it cannot be in view of the prohibition of interest which allows trading in loans).

The difference between the trade and *ribā* among other things, is the fact that the business risk in trading is more evenly allocated among all the parties involved, whereas in *ribā* operations the business risk lies heavily, if not solely, with the borrower (Ashker, 1987).

3.4 Zakāh

Zakāh is a tax levied on all persons having wealth above an exemption limit, in order to purify their wealth and their souls. The rate of tax and the exemption limit are set by the *sharī'a* (Khan, 1990a). The main purpose of the tax is redistribution of wealth and income. However, the transfer of income generates changes in the composition of demand for commodities that satisfy basic needs. Consequently, the composition of aggregate supply should change in the direction of more food, clothing and shelter and fewer luxuries (Kahf, 1982). The proper recipients of expenditure of *zakāh* funds are specified in the Qur'ān (9:60); the poor and the needy, *zakāh* collectors, new converts to Islam, travellers (when in difficulty), in the way of Allah, the relief of captives and debtors, and otherwise as interpreted by Muslim scholars.

Most Muslim scholars believe that a major objective of *zakāh* is to alleviate poverty. That objective is not left to private individuals, although charity (*sadaqa*) is also strongly encouraged. Without doubt *zakāh* is meant to be collected and distributed in an organized collective way (Salama, 1982).

The basic instrument for circulation of wealth in an Islamic society is a mandatory, fixed and stable tax, collection and payment of which is a religious duty. It is not a fiscal measure subject to variations of government policies (Uzair, 1981).

Zakāh is calculated at 2.5% of the total value of capital and profits minus bad debts and depreciation. In agriculture it varies from 2.5% to 10% according to the type of irrigation. There is a different way for calculating the tax on livestock. *Zakāh* should be collected and distributed locally. Only the surplus may be expended elsewhere and must be expended according to the heads of expenditure indicated in the Qur'ān.

3.5 The role of government in the economy

The two major objectives of Islamic government in relation to the economic life of the community are (Abbadi, 1977):

- a) To enable rich and varied economic activity in compliance with the law. This involves supervision of the different transactions and functions in which people engage, and the provision of legal mechanisms to settle any disputes that may arise. It also involves the appointment of officials to ensure the freedom of the market from hoarding and monopoly and to guarantee standards (coinage, weights, measures, etc.).

- b) To raise revenues in order to secure the administration of *sharī'a* laws and norms, central among which is the achievement of a degree of distributive justice. This objective is served directly through the collection and distribution of *zakāh* revenues, and indirectly through maintenance of Islamic inheritance laws which also ensure a measure of wealth division and circulation.

The role of government is recognized and affirmed in Islam. That role is a limited one, but one vital for the smooth running of an Islamic economy. Whenever a market fails to operate on its own, an Islamic government may step in to remedy the situation using various policies at its disposal. The Prophet used to inspect markets to check business frauds and other market imperfections. Once he cautioned a fraudulent trader saying: 'whosoever cheats is not one of us'.

An Islamic government has to take responsibility for certain fundamental economic goals such as the eradication of poverty, the creation of employment, the maximization of economic growth, the establishment of an equitable distribution system and socio-economic justice, the creation of a conducive environment for economic activities and so on. The welfare functions of an Islamic government include moral and spiritual education as well as the material development of an Islamic economy (Jalaluddin, 1991).

In Chapra's opinion (Chapra, 1981) we should follow closely the essential functions of the Islamic welfare state with respect to the economy outlined above. In summary form:

- a) to eradicate poverty and create conditions for full employment and a high rate of growth;
- b) to promote stability in the real value of money;
- c) to maintain law and order;
- d) to ensure social and economic justice;
- e) to arrange social security and foster equitable distribution of income and wealth; and

- f) to harmonise international relations and ensure national defence.

3.6 Production norms

In the field of production, there is a three-level hierarchy: necessities, conveniences and refinements (Ahmad, n.d.).

- a) Necessities comprise all activities, services and goods essential to the preservation of the five foundations of sound individual and collective life, according to Islam, namely religion, life, mind, offspring, property.
- b) Conveniences comprise all activities, services and goods not vital to the preservation of the five foundations, but rather, needed to alleviate or remove impediments and hardships.
- c) Refinements consist of activities, services and goods that go beyond the limits of conveniences. The category includes whatever does not remove or alleviate difficulties, but consists rather in adornments and refinements which brighten one's life or console it.

These categories, it must be remembered, are not closed. Changes in the mode of life may shift certain activities, goods or services from one category into another. Going beyond refinements into prodigality and self-indulgence is considered by Islam as a disservice for individuals and society alike and is strongly disapproved (Zarqa, 1981).

3.7 Consumption norms

Islam does not encourage Muslims to seek to expand their needs, but to contain them at a disciplined level. In fact, Islam encourages moderation and modesty, and prohibits *isrāf* (spending wastefully) and *tabdhīr* (spending wastefully on unlawful things) (Ahmad, n.d.).

3.8 Profit-sharing and risk-sharing

The implication of the principle that there should be no profit-sharing without risk-sharing (*al-ghunm bi-'l-ghurm*) is that earning profit is legitimized by engaging in an economic venture and thereby contributing to the economy (Ahmad, n.d.). The traits that distinguish Islamic economy and finance from their conventional counterparts reflect a different understanding of the value of capital and labour. In lieu of a lender-borrower relationship, Islamic finance relies on equitable risk-sharing between the person who provides the capital and the entrepreneur. This practice derives from the central tenet of Islamic banking based on the Qur'ān which forbids *ribā*. The economic rationale for profit-sharing is not only distributive justice but efficiency, economic stability and growth. As far as allocative efficiency is concerned, it is contended that debt financing usually goes to the most credit-worthy borrower and not necessarily to the most productive and potentially profitable projects. As for stability, the argument is advanced that an interest-based economy has a built-in tendency towards inflation because the creation of money is not linked to productive investment at the level of other central banks or of commercial banks. The prohibition can be expressed in more technical terms by saying that while money is recognized in Islam as a means *of* exchange, it may not lawfully be regarded as a commodity *for* exchange (Wohlers-Scharf, 1983).

3.9 Islamic economics and Islamic ethics

If one examines the balance of emphasis in the publications in conventional economics, it is hard not to notice the eschewal of deep normative analysis and the neglect of the relevance of ethical considerations in the characterization of actual human behaviour (Sen, 1991).

In Islamic economics it is clear that economic considerations are subordinated to moral considerations, as for instance in the verse prohibiting *ribā* (interest) wherein the practice is described as gross injustice. The general requirement is that both the ends and the means must be Islamically legitimate (Naqvi, 1981). Beyond that, great emphasis is laid on maintaining a balance between the conflicting interests of individuals and the different sections of society (Zaman, 1991).

Regarding Islamic banks, the relevance of Islamic banking to ethical banking generally is that it offers a number of alternative approaches to the banker-customer relationship. It helps to stimulate new thinking about alternative banking and possible ethical solutions to emerging problems such as coping with the underclass and financing small businesses based on networks or communes. What we witness in the growth of Islamic banks is the growth of a type of banking which explicitly asserts its ethical values (Lynch, 1991).

Chapter 3

Islamic Banking Theory

1 Background

Over the last fifteen years there has been a rapid expansion of financial institutions that can be characterized as Islamic in that they do not conduct interest-based transactions. At present about 45 countries, encompassing most of the Muslim world, have some type of Islamic banking or financial institution (Iqbal and Mirakhor, 1987). At present there are three countries implementing Islamic banking at a macro-level, Pakistan, Iran and Sudan.

Since the elimination of *ribā* has generally been seen as the first step in the Islamization of the economy, and since that first step is at the same time a first step in the introduction of an alternative system, it is perhaps natural that the institution of interest-free banking should have received the most attention.

It was the theoretical discussions of, and articles on, Islamic economics and banking that led to the pioneering experiment in Egypt starting in 1963 in the town of Mit Ghamr 80 kilometres from Cairo. This experiment lasted till 1967 by which time there were nine banks in operation including those in Cairo with more than 250,000 depositors and a total of 1.8 million Egyptian Pounds in deposits. These banks neither paid nor charged interest. They made profits for their depositors sometimes by financing business on a profit sharing basis, but mostly by engaging in trade and industry directly or in partnership with others. They were barred from charging or paying interest but their charter did not refer to Islam or *sharī'a* (Siddiqui, 1986). The success of the Mit Ghamr experiment in Islamic banking was short-lived, 'for political reasons' (Zineldin, 1990). After that in the seventies the movement began again, in a professional way, to establish banks which would work under Islamic law, and the establishment of the Islamic Development Bank was considered as a "kick start" for the contemporary Islamic banking movement (Abdel-Haq, 1989).

There are currently four categories of Islamic banks which are operating, each of which, it is important to note, is supposed to be doing so on the same general principles (Masri, 1981):

- a) The Islamic Development Bank (I.D.B.).
- b) Those banks which operate in countries where the whole banking system has been converted to operating on Islamic principles and whose activities are overseen in some way by religious bodies (for example, Iran and Pakistan).
- c) Those banks which operate in Muslim countries and which co-exist with interest-based banks (for example, Jordan, Egypt, Malaysia).
- d) Islamic banks which exist in non-Muslim countries (for example Al-Baraka International Bank in London).

This thesis will focus principally on categories three and four; category two has been left out because: i) there have already been extensive studies published on it¹; ii) a serious academic study of such banks is very difficult without becoming involved in the political and cultural circumstances which influence their operation; iii) because of limitations of time and resources. However, before turning to categories three and four, it is worthwhile summarizing briefly the aims and intentions of the Islamic Development Bank (Abdel-Haq, 1989).

2 An overview of the Islamic Development Bank (I.D.B.)

The I.D.B. is the premier Islamic financing institution and a unique phenomenon. It came about following a meeting of the finance ministers of Islamic countries held in Jeddah in 1973. The

¹ For more details about Pakistan and Iran's experience see Iqbal, Z. and Mirakhor, A. (1987) *Islamic Banking*. International Monetary Fund, Washington, DC. And Khan, M.A. (1992) *Islamic Banking in Pakistan: The Future Path*. All Islamic Education Congress, Lahore.

feasibility of an international development bank was discussed at that meeting, and an inter-governmental Islamic institution was actually opened on 20 October 1975, also in Jeddah. This institution was named the Islamic Development Bank.

2.1 The objectives of the I.D.B.

The objectives of the bank, as set out in its Articles of Agreement (I.D.B., 1981a), are to meet the following needs:

- a) the need to foster the well-being of the people of Muslim countries and to achieve a harmonious and balanced development of these countries on the basis of Islamic principles and ideals;
- b) the need for mutual financial and economic co-operation among the Muslim states in economic, social and other fields;
- c) the need to mobilize financial and other resources both from within and outside the member countries, and to promote domestic savings and investments and a greater flow of development funds into member countries.

The charter of the bank stipulates that the international financial institution being established shall be oriented to development, investment and welfare, be based on Islamic principles and ideals, and be a practical expression of the unity and solidarity of the Muslim *ummah*.

More specifically, the purpose of the Bank as expressed in Article 1 is to foster economic development and social progress in member countries and Muslim communities, separately as well as jointly, in accordance with the principles of *sharīʿa*.

In this regard, two facts deserve special mention. First, that the mission and task assigned to the Bank embraces the Muslim *ummah* as a whole and is not confined to only the member countries.

Secondly, while the Bank is required to operate in accordance with the principles of *sharī'a*, this is a broad and general requirement applying to all the Bank's activities; beyond that, no guidance is provided in specific terms (Meenai, 1989).

2.2 The operations and role of the I.D.B.

The Bank has been assigned the following functions and powers (I.D.B., 1981b):

- a) to participate in the equity capital of productive projects and enterprises in member countries;
- b) to invest in economic and social infrastructure projects in member countries through participation or other financial arrangements;
- c) to make loans to the private and public sectors for the financing of productive projects, enterprises and programmes in member countries;
- d) to establish and operate special funds for specific purposes, including a fund for assistance to Muslim communities in non-member countries;
- e) to operate trust funds;
- f) to accept deposits and to raise funds in any other manner;
- g) to assist in the promotion of foreign trade, especially in capital goods, among member countries;
- h) to invest suitable funds not needed in its operations;
- i) to provide technical assistance to member countries;
- j) to extend training facilities for personnel engaged in development activities in member countries;
- k) to undertake the research necessary to enable the economic, financial and banking activities in Muslim countries to conform to *sharī'a*;

- l) to co-operate in such manner as the Bank may deem appropriate with all bodies, institutions and organizations having similar purposes, in pursuance of international economic co-operation;
- m) to undertake any other activities which may advance its purpose.

The foregoing list clearly demonstrates that the Bank has been assigned a very wide-ranging set of tasks which in many ways exceed the functions assigned to other international development banks (Meenai, 1989).

2.3 The relationship between the I.D.B. and other Islamic banks

The Bank's charter clearly stipulates that it should co-operate with all bodies, institutions and organizations having similar purposes in pursuance of international economic co-operation. The Bank has, therefore, from its inception endeavoured to establish close relations with Islamic banks. To this end, it has held extensive discussions with them, as well as ad-hoc contacts. Since 1980 the I.D.B. has organised a special meeting each year to coincide with its annual meeting to which the Islamic banks are invited for the purpose of discussing problems and avenues for co-operation. It is also worth mentioning that some founders of the Islamic banks have agreed on the establishment of an international organization under the name of the International Association of Islamic Banks. The objectives for which the Association has been established can be summed up in the following (I.A.I.B, 1990):

- a) The provision, upon request, of technical assistance and expertise to Islamic communities wishing to establish Islamic banks.
- b) Follow-up procedures concerning the establishment of Islamic banks both at national and international levels, encouragement of their activities and extending assistance for their development.

- c) The formulation of bases for co-operation, co-ordination and exchange of expertise among member Islamic Banks; mutual exchange, within absolute confidentiality, of information pertaining to individual clients; an agreement not to exchange such data with non-member banks, and the extension of assistance to member banks to overcome possible difficulties without interference in their executive activities.
- d) Representation of Islamic banks and of their common interests at all levels.
- e) Catering for free movement of capital between Islamic banks.
- f) Co-ordination and standardization of work systems, banking forms, and the regulations pertaining to the activities of member banks.
- g) Raising the standards of member bank employees.
- h) Advising on, and helping prepare, studies relating to projects to be financed by Islamic banks. This would include, for example, mobilization of the required resources, and the role of Islamic banks in this regard.
- i) Mediation and arbitration between Islamic banks in accordance with rules to be laid down by the Board of Directors of the Association.
- j) Studying the monetary, credit and banking problems at national and international levels and the suggestion of appropriate policies that would enable Islamic banks to find solutions for the problems they encounter.
- k) Waging publicity campaigns to disseminate the concept of Islamic business dealings.

It has also sought to promote the establishment of Islamic banks by contributions to their equity. It has an Investment Deposit Scheme in operation under which the Islamic banks are able to place their surplus funds in the Bank's foreign trade financing operations in accordance with the principles of *sharī'a* (I.D.B., 1981b).

The I.D.B. has also offered training facilities to the Islamic banks through its Islamic Research and Training Institute. It is also engaged in setting up new procedures for co-financing arrangements with Islamic banks and for development of a trade and leasing portfolio (the Islamic Banks portfolio managed by I.D.B. on behalf of twenty-two Islamic banks). The resources will be mobilised through the issuing of certificates which will be negotiable and tradeable among Islamic banks.

The Islamic banks for their part have very high expectations of the I.D.B. and expect it to play something of a parental role, plead their case with governments and central banks of member countries and to use any leverage it may have with them for the purpose of helping the Islamic banks.

In recent years the Islamic banks have evinced growing interest in using the I.D.B.'s Investment Deposit Scheme to place their surplus funds. This is the result of several factors:

- a) there has been a larger inflow of deposits into these banks as they have become established and confidence in them has grown;
- b) the return which they offer to depositors has become especially attractive as deposit rates have generally fallen in the international money market.

The two most positive aspects of the I.D.B. are its treatment of the Islamic world as a single region, and application of the *sharī'a* to development (Abdel-Haq, 1991).

2.4 Conformity to *sharī'a*

The initial exploratory work done clearly showed that there was a difficulty in investing or placing surplus funds in the international money market or with conventional banks which would satisfy the requirements of *sharī'a*. This led to an effort by the I.D.B. to seek ways and means of placing them with a new Islamic institution to be called the Foreign Trade Financing Operations of the I.D.B. Simultaneously, it was decided that the placement operations in the conventional manner with banks would have to continue until such time as alternative methods could be found. Nevertheless, it was resolved that the interest proceeds from these deposits should be held separately.

This gave rise to the question as to how these very large funds built out of interest could be utilized. Consultations with the religious committee led to the conclusion that under the rule of necessity, interest proceeds could be utilized for assistance to the poor in member and non-member countries and to assist Islamic communities in non-member countries to maintain their Islamic identity and legitimate rights. Such an approach is considered balanced, wise, and beneficial.

3 **Islamic financing techniques (investment activities in Islamic banks)**

Islamic law permits a wide range of contracts to be designed and implemented within the law. Some of these techniques were founded in the period of the first Islamic state, others have emerged recently to meet contemporary financing requirements within the light of the teachings of Islam (Iqbal and Mirakhor, 1987):

3.1 *Qard ḥasan*

Is a pure loan transaction in which the client obtains cash from the bank to be returned at a stipulated future date, free of interest (Ahmad, 1987a).

3.2 Loan with service charges

This is the same as *qard ḥasan* except that the lender is allowed to charge any cost that may have to be incurred by him in making the loan available to the borrower. The service charges are not profit: these are actual costs in respect of rental of premises, workers' wages, stationery, etc. Islamic law allows a lender to recover from the borrower the costs of operation over and above the principal (M.F.I, 1986), but an important condition attached to such charges, to prevent them becoming equivalent to interest, is that the commission or charge cannot be made proportional to the amount or to the term of the loan (Ashker, 1987).

3.3 Mudarabah

This is a financing technique in which the capital-owner provides funds to the capital-user for use in some productive activity on the condition that the profits they generate will be shared by the capital owner and the capital user. The loss, if any, incurred in the normal process of the business and not due to neglect or misconduct on the part of the capital-user is borne by the capital owner. The user does not invest anything in the business except his human capital and does not claim any wage for conducting the business. The capital owner simply provides the finances and is not authorized to interfere in the management of the business. The ratio in which profits are distributed is fixed and predetermined and known in advance to both parties. In the event of loss the capital provider loses his capital to the extent of the loss, and the user of the finance loses all his labour. The willingness to bear the risk of loss justifies a share in the profit for the finance provider. The profit-sharing ratio mutually agreed upon between finance provider and finance user is determined by market forces (Siddiqui, 1987). The client guarantees to return funds only on two conditions, if he is negligent in the use of the funds or if he breaches the conditions of *mudarabah* (Iqbal and Mirakhor, 1987).

3.4 Musharakah

This is a financing technique in which a capital owner finances investment in another party's business. Additional finance is provided to the party (individual or group) who already has some funds for investment. The finance provider provides the additional funds on the condition that he shares in the profits from the business. The ratio in which the finance provider shares the profits of the business with the party receiving the additional funds is fixed and predetermined, and made known in advance to all concerned. The loss, however, will be shared in the exact proportion of the capital invested by each party. The profit-sharing ratio is left to be mutually agreed upon and may be different from the ratio in which the two parties (finance provider and user) have invested in the total capital of the project. This is because the two parties may share the work of managing the project in any amount mutually agreed upon. Both parties are allowed to charge a fee or wage for any management or other labour put into the project (Khan, 1987). All providers of capital are entitled to participate in management but are not necessarily required to do so. The *musharakah* is continuous if the partnership lasts as long as the business operates (Khan and Mirakhor, 1987).

These techniques are very similar because the provider of finance directly shares the profits and is contracted to bear the losses, if any, to the extent of his investment. That is why these two techniques are often put together into one category known as profit-and-loss-sharing. In Islamic banking, with the replacement of interest by profit-and-loss-sharing from the return on the capital advanced by the banks, repayment depends entirely on the productivity of the projected enterprise (Siddiqui, 1987).

Necessarily, the norm for an Islamic bank will be to assess the productivity of a project and back those projects which promise the highest rate of profit. Thus, projects for funding through partnership are expected to be selected primarily on the basis of their anticipated profitability rather than the credit-worthiness or solvency of the borrower. The relationship between finance and

business is transformed, the interests of the two come together, both need to work jointly to create more wealth (Iqbal and Mirakhor, 1987).

A pure P.L.S. system has a number of positive qualities. Significantly though, the qualities that make P.L.S. partnership so attractive to Islamic economists and entrepreneurs are the ones that make it so unattractive to Islamic banks. The bank does not know in advance its absolute income from the transaction: by contrast, a conventional bank can work out the figure from the interest rate. The Islamic bank has to study and evaluate entrepreneurial proposals which requires highly qualified personnel; then it has to find adequate measures to protect itself against manipulation of the profits which are to be shared. While it does those things, at the same time it has to offer its depositors attractive P.L.S. projects to finance which will break even and provide an income for the bank quickly. Another practical drawback of the P.L.S. technique is that, from the point of view of an entrepreneur who is sure of a high profit rate, paying out a fixed amount of interest will be more attractive than sharing the substantial anticipated profit. This means that if purely economic considerations are paramount, and if Islamic banks are in competition with conventional banks, the Islamic banks will be left financing the less profitable projects. For all these reasons, Islamic banks have looked for other ways to employ funds, ways which do not involve risk-sharing and are economically profitable. So the majority of actual transactions made by Islamic banks are in trade financing where mark-up and similar arrangements assure the banks of a more or less fixed return (Nienhaus, 1984).

3.5 Leasing/Ijara

Leasing certainly is, or can function as, a financing technique. An individual short of funds may approach another with a surplus (the financier) to fund the purchase of a productive asset. The financier may do so and rent it out to the one who needs the asset. This certainly is a financing technique in that the investor's financial difficulties (with respect to purchasing the required asset)

are overcome. He pays only the rent and does not have to incur the capital investment involved in the purchase of the asset (Naseef, 1988).

To be acceptable in an Islamic framework, the leasing contract must meet certain conditions, of which the principal are the following (I.D.B, 1981c):

- a) the service that the asset is supposed to provide and for which it is being rented should be definitely and clearly known to both parties;
- b) the asset remains in the ownership of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented;
- c) the leasing contract is terminated as soon as the asset ceases to give the service for which it was rented. If the asset becomes damaged during the period of the contract, the contract will not remain valid;
- d) the price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be determined only at the time of the expiry of the contract.

Payments to the bank are made in instalments over a mutually agreed period. At the end of that period, the title to the equipment is fully transferred to the hiring company (I.D.B. 1981c). Banks provide companies with machinery and equipment under a joint-ownership agreement subject to conditions of security or surety (Ashker, 1987). In addition to the repayment of the original cost price, banks receive a share in the rental value of equipment which is calculated as a proportion of the asset's value, which is the amount of the bank's capital outlay.

3.6 *Ijara wa Iqtina*

This is a hire-purchase agreement between the bank and its clients. The bank agrees to buy and rent a building, equipment or other facility for the client, in conjunction with an undertaking by the client to make incremental payments into an account. At the end of each year profits are added to

the instalments paid until such time as the investment account contains the identical amount the bank paid to purchase the building equipment or facility. The client becomes owner of the financed equipment and the contract ends (Siddiqui, 1986).

3.7 *Morabaha*

This is a cost-plus contract in which a client, wishing to purchase equipment or goods, requests the Islamic bank to purchase the items and sell them to him at cost plus a declared profit (Ali, 1987). By this technique a party needing finance to purchase certain goods gets the necessary finance on a deferred payment basis. The finance-provider does the purchasing of the required goods and sells them on the basis of a fixed mark-up profit, agreeing to defer the receipt of the value of the goods even though the goods can be delivered immediately.

The need for finance of the one in need is thus met. He needed funds to purchase certain commodities (e.g. raw material or capital goods or even consumer goods). His purchase is financed, and paid for at some later date, though he may end up paying more than he would have paid if he had his own money to purchase these goods. The desire of the finance-owner to earn income on his capital is also met. He makes profit in terms of the mutually agreed-upon mark-up (Hamoud, 1985).

This financing technique is sometimes considered to be the same as interest because a person who needed say \$1,000 to purchase certain goods gets the funds but ends up paying a 10% additional value which does look like paying interest. However in theory the mark-up is not in fact in the nature of a compensation for time or deferred payment, though the entire cost had to be incurred because the needy person did not have means at hand to make the purchase he wanted. The mark-up is for the services that the finance owner provides, namely, seeking out and locating and purchasing required goods at the best price. This is a recognized service which can be paid for and whose value is predeterminable. Furthermore, the mark-up is not related to time since, if the

financed person is unable to pay in time as agreed, the amount of mark-up remains as fixed in the contract - it does not increase due to delay in payment (Khan, 1988).

Consider the position of finance provider - what justifies his earning the fixed mark-up? Firstly, he provides a definite service in the form of obtaining the goods for his client, for which service he can charge a fixed price. Secondly, in obtaining the goods, he is taking a risk. The client may not accept the quality or price at which he purchased and the financier is then stuck with the goods. This risk is over and above the risks normally involved in trading activity - such as storage costs, damage in storage or in transit, etc. All these risks justify his earning profit; they also mean that, though he has fixed the mark-up, he may not necessarily end up making profit or getting the rate of return on his capital equal to the amount of mark-up fixed at the time of contract (Khan, 1988).

The *morabaha* type of contract suggests a difference in price familiar in conventional economics as the difference between cash price and credit sale price. The question naturally arises: under the *sharī‘a*, is a seller allowed to charge a higher price for a credit sale than for a cash sale? (Khan, 1988). The short answer is yes, but four conditions must be satisfied:

- a) the buyer must be told that the price is a credit price and the difference between the credit and cash price must be made known to him;
- b) the buyer must have been given the option of buying at either price;
- c) the buyer must be told if the goods being sold were originally purchased at a credit price;
- d) the transaction must be a trade transaction (as distinct from a purely financial one).

The last condition above introduces a particular distinction between the time-value associated with trade transactions and the time-value attached to purely financial transactions. While the former are permissible, the latter are not. This is a very important point that has been often and widely confused. Time has a value when it is associated with trade transactions in particular, but it does not have a value when it is associated with purely financial transactions. In trade credit, the difference between credit price and cash price varies with the profitability of the business. The

relationship is also different between different industries and different businesses. In this respect, such contracts are not at all like credit contracts based on interest - which does not vary at all, being independent of the monetary value of the transaction, and independent of the goods or services transacted.

4 *Ushr*

Banks and financial institutions can meet the financing needs of trade and industry on the basis of *musharakah*, *mudarabah*, *morabaha* and *ijara*. But doing the same in the agricultural sector, still in accordance with *sharī'a*, presents a formidable challenge. Improving agricultural production per acre and per man is naturally the objective and one impossible without providing institutional credit to subsistence farmers. A solution compatible with *sharī'a* uses the following instruments.

4.1 *Bai Muwajjal*

This literally means sale on a deferred payment basis. Delivery of goods, inputs or implements is made immediately and the price agreed is paid by the purchaser at a given date in the future. The price includes the cost plus a reasonable margin of profit to cover the administrative cost. The concept is based on mark-up in price and is also known as *morabaha* (see 3.7 above). The bank sells to farmers inputs and implements on a deferred payment basis. This is a sale and not a loan transaction. *Sharī'a* permits a trader to sell his goods either for cash or on credit on the condition that the price, once agreed between the parties at the time of bargain, is not changed even if the payment is not made at the due date: mark-up on mark-up, that is compounding of the amount of profit, is not permitted. If this condition is not fulfilled or is violated, the transaction degenerates into *ribā*. If mark-up on mark-up is not avoided, the objective of eliminating interest is defeated and we come back to square one even after adopting roundabout, tedious and time-consuming procedures. *Bai muwajjal*, if it is acceptable according to *sharī'a*, lacks any deterrent for

defaulters; the only guarantee of timely payment is the credit-worthiness of the purchaser. This defect can be countered by enacting suitable laws allowing for the imposition of monetary fines on malicious defaulters. The amount of the fine on recovery shall have to be deposited in the government treasury and not used as income by the seller (Zaidi, 1983).

4.2 *Bai Salam*

This is also a trade transaction and not a loan transaction. Under this arrangement, the buyer (financier) agrees to purchase a commodity from the producer in advance and pays the agreed price immediately but the commodity is delivered at a future date (Qudah, 1981). The details of commodity and its quality, price and time/place of delivery are specified. Now if the banks embark upon financing on this the practical problems in dealing with millions of farmers can be well imagined. Taking delivery of the produce, assessing its quality, storage and disposal, all have to be considered. *Bai salam* has no practical advantage over *bai muwajjal* (Hawari, 1984). Such sales have not been used by Islamic banks in the field of agricultural financing. As mentioned, the produce is delivered at a future date against an advance payment for it. Its main conditions as agreed upon by the majority of Muslim jurists are (Hamidi, 1986):

- a) The agreed price for the produce to be delivered should be paid immediately at the time of contract, cash in full.
- b) Delivery of the goods must be postponed for a definite fixed time.
- c) The goods to be delivered should be of a type that is commonly available at the time fixed for delivery i.e. the contract should not specify delivery of goods from a certain plot or location. This is to ensure the financier against unnecessary risk and to enable the farmer to deliver produce which he may obtain from another source if need be. However, the contract must specify clearly the kind, description and quality of goods to be delivered.

All of these banking operations described (see above) are feasible and positive, and no doubt beneficial to the economy as a whole. They require Islamic banks to study the economic viability of potential investments and to audit and supervise business operations financed by them with great care. In this respect, Islamic banks need to have or to engage more staff expertise than conventional banks.

5 Islamic banking services

Islamic banks accept deposits from its clients', Ismail (1992) identified four types of accounts: i) Current Accounts; ii) Saving Accounts; iii) General Investment Accounts; iv) Special Investment Accounts.

5.1 Current accounts

- a) Islamic banks accept deposits from clients looking for safe custody of their funds and absolute convenience in their use in the form of Current Accounts on the principle of *al-Wadiah*.
- b) Islamic banks requests permission from such clients to make use of their funds so long as these funds remain with them.
- c) The clients may withdraw a part of the whole of their balances at any time they so desire and Islamic banks guarantee the funds of such balances.
- d) All the profits generated by Islamic banks from the use of such funds belong to them.

- e) Islamic banks provide its clients with cheque books and other usual services connected with Current Accounts.

5.2 Saving accounts

- a) Islamic banks accept deposits from their clients looking for safe custody of their funds and a degree of convenience in their use together with the possibility of some profits in the form of Savings Accounts on the principle of *al-Wadiah*.
- b) Islamic banks request permission from such clients to make use of their funds so long as these funds remain with them.
- c) The clients may withdraw a part of, or the whole of their balances at any time and the Islamic banks guarantee the balance of such funds.
- d) All the profits generated by the Islamic bank for the use of such funds belong to them. However, in contrast with Current Accounts, the Islamic banks may at their absolute discretion reward the clients by returning a portion of the profits generated from the use of their funds from time to time.
- e) Islamic banks provide their clients with Savings Pass Books and other usual services connected with Savings Accounts.

5.3 General investment accounts

- a) Islamic banks accept deposits from their clients looking for investment opportunities for their funds in the form of General Investment Accounts on the principle of *mudarabah*.

- b) The deposits will have to be for a specified period. As its full-fledged operations, the Islamic bank intends to accept deposits for the following periods:

1 month	9 months	18 months	48 months
3 months	12 months	24 months	60 months and over
6 months	15 months	36 months	

- c) In basic *sharī'a* relationship, the Islamic bank acts in this case as the 'entrepreneur' and the clients as the 'providers of capital' they both agree on how to distribute the profits, if any, generated by the Islamic bank from the investment of the funds. At present, the Islamic banks offers the distribution in the ratio of 70 per cent to the clients and 30 per cent to the Islamic bank. This offer of the ratio of distribution of profits may be varied from time to time.
- d) In the event of a loss in the investment, the client bears all the loss.
- e) The client does not participate in the management of the investment of the funds.

5.4 Special investment accounts

In addition to the above facilities for accepting deposits from its ordinary clients, the Islamic bank may also selectively accept deposits from its Government or corporate clients in the form of Special Investment Accounts. These accounts are also operated on the principal of *mudarabah*; but the modes of investment of the funds and the distribution of profits may usually be individually negotiated.

In addition to these accounts the banks offer the following services:

5.5 Correspondent banking services

Islamic banks also offer services in the sphere of international trade and money transfers. To do this, they establish correspondent relationships with foreign banks to facilitate services to be done on their behalf. In case of direct money transfers, no special relationship is needed beyond providing the correspondent bank with ready balances in a current account to meet such obligations. The correspondent bank can legitimately claim commission on these services. Islamic banks however may ask the correspondent bank to add its confirmation to letters of credit opened on behalf of foreign suppliers to importers in the country where the Islamic banks operate. Suppliers usually ask for this as an added security for their payments. Either Islamic banks keep huge surpluses in their account with the correspondent bank to meet such obligations or they must ask the correspondent bank to cover their obligations to the third party (the suppliers), while they seek to replenish their accounts with the correspondent bank. This amounts to taking (short-term) loans from the correspondent bank for which Islamic banks could not agree to pay any interest. How do Islamic banks solve this problem? Foreign banks agree to deal with Islamic banks on the basis of mutual agreement, initiated and confirmed by a simple exchange of letters, to provide Islamic banks with confirmation facilities up to an agreed ceiling without charging interest, should the accounts go red. In return for this consideration, Islamic banks undertake to abide by the following:

- a) to keep a reasonable amount of cash in their current account with the confirming banks;
- b) endeavour to cover any debit as soon as possible.

5.6 Other services

Islamic banks also provide other usual banking services under various rules of *sharī'a*. It is suffice

to mention just a few as follows:

- a) Remittance and transfers;
- b) Sale and purchase of foreign currency;
- c) Sale of travellers' cheques;
- d) Trustee and nominee company services;
- e) Safe custody services.

6 The nature of the financing

Financing modes can be distinguished according to the nature of financing involved in different techniques. *Bai muwajjal*, *bai salam* and mark-up-based modes can be regarded as debt-creating modes of financing since financing in these two modes is in the nature of a debt. The finance user stands obliged to pay back the entire financing (or its equivalent as agreed in *bai salam*). The repayment by the finance user is, in fact, predetermined and hence becomes a sort of debt from his point of view. On the other hand, *mudarabah* and *musharakah* are non-debt-creating modes in the sense that the user is not obliged to pay back the total amount of finance. To some extent *ijara* can also be regarded as a non-debt-creating mode of financing. In *mudarabah* and *musharakah*, the finance user pays according to the profits or loss that he makes out of the use of the finance, while in *ijara*, only the rent is paid which, for any individual user, may be a small part of the total value of the asset (Khan, 1988).

7 The relationship between the central banks and Islamic banks

Since Islamic banks in fact form part of the banking systems in the countries where they operate they are naturally expected, like other banks, to come under the control of central banks (Qarni, 1990). As previously explained Islamic banks differ from conventional banks as regards the

nature of their relationship with their clients. In the case of Islamic banks the relationship is one of direct trading or participation and not that of lender/borrower. Furthermore, Islamic banks do not trade in debts as conventional banks do. Therefore, central bank regulation of Islamic banks, undoubtedly essential, should take into consideration the special nature of these banks as formulated in their statutes. A controversy has arisen recently about whether it is necessary to devise special legislation for regulation of Islamic banks or to make do with the rules applying to conventional banks in this respect (Radwan, 1990). Central banks in some countries, for example Jordan, have issued special legislation concerning Islamic banks; other countries have issued special legislation concerning Islamic banks but refuse to call them Islamic banks and call them Special Finance Houses (Turkey). Other countries, for example the U.K., have not.

Theoretically, the main function of central banking in an Islamic financial system is the provision of the institutional framework necessary for the smooth operation of financial markets in compliance with the rules of the *sharī'a*. In particular, the central bank has the task of fostering the development of primary, secondary and money markets. It is important to mention that mere adoption of Islamic rules of finance will not necessarily create the impetus for financial and economic development where the shallowness of financial markets and lack of attractive financial instruments limit the scope for financial intermediation. (Iqbal and Mirakhor, 1987)

There is a consensus among Muslim economists that the central bank should supervise the Islamic commercial banks. This supervision should not be confined to a formal audit of transactions but should also encompass a material appraisal of the quality of management decisions especially with respect to the more risky P.L.S. financings. One of the aims of this supervision is to protect the clients who have put their money into investment accounts against avoidable losses. Minimum reserve requirements are suggested for similar reasons (Nienhaus, n.d.).

In general, the central bank in an Islamic economy would continue to have the power to regulate banking and financial operations so as to allocate resources in conformity with the priorities of society as well as to direct monetary policy towards specific goals.

To achieve its policy objectives, the central bank has control over the money supply, the reserve ratios on different types of assets, and the maximum amounts of assets which the banks can allocate to their profit-sharing activities. Additionally it has been argued by some economists and bankers that the central bank can regulate profit-sharing ratios between the banks and borrowers on the one hand and the banks and depositors on the other hand. There is however a question as to whether such a policy is valid since it represents a limitation on the freedom of contract between the bank and the client and may be inequitable (Khan, 1990).

Siddiqui (1984) suggested that the Islamic Central Bank will have no difficulty in playing the part of the lender of last resort. He suggests that open market operation methods of control can be partially replaced by the central bank holding large shares in public enterprises which it can sell or buy at times to absorb or inject liquidity. He finishes his assessment by saying:

“It is not necessary to have the same weapon by weapon or instrument by instrument of monetary policy written in the text books of modern banking. What is important is not that we should be able to point out to open market operations and its counterpart in Islamic banking system but that the central bank in an Islamic banking framework should have effective means of controlling the supply of money.”

8 How can Islamic banks operate without involvement in *ribā*?

A key element in understanding the theoretical framework of Islamic banking is how Islamic banks can operate without paying or receiving interest (*ribā*). The Islamic bank should operate on the basis of profit. Islamic banks can earn profits in three ways (Khan, 1988):

- a) trading;
- b) leasing;

- c) by direct financing in profit/loss-sharing contracts.

They are free to devise instruments to earn profit in any of these ways. But any instrument that ensures profit without carrying risk or less than required risk will not be an Islamic instrument.

This constraint implies the following:

- a) Islamic banks cannot extend loans because they cannot earn any profit on loans. They will have to invest with the associated risks of investment if they want to earn income (Ali, 1987).
- b) Islamic banks will not advance money for consumption purposes for which, as there is no concept of sharing profit, they would not be able to earn any income. Commercial banks will advance money only for commercially productive activities (Ahmad, 1987a).
- c) This implication of the principle that there should be no profit-sharing without risk-sharing (*al-ghunum bi al-ghrum*) is that the condition for earning profit is to engage in economic venture and thus contribute to the economy (Ahmad, 1987a).
- d) Depositors are regarded as shareholders of the banks and consequently are not guaranteed a nominal value or a predetermined rate of return on their deposits. If the bank makes profit, the depositors are entitled to a share corresponding to their investment; equally, if the bank incurs a loss, the depositors share it similarly and receive a negative rate of return. To remain consistent with religious strictures, banks cannot charge interest on their lending operations but have to use other modes of investment and financing that are also based on profit-and-loss-sharing (Khan and Mirakhor, 1987).

- e) Theoretically, Islamic banks should provide capital to dynamic entrepreneurs who have good projects but cannot offer collateral and so create new businesses and thus contribute to the community's economic development (Nienhaus, 1988).
- f) Islamic banks will always be at an instrumental disadvantage compared to conventional banks. If the Islamic banks develop new financial instruments, conventional banks are not prevented from adopting their practice if they judge it profitable. By contrast, Islamic banks cannot adopt the instruments available to conventional banks (Nienhaus, 1988).
- g) Some researchers have tried to link the establishment of Islamic banks with the accumulation of surplus oil revenues in the petroleum-producing countries. Ahmad (1987a) argues against that by suggesting that:
 - i) a few Islamic banks had already been established before 1973 when oil prices were increased and the so-called petrodollars started flowing in the Arab world;
 - ii) Islamic banks are not confined to the Gulf region which has been the main recipient of petrodollars.
- h) All existing Islamic banks have only very recently been set up; the oldest was only established in 1973 (Nienhaus, 1988).
- i) In discussions of Islamic financial systems a distinction is made between Islamic banking and interest-free banking. Islamic banking has been defined as banking in consonance with the ethos of the value system of Islam (Masri, 1981). Interest-free banking, by contrast, is a mechanical concept, denoting a series of banking operations which avoid interest. Islamic banking is expected not only to avoid transactions on the basis of interest, but also to participate actively in achieving the goals and objectives of an Islamic economy.

- j) In addition to being compatible with Islamic norms, the banking operations adopted must be viable because the system should be such as to protect the depositor and give him an adequate rate of return (Ahmad, n.d.).
- k) Some Muslim writers suggest that because of the special importance of the financial intermediation sector in the Islamic economy, and its great influence, it should be nationalized (Naqvi, 1981). The view is not popular, however. This proposal of nationalization in general is not an authentic Islamic policy. It violates the basic Islamic philosophy of free will and respect for private property.
- l) Four principles are of particular importance for Islamic banking (Mirakhor, 1988):
 - i) there must be some risk whether loans are used in a commercial or productive venture;
 - ii) all loans must finance socially productive activity;
 - iii) financial risk must lie solely with the lenders of the capital and not with the managers or agents who work with the capital;
 - iv) interest is forbidden in that it is a predetermined, fixed sum owed to the lender irrespective of the outcome of the business venture in which the loan is used.
- m) The objective of Islamic banks in general is to develop the application of Islamic principles. In no eventuality, therefore, can such banks engage in the alcoholic beverage trade, in the payment or receipt of interest, in the gambling industry or in the pork meat trade, or in any other explicitly un-Islamic activities, even if such activities were conducted under a profit-and-loss-sharing contract (Khan, 1983).
- n) Islamic banks with very limited funds for consumption loans will be ignoring the needs of quite a large class of people. Institutions will have to be developed to meet the demand for loans for purely consumption purposes (Khan, 1983).

- o) The interpretation of the prohibition of *ribā* has in practice been subject to great controversy. Should the prohibition apply to all interest, or does it merely mean that interest rates should remain at moderate levels? Are interest charges for business loans permissible, as the borrowers are seeking to use their credit to generate profits? Are fixed interest loans preferable to those subject to interest rate variations, as at least the borrower knows the exact charges in advance, and there is no element of uncertainty? Finally, under inflationary conditions, should interest rewards be allowed to compensate savers for the depreciation of the value of their savings? A prohibition of nominal interest to compensate for inflation would penalize lenders and subsidize borrowers. It could be argued that the prohibition of *ribā* applies to real interest, not nominal interest; as with inflation, a ban on the latter may result in negative real interest (Baldwin, Wilson, 1988).

9 Islamic perspective on time value of money

A number of Islamic economists have tackled this question (notably, Khan, 1988). They start by arguing that *bai muwajjal* and *bai salam* (see sections 4.1, 4.2 above for definitions) are permissible modes of trade in Islam. In this type of sale, it is permitted that the price of a commodity sold on, respectively, credit or advance payment basis, may be different from its spot price. The *sharī'a* does therefore recognize a difference in value due to a time element, and does not prohibit realizing time value of money. What is prohibited is any claim to time value of money as a pre determined quantity calculable at a pre determined rate.

Time is considered as malleable capital: the realization of time value requires waiting for the outcome of the use of the assets (physical or monetary) over time. If that outcome over time is visible and tangible, it may justify time value of money; however, if the money has been used for mere consumption purposes, the money owner is not entitled to claim a time value for his money. The subject cannot be fully expounded here, but there should be no confusion with the concept of

rent. It might be argued, for example, that rent includes time value of money and, since rent is predetermined, a predetermined time value of money must by analogy be permitted in Islam also. This is incorrect. It is indeed true that the rent of an asset is calculated in a way that will realize not only the value of the asset but a certain time value of money as well. But this calculation is made over the life of the asset, which life is in principle uncertain - nor is it necessarily the case that an asset will earn rent continuously throughout its life. Hence, how much time value of money is actually realized remains uncertain until the asset has completed its economic life.

Finally, there are two related points which need clarifying in this context:

- a) The argument that an uncertain rate of inflation makes the real rate of return on an interest-based loan a risk-bearing investment is not acceptable in Islam. Once we call it a loan, nothing can be charged on it irrespective of whether inflation or any other consideration makes the charge positive or negative in real terms. All financing is termed a loan when the principal remains guaranteed whether in nominal or real terms (Khan, 1988).
- b) In theory, in mark-up-based financing the financier faces all the costs and risks normally involved in trading activity - locating and buying goods, storage, damage in transit, etc. Furthermore, the finance provider also runs the risk that the goods purchased for the finance user may not be finally accepted by the latter on account of quality or other reasons. It is such risks that, in principle and in reality, keep the rate of return uncertain until the goods have been finally handed over to the finance user.

10 The social dimension of Islamic banks

10.1 The duty of Islamic banks towards their society

One of the clearest statements of the duty of Islamic banks towards the society they operate in is as follows: The International Association of Islamic Banks' view of the social dimension of Islamic banking has been publicly stated. This statement represents the core of what the theoretician of Islamic banking expects Islamic banks to do in terms of social responsibility (I.A.I.B, 1990):

“The Islamic banking system involves a social implication which is necessarily connected with the Islamic order itself, and represents a special characteristic that distinguishes Islamic banks from other banks based on other philosophies. In exercising all its banking or developmental activities, the Islamic bank takes into prime consideration the social implications that may be brought about by any decision or action taken by the bank. Profitability - despite its importance and priority-is not therefore the sole criterion or the prime element in evaluating the performance of Islamic banks, since they have to match between both the material and the social objectives that would serve the interests of the community as a whole and help achieve their role in the sphere of social mutual guarantee. Social goals are understood to form an inseparable element of the Islamic banking system that cannot be dispensed with or neglected.”

10.2 The relationship between the duties of an Islamic bank and *zakāh*

This relationship can be best understood if we consider the following (I.A.I.B., n.d.):

- a) Being part and parcel of the society, the bank must shoulder the responsibility that results from continual contact with the people, and create a genuine Islamic atmosphere.
- b) *Zakāh* constitutes an indispensable part of the fabric of the Islamic economy.

- c) The function of *zakāh* is primarily socio-economic; it aims not merely to satisfy the hunger of a poor man or to help him with a few pounds but to enable him to support himself by his own efforts so that he may have a fixed source of income. This rescues the individual from the indignity of dependence on others, or even the state, for a livelihood. *Zakāh* funds supply craftsmen and merchants with enough resources to carry on their work and support their dependants. As each disease has its specific medicine, so *zakāh* is the medicine for poverty. A *zakāh* fund must therefore be established in each bank in those countries where the ruler takes charge of collecting alms. The Islamic bank can then play a technical assistance role in the government's fight against poverty.

10.3 Social responsibilities of Islamic banks

Social activities are emphasized among the responsibilities of Islamic banks, and expressed explicitly in their articles of association. Among other objectives, the Jordan Islamic Bank for Finance and Investment, for example, has stated that it will put special emphasis on introducing services designed to revive various forms of collective social responsibility on a basis of mutual benefit (J.I.B., 1978).

Social services are performed by an Islamic bank in two ways:

- a) in its capacity as an agent of *zakāh* funds, the bank receives *zakāh* from *zakāh* payers and holds these separately from its other resources;
- b) interest-free loans, advanced by the bank, in the form of overdrafts (Askher, 1987).

11 Religious regulations of Islamic banks

In order for all dealings and activities of Islamic banks to conform to *sharī'a* injunctions, their statutes, deeds and all other foundation documents expressly stipulate that all transactions carried out by the bank should be subject to the supervision of a religious committee or at least a religious counsellor. The committee members and the counsellors should all be chosen from among top specialized religious scholars. Their opinions (rulings) are binding.

The supervisory committee has to give an opinion on every financial instrument used by banks as well as on any innovation in instruments or operations. It has also to prepare annual reports on the final accounts and financial statements for the consideration of the General Assembly alongside conventional auditors' reports. The committee report should include the results of its investigation of all bank operations, confirm that these have been found to conform to *sharī'a* provisions, and fall within the range of operations already approved by the committee and for which religious rules and principles have already been laid down by the committee. Throughout the year, the religious committee gives rulings on all operations done by the bank unless already approved by the committee as standard operations.

A fundamental condition for an Islamic bank to become a member of the International Association of Islamic Banks is to have a religious committee or a religious counsellor for religious supervision, by way of guarantee of the bank's adherence to *sharī'a* provisions (I.A.I.B., 1990).

Part Two

The Case Studies

1 Introduction

To reiterate: the thesis will focus on Islamic banks operating in a Western environment and then in an Islamic environment and then in a secular environment with Muslim communities in the light of theory already studied. It will attempt to test the following hypotheses:

- a) Islamic banks are profit seeking organisations within the framework of a social developmental role based upon Islamic law regardless of the environments in which they operate.
- b) The operations and performance of Islamic banks differ in accordance with the economic, financial, social, legal and religious environments in which they operate.
- c) Profit-and-loss-sharing i.e. *mudarabah* and *musharakah* is the concept which underlies Islamic banking theory and practice.
- d) Islamic values determines the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.

Chapter 4

Research Methodology

1 Background

This study was designed to investigate the practice of Islamic banks within different economic, financial, social, legal and religious environments with a view to determining whether or not the Islamic banking theory is reflected in practice.

The general assumptions within which this work was carried out were:

- a) It was not an objective of this study to validate Islamic economics or Islamic values generally as against 'Western' values.
- b) That the charging of interest on loans is forbidden in Islam is an underlying assumption of Islamic banking (M.F.I, 1986). That assumption is not formally questioned nor formally tested in this thesis. My research did not address the question of why interest is prohibited, but how that prohibition is expressed in specific economic objectives and operations by Islamic banks. It may well be that answering the how-questions (and the plural is apt) throws up ideas and data which will inform and influence a response to the why-question: but that question remains outside the central concern of the work here presented; it is touched upon only where necessary for the purposes of essential theoretical or historical background.
- c) It was not the aim of this thesis to compare Islamic banks with conventional banks even though in some areas a comparison has been made between them.
- d) It was not an objective of this thesis to compare Islam as a religion with any other religion.

The most effective means of gathering high-quality data appeared to be face-to-face interviewing with bank executives, managers, clients, Islamic economists and other Islamic academics. Because i) the shortage of relevant data about the Islamic banking practice (Ahmad, 1987b; Siddiqui, 1988a); ii) the experience during my M.A. study on 'Islamic Economics' (Islamic Studies Centre, Yarmouk University, Jordan) of the difficulties of gathering data; iii) in the opinion of senior Islamic economists and senior management in Al-Baraka that for reasons of confidentiality and non-co-operation, information would not be forthcoming. Taking account of these factors the response to a mail questionnaire would be minimal and the data gathered from such an exercise would be of a dubious quality. This view was supported by Geertz (1973) where he said a good face-to-face interview can provide rich thick description, it can be polemic and convey a feeling of what it is like to experience an organisation or a problem from the inside so face to face interviewing can explain attitudes and behaviour in context and from their actor's own frame of reference (Shaw, 1986).

2 Data collection methods

2.1 Interviewing

The principal technique employed to obtain data was in-depth semi-structured interviews. The researcher carried out one hundred and two interviews with different sorts of interviewees. Executives and middle management were interviewed in order to understand the policies, strategies, profit-and-loss-sharing implementation transactions mechanisms, the values and the real and practical problems of acting Islamically. Clients were interviewed in order to understand the societal attitude and motives towards Al-Baraka as an Islamic bank and also the nature of the banking facilities that were used and why (Appendix 4 tends to summarize the key points which arise from the interviews, Appendix 5 gives the actual replies and comments of the interviewees)

addressing each hypothesis. It appears that this is the first study which uses Islamic banking clients as a source of data. The interviewing of members of Al-Baraka began with a six-week visit to the headquarters of Al-Baraka in Jeddah, Saudi Arabia, for a preliminary study of the Group. At the meetings attended by the researcher the subjects discussed were: i) establishing the new Islamic banks in Pakistan, India, South Africa and China; ii) the problems they had with the monetary authorities and finding local share holders in each country. Advice was sought through unstructured interviewing with executives in the headquarters, about the research design, in particular the research samples and nature of the Al-Baraka Group (i.e. the structure, the history, the development and the future, etc.). After that three separate questionnaires were prepared for executives, managers and clients. Interviews were then carried out in London where Al-Baraka International Bank Limited works as an Islamic bank in a non-Islamic country (for one month), in Jordan where the Jordan Islamic Bank works as an Islamic bank in an Islamic country and in Turkey where Al-Baraka Turkish Finance House works as an Islamic bank in a secular country within a Muslim society (for almost three weeks). Some of the transcripts of the interviews were sent to interviewees for verification of the facts and further discussions have been carried out with the employees in these three banks on a non-structured interviewing basis (see Appendix 1 for the questionnaires). Visits were made to the International Association of Islamic Banks, and Saleh Kamel Centre for Islamic Economics, with its associations with Al-Azhar University. There has been continuous dialogue and debate with Islamic economic scholars from all over the World who have visited the Islamic Foundation and the Oxford Centre for Islamic Studies. A particularly valuable experience was the one day seminar the researcher set up in the Oxford Centre for Islamic Studies. The main speakers were Professor K. Ahmad, Dr F. Khan and Mr D. Smith. It was attended by Islamic scholars, academics and bankers, where the key areas studied in the seminar were how to promote Islamic banking performance.

The interviewees may be categorized as follows:

- a) Islamic economists (6 interviews);
- b) Islamic banks working in a Western environment (middle management and executives) (15 interviews);
- c) Islamic bankers working in a secular environment (middle management and executives) (14 interviews);
- d) Islamic bankers working in a Muslim environment (middle management and executives) (20 interviews);
- e) Conventional bankers working within the Islamic investment department of a conventional bank (5 interviews);
- f) Economists working in the central banks (4 interviews);
- g) Conventional bankers (8 interviews);
- h) Corporate and individual clients from London, Istanbul, Amman (30 interviews).

Some indication of the richness of the quality of the data, the depth of understanding of the problems inside the organization, and the attitude and behaviour of the actors of the organization can be identified from the status and differing roles of the interviewees, for instance, the Chairman of the Group, the Chief Executive of the Group, twenty three of the Chief Executives of the Al-Baraka Banks and other Islamic banks from all over the world, the Governor of the Central Bank of Jordan and six Senior Islamic Economists (for more details see Appendix Number 2).

2.2 Case studies

Because of the comparative nature of this research it was necessary to develop case studies suitable for different environments in the sense of Yin's (1989) definition of the case study which is: 'a

case study is an empirical enquiry that investigates a contemporary phenomenon within its real life context when the boundaries between phenomenon and context are not clearly evident and in which multiple sources of evidence are used'. This methodology appeared relevant in that we are investigating a contemporary phenomenon with real life context i.e. Islamic banks in different environments where the boundary between the phenomenon and the context is not clear. Evidence of these problems of boundaries is illustrated by looking at the following: i) the bank was the context and the phenomenon was the financial instrument within the bank; ii) the context was Islamic banking and the phenomenon was Al-Baraka Group; iii) the banking system was the context and the phenomenon was Islamic banking, especially its relationship with the central bank; iv) the context was Islamic values and the phenomenon was the Islamic banks, i.e. how they recognize and implement these values in their operations and transactions.

Multiple resources of evidence were used as suggested by Denzin (1989): 'no single method will ever meet the requirement of interaction theory. Multiple methods of observations must be employed, this is what is called *triangulation of data sources and methods*'. *And this necessitated:*

- a) **Participant observation and non-participant observation** - to develop the knowledge or understanding received from the interviews and from the interpretation of literature. The key activity here was attending the Al-Baraka Annual Conference which was held in Torquay, England in September 1991, which included the top management of all Al-Baraka banks and the other banks which related to them. The objectives of that conference were, mainly to evaluate the performance of the Group, to exchange experiences for the future directions and to discuss the situation of Al-Baraka International Bank, London. As a result of the researcher being the official interpreter for the conference it provided him with a great deal of information which it would not have been possible to obtain without his being there. He also attended a board meeting for one of the Al-Baraka banks immediately after the conference. This provided an opportunity to observe the way

decisions were made and the underlying values expressed through the decision-making process. In addition there was continuous observation, for two weeks in London, five days in Turkey and three days in Jordan of the day to day operational practices within the three banks.

- b) **Secondary data** - Archival records such as policy memoranda, operational memoranda, minutes of meetings, annual reports, legal documents, published and unpublished working papers and company researches were studied, plus articles which appeared in the Press.

One of the problems which faced the researcher was the different languages in which the data was obtained, e.g. the London case was in English, in Jordan: Arabic, in Turkey: Turkish. In Turkey most of the interviewees could not speak either Arabic or English, therefore the Turkish Finance House made sure that the researcher had an interpreter with him for the whole field trip in Turkey.

3 **Basis of data analysis**

To check the validity and reliability with which this case-study research was conducted, three main assessing indicators were taken into consideration (Strauss and Corbin, 1990):

- a) **Frequency:** that nothing should be considered unless it happens frequently; for example it was common to find a lot of employees with a lack of vision with regards to the functions, objectives, aims and the nature of Islamic banks.
- b) **Observability:** nothing should be considered unless it is publicly observed; for example the researcher noticed that one of the employees was not paying attention to Ramadan and he was drinking water behind the scene. The researcher did not take it as a sign of disrespect because it did not happen in public.

- c) Comparative analysis was made of Islamic banks working in a non-Islamic, Islamic and secular context, including the implementation of Islamic values in the three banks.

4 **Limitations on research methodology**

Time and budget constraints restricted the sample size. The randomness of the sample cannot be confirmed or denied because of the serious lack of data regarding the industry. This obviously could raise some doubts regarding the validity of the research findings; also the quality of information in different case studies was potentially inconsistent due to the fact that some banks were extremely cooperative and some were not. Some answers to some questions were neither logical nor satisfactory, at least from a Western perspective (e.g. in an interview one of the senior managers was asked how he could justify and explain the success behind his bank; the answer was it was due to Allah's blessing). While this answer is more than adequate to people of faith, I doubt whether Western academics would accept it.

Chapter 5

**“Al-Baraka International Bank Limited” (A.I.B.L.):
The Experience of an Islamic Bank in England**

1 Introduction

This chapter examines the phenomenon of Islamic interest-free banking in the context of the Western financial system in England through the study of Al-Baraka International Bank Limited. It discusses the objectives, functions, methods of fund collection and utilization; how far the Islamic values shape strategic goals and select priorities; supervision and evaluation of A.I.B.L financially and from a managerial point of view.

The presence of Al-Baraka in London is considered to be a pioneering experiment which could open the door for the Islamic banking movement to penetrate the international banking system. Alternatively in the event of failure, it could be the end of any thoughts of starting other Islamic banks in non-Muslim societies.

Perhaps the largest obstacles facing the bank are excess liquidity, a lack of investment opportunities which are Islamically acceptable and profitable, and its existence in a non-Muslim society.

2 A profile of Al-Baraka International Bank Limited

2.1 The establishment or entry into the English financial market

A.I.B.L. is a member of the Dallah-Al-Baraka Group. The founder of A.I.B.L. was advised that the best way to get into the U.K. financial market was to take over or acquire an existing *Licensed Deposit Taker (L.D.T.)*, as all previous applications by Islamic financial institutions to the Bank of England in their bid to obtain a licence to operate as a licensed deposit taker had failed (Junejo, 1989).

The search for a suitable vehicle in late 1982 came up with Hargreaves Securities, an ailing L.D.T. operating at an annual loss of £250,000 at the time of the takeover. Following a special resolution passed at an extraordinary general meeting held on 2nd November 1982, the company changed its name from Hargreaves Securities to Al-Baraka International Bank Limited. The change of name was registered with effect from 10th February 1983. Its authorized capital was increased from £10 million to £100 million by an ordinary resolution. It was licensed by the Bank of England as a deposit taker and meets all its rules, regulations and requirements as well as those of the Inland Revenue and the Department of Trade and Industry in the United Kingdom. What the above rules and regulations mean for an Islamic financial institution is examined below (Junejo, 1989).

The number of authorized institutions and incorporated institutions resident in the UK but registered outside the United Kingdom is 525 (*Almanack*, 1992) of these, Al-Baraka International Bank Limited is the only bank or deposit-taking institution which claims to work under the Islamic banking code.

2.2 The objectives of A.I.B.L.

Junejo (1989) gave the reasons for Al-Baraka's wish to enter the UK as follows:

- a) To expand Al-Baraka Group's international business and look for new markets;
- b) To complement and extend full services to foreign branches, subsidiaries of home clients and other corporations;
- c) To have some representation in *one of the world's largest financial centres*;
- d) To take part in the financing of trade between the United Kingdom and the home country and the Middle East;
- e) To introduce and spread Islamic banking across the world;

- f) The relatively stable financial system of the UK which commands trust and confidence;
- g) The expertise of its institutions in international business;
- h) The opportunities for liaison with the offices of other leading financial institutions;
- i) The availability of skilled bankers and staff at all levels, and of such professionals as accountants and lawyers etc;
- j) The existence in London of leading world markets, e.g. the stock exchange;
- k) The relative political stability of the country;
- l) The central time zone between New York, Tokyo, Hong Kong and Singapore;
- m) The convenient geographical location.

These reasons can be classified broadly as:

- a) Political stability (6,11,12,13).
- b) High return (1,2,3,4,7,8,9,10).
- c) Ideological (5).

In an interview with the Al-Baraka Chairman he said that ‘the reason why we opened A.I.B.L. in London was that we did not have a unit in any of the rich countries, so we decided to have two units, one in London and the other one in Bahrain.

A.I.B.L.’s objectives are stated as they appeared in the official leaflet distributed to their clients:

- a) To invest A.I.B.L. capital and depositors’ funds in a correct Islamic manner to achieve the best possible level of *ḥalāl* profit compatible with acceptable risk.
- b) To provide individual and corporate clients with banking services conforming to *sharī‘a*.
- c) To develop trading relations, particularly among Islamic countries.

2.3 The Bank of England's supervision¹

The Bank of England was incorporated under royal charter in 1694 (Kindleberger, 1987). It is the banker of the government, on whose behalf it manages the issue of bank notes and national debt. As the central reserve bank of the country the bank holds the accounts of British banks which keep a proportion of their cash resources with the Bank of England, and of most overseas central banks (Almanack, 1992) as the Bank of England has not issued a special law for Islamic banks, it therefore treats A.I.B.L. as any other bank operating in England.

a) *The duties of the Bank of England*

The Bank of England has two major duties:

- i) To supervise the institutions authorized by it;
- ii) To keep under review the operation of the Banking Act and developments in the field of banking which appear to the Bank to be relevant to the exercise of its powers and the discharge of its duties.

The Bank of England fulfils these roles for all banks, including Al-Baraka. The Bank of England does not have any special law or rules for Islamic banks; although despite this it recognizes Al-Baraka as an 'Islamic bank', it does not allow Al-Baraka to add the work 'Islamic' to its name.

¹ I tried to get an interview with employees of the Bank of England but my request was refused on the grounds that Bank of England employees are not allowed by law to discuss the affairs of any individual bank.

b) *The Bank of England's supervision of A.I.B.L.*

Comments made by A.I.B.L. staff suggested that the Bank of England has recently started to intensify its supervision of Al-Baraka. This could be seen as a justifiable move because, as the researcher was advised by one of the Al-Baraka Managers, the Bank of England is not wholly satisfied with Al-Baraka for two reasons:

- i) their frequent changing of chief executives. The Bank of England has hinted that there is unstable management within A.I.B.L., so it put A.I.B.L. under observation in order to avoid any future problems;
- ii) because of complaints from customers about poor services and about mistakes that have occurred with their accounts.

c) *The deposit protection scheme*

The Bank of England according to the 1987 Act decides which deposits deserve protection and which do not. That power of decision is a key element of the deposit protection scheme. Under the scheme, protection is limited to an overall amount of £20,000 per deposit per institution (Penn, 1989).

In normal operation conventional banks guarantee the current and deposit accounts, principal and interests, and in the case of bankruptcy the protection scheme is implemented. Now the question is, does this contradict Islamic law? Islamic law is very clear that current accounts, regarded as *amana* (trust) must be fully guaranteed for depositors, but that in all other cases deposit or investment accounts should be subject to profit-and-loss-sharing so

that they are not guaranteed. As conventional banks also guarantee current accounts, there is no contradiction with Islamic law in the case of current accounts, nor with implementation of the protection scheme should a crisis occur.

However, in the case of deposit accounts which, in normal operations, conventional banks also guarantee (and indeed the whole of the deposit is guaranteed), there is a contradiction with Islamic law. According to *sharī'a* requirements investment accounts must be subject to profit-and-loss-sharing; any guarantee of principal or of the result of its use is a violation of *sharī'a* requirements.

In the event of a crisis the Bank of England, under the protection scheme, as stated above, guarantees up to £20,000 per account per institution. This is intended to provide partial cover of depositors' losses, but even this partial cover contradicts the *sharī'a*. The A.I.B.L., in operating under the jurisdiction of the Bank of England, must follow its laws. With regard to all other conditions also the Bank of England requires that Al-Baraka meet them.

A.I.B.L., as an Islamic L.D.T., has not faced major obstacles in satisfying the Bank of England on the questions of capital adequacy and liquidity. The minimum requirement for a L.D.T. under the 1987 Banking Act is £1,000,000. A.I.B.L. began with £5,000,000 at the start of its UK operations, a sum subsequently increased to £10,000,000. In 1988 the figure had risen to £30,000,000. It was decided to inject fresh capital of £15,000,000 in 1990 in order to strengthen A.I.B.L. further.

Thus, as far as the capital requirement is concerned, A.I.B.L. will not face a difficulty. However, A.I.B.L.'s difficulty arises in satisfying the Bank of England in the area of liquidity and asset management. In order to do so, A.I.B.L. has invested most of its short-

term funds in the commodity market via the merchant banks and arranged with merchant banks to guarantee the certainty of these short-term commodity contracts (Junejo, 1989).

2.4 A.I.B.L.'s business relationship with other financial institutions

a) *With other Islamic financial institutions*

A.I.B.L, like all other Islamic financial institutions, is conducting business transactions on Islamic principles with other banks and financial institutions such as sister companies and other institutions which have branches or subsidiaries in the UK and other Islamic banks in other parts of the world. Some Islamic banks, especially banks in the Middle East and other members of the Al-Baraka Group see A.I.B.L as a reliable solution to depositing their money, especially in a crisis. But so far A.I.B.L. has failed to prove that it could take on such a responsibility. Evidence from the Al-Baraka Annual Conference shows that during the Gulf crisis the Jordan Islamic Bank sought to transfer around \$100 million to A.I.B.L. but the A.I.B.L. Chief Executive at that time refused to accept the deposit in his bank—without giving a reason for the decision. The A.I.B.L. Chief Executive's defence at the Al-Baraka Annual Conference was the lack of investment opportunity available to A.I.B.L. Most of the participants, including the Chairman, were not convinced by such an answer.

b) *UK-based conventional commercial banks, financial houses, merchant banks, security houses and corporate clients*

A.I.B.L. established a bilateral relationships with a number of conventional financial institutions (large merchant banks) to manage its short-term funds. These funds are invested in commodity transactions. In interviews with four executives working as heads

of Islamic Investment Departments within conventional banks they were asked what is the percentage of A.I.B.L.'s money invested through Islamic deals within conventional banks? The answers from all of them was 'around 80%'. This raises a serious and essential question about the viability of this process, especially if we know that these banks take at least 50% of the profit margin of the A.I.B.L. after all transactions. It should also be asked here why Al-Baraka's management does not do its own investments. It would be understandable if any Islamic bank outside England did these sort of deals, for reasons of distance and access to the international market; but for A.I.B.L. the only reason behind it could be that it does not want to take any risk with the deals, so it asks others to do it on its behalf. This issue raises two questions: the first concerns the efficiency of the A.I.B.L. team; the second concerns the poor performance that A.I.B.L. achieved. A complaint was made by a manager at Barclays, who was responsible for making Islamically acceptable investments on behalf of A.I.B.L., that A.I.B.L. was always changing its mind about what is Islamically acceptable; in other words, they would agree to such-and-such a deal one day but the next day A.I.B.L. would say that they had discovered that this deal was not allowed in Islam. Although the banker did not explain what the deal was, exactly the same complaint was made by another merchant banker who remarked: 'this suggests some "consistent" inconsistency'.

2.5 Fund collection

The main sources of funds available to A.I.B.L. come from shareholders or from depositors through various forms of deposits. The types of account which are available in A.I.B.L. are as

follows:

- a) ***Current account.*** This type of account is the same as provided by conventional banks where by clients deposit funds with A.I.B.L. for safe keeping and with transaction motives. It is regarded as a demand deposit and guaranteed by A.I.B.L. A.I.B.L. provides all the current account facilities that a conventional bank offers (cheque book, standing orders, etc.). No profit or return is offered on this type of account.

- b) ***Bonus current account.*** This account is similar to the savings and deposit accounts in conventional banks. A.I.B.L. accepts deposits from clients and, as with the current account, is allowed to use the funds. A.I.B.L. guarantees the principal deposited. The main difference between the current and the bonus current accounts is that if the cleared balance maintained in the latter averages £2,500 (the bonus level) or more for a period of six calendar months, a bonus will be credited to it. The question to be raised here is how this differs from payment of interest. According to *sharī'a* we must differentiate between an obligation to add a certain bonus after a certain term, and a non-obligatory addition of a bonus. In the latter case, there is no violation of Islamic law. If, however, the depositor has a right to demand a bonus after a certain term, this amounts to *ribā* and a severe violation of Islamic law (Abdel-Haq, 1989).

- c) ***Fixed-term deposit account*** - invested in accordance with the Islamic principles of *mudarabah*, *musharakah* and *morabaha*. A minimum deposit of £500 or \$1,000 is required to open such an account. The minimum term is one month and the gross return to depositors is based on a percentage of the monthly profit yield earned on the bank's

investments and varies according to the period of the deposit as follows:

TABLE 1
A.I.B.L. PERCENTAGE OF MONTHLY PROFIT YIELD

Period	Percentage of Bank's monthly profit yield earned by depositor
Up to and including 3 months	75%
Over 3 months, less than 6 months	80%
Over 6 months, less than 1 year	85%
Over 1 year	90%

The bank retains the remainder of the profit as its management fee. It may be asked: what happens if there is no monthly profit or a loss? The ex-Chief Executive answered that by saying: 'In reality A.I.B.L. never enters into any deals unless there is a guarantee of profit—to this end it places its money in one of London's commercial banks.' But assuming that the worst happens and there is a loss, what then? He replied: 'In the case of loss A.I.B.L. has so far never passed the burden of loss to its clients' deposits—the bank's share holders have absorbed the loss, not its clients.'

d) **Specified deposits.** This is a special form of term deposit designed for institutions or high net worth depositors who are seeking a guaranteed income 'which is at more or less the rate of interest'. It is invested on the international commodity markets or in trade finance on a *morabaha* basis through very reputable commodity dealers or banks. The transactions are closely monitored and approved by the bank in advance for compliance with the *morabaha* format. The repayments by the end-purchaser are usually supported by letters of guarantee by banks. This means that (given the nature of *morabaha* transactions on an agreed predetermined mark-up) depositors know in advance what profits to expect.

The gross return to depositors is equivalent to 95% of the profit earned on the related investment.

- e) **Other banking services.** In addition to deposit accounts A.I.B.L. provides a number of services to its clients, on a commission or fee basis: standing instructions; special presentation for express cheque clearance; sales of travellers' cheques; investment management services; banker's reference and buying and selling of foreign currency.

3 A.I.B.L's function

Financial intermediation means taking deposits or loans from people who wish to lend and then lending at a slightly higher interest rate to businesses or householders who wish to borrow (King, 1987). This definition of the financial intermediation is as applied in the conventional terms. Islamic banks cannot adopt this definition for the simple reason that Islamic banks are not supposed to deal with interest rate directly or indirectly.

Then what is the function of A.I.B.L.? In interviews with five executives and six managers who either still work or used to work in A.I.B.L., they were asked what are the functions and the role of your bank? Do you see your bank as a developmental institution, or a profit-seeking institution? The answers given from eight interviewees were 'we are a financial intermediary, we exist to maximize profit in a *ḥalāl* way, this is the key objective for us.' A.I.B.L. functions as a financial intermediary and resource mobilizer like any other conventional bank but without any contradiction to Islamic law. Two executives working in a city bank within the Islamic Investment Department mentioned that the role of A.I.B.L. is like any other conventional bank but in addition A.I.B.L. is allowed to play the role of an investment company. A.I.B.L. could do their own deals with materials and commodities for their own interest. This facility is not available to the conventional

banks working in London.² However, two executives at A.I.B.L. demonstrated their view in a different way when they pointed out that Islamic banks originally came into existence to make profit as well as for developmental purposes for the society they were working in; they exist to adapt profit-and-loss-sharing instead of the interest rate in order to spread social justice and to fight unemployment. But what happened to Islamic banks (including A.I.B.L.) was that instead of doing that, they wore the conventional banks' dress but changed the colour only. They adopted mark-up instead of P.L.S. to replace interest and in actual fact there is no difference between them. They followed that by saying that 'We are not satisfied at all'. While this was their view, the striking thing about the other executives and managers was that they were extremely sceptical of the whole concept of interest-free finance and inadequate legal support. In another interview, an executive went even further when he said: 'Islam does not recognize money as a commodity and as a consequence of that we do not have financial intermediate bodies called banks in Islam—because that means recognizing money as a commodity and that means there is a price for such a commodity which is the interest rate which is definitely prohibited in Islamic law.'

In interviews with the ten clients of A.I.B.L. all of them believed that A.I.B.L. had a responsibility beyond making profit and A.I.B.L. had a responsibility towards the Muslim community in this country. When they were asked 'what do you expect from A.I.B.L.'? the answers were varied and are summarized as follows:

- a) Some of them stated that A.I.B.L. should give more *Qarḍ ḥasan* loans (interest-free loans).
- b) Some more expected profit-and-loss-sharing.
- c) Others wanted A.I.B.L. to help students and needy people through *zakāh* funds.

It would seem that the London clients expected A.I.B.L. to do more for the Muslim society in England.

² This information has not been confirmed through any other sources.

The different views about the functioning of Islamic banks are summarized as follows:

- a) A.I.B.L. functions as a financial intermediary is an Islamic profit-seeking organisation like any other conventional bank but without violating Islamic law.
- b) A.I.B.L. is an Islamic profit-seeking organisation with a socially responsible duty towards the society it operates in.
- c) A.I.B.L. cannot work under Islamic law because Islamic law does not accept financial intermediaries.

From the above it might be seen that A.I.B.L. considers itself as a financial intermediary like other conventional financial intermediaries but that it makes sure that it does not contradict Islamic law.

4 A.I.B.L. priorities and conformity to Islamic values

How far Islamic values shape strategic goals, whether they can be translated into institutional forms that operate Islamically and whether or not Islamic transactions or investments can still be profitable from an economic point of view are the questions which are going to be the core of the following discussion.

While there is no particular law governing Islamic banking within the U.K, A.I.B.L. has mentioned in its leaflets and its annual reports that it is working under Islamic law. A.I.B.L. has a *sharī'a* adviser in London as well as an expert *sharī'a* consultant in the Al-Baraka headquarters in Saudi Arabia. They are consulted whenever the A.I.B.L. management feels that it is necessary.

In interviews with executives at A.I.B.L., managers and selected clients were asked what criteria influenced them in deciding whether or not to get involved in any new business. Answers were always given without any reluctance or hesitation or suspicion and all interviewees said that the very first thing they do is to ensure that the potential project does not contradict Islamic values. If it does, all said they reject it immediately. I also asked them whether they would take on a project which did contradict *sharī'a* but which was 100% profitable. They all answered that they would never enter into any transaction which violated *sharī'a*.

In Al-Baraka's Chairman's speech at the last Annual Conference which was held in Torquay, England, 1991, he insisted that all top management refuse any deals which were unacceptable in Islamic law even if they were 100% profitable. The Chairman said 'I do not want to find out that any of my colleagues, for any reason and under any circumstances, did any deal with anything which was not acceptable in Islamic Law. We do not want any *ḥarām* profit. I would like to be able to tell Allah on the day of judgement that all my investments were *ḥalāl*.'

But despite all of that there will always be a chance of misunderstandings from time to time. For example, in 1991, there was a memo circulated by the senior manager asking the branch managers to charge for any overdraft. Plainly this senior manager does not know even the basics of Islamic economics: any extra money above the principal makes the loan a *ribā* transaction which is forbidden in Islamic economics. An employee raised this point with the Chairman of Al-Baraka during one of his visits to London and the memo was withdrawn. Here we can see that not only was the Chairman's directive ignored but nor was the *sharī'a* consultant asked for his advice, and that raises the role of the *shari'a* adviser and his authority in the bank.

From an analysis of the literature of social responsibility it is very difficult to determine the definition of it and how the social responsibility could be quantified. There is a considerable

debate in this area and it is a very controversial issue. In order to make some assessment of A.I.B.L.'s social responsibility it was necessary to set some criteria by which the existence and effectiveness of the social responsibility policy within A.I.B.L. could be measured.

So here A.I.B.L. will be considered to have a social responsibility policy if there is a positive response to the following questions:

- a) whether A.I.B.L. implements a profit-and-loss-sharing policy on a wide scale or not;
- b) whether A.I.B.L. has an interest-free loan policy;
- c) whether A.I.B.L. contributes to develop social projects which could help the community in England.

With regard to the first question, through interviews with the five executives, the evidence tends to suggest that A.I.B.L. has completely stopped dealing with profit-and-loss-sharing for the reasons which will be explained later in this chapter. With regard to the second question, the evidence also tends to suggest, through the A.I.B.L. Annual Reports 1986-1990, that A.I.B.L. does not have an interest-free loans policy. In an interview with the ex-Chief Executive of A.I.B.L. and one of his branch managers, they were asked whether A.I.B.L. has such a policy for interest-free loans and if not why not. The answers in both cases were: 'No! A.I.B.L. does not have such a policy. We sometimes provide interest-free loans in very very rare circumstances'; and the justification for this policy which was given was 'we are not a charity'. Regarding question three, it was found through the interviews that A.I.B.L. has not contributed so far to any development project for the Muslim community in England.

When the Chief Executive was asked what criteria they use for their investment policies in A.I.B.L. the answer was that 'once sure that the project does not violate *sharī'a*, A.I.B.L. adopts

the conventional banking investment criteria before taking any decision', which are as follows:

- a) credit risk (credit-worthiness, duration, etc...);
- b) return;
- c) complexity;
- d) administrative cost (documentation, monitoring);
- e) how well the project fits in with the bank's strategy and its other assets.

The adaption by A.I.B.L. to Islamic values as a code for its investments is considered to be a major constraint on the bank's investment activity. In an interview with the former and current chief executives they said that: '*Shari'a* is one of our major obstacles, in that there are not enough investment products that are Islamically acceptable and profitable enough to allow A.I.B.L. to invest all the funds available.' Thus A.I.B.L. has a major dilemma which was confirmed by Nienhaus (1988) when he said: 'Islamic banks will always be at an instrumental disadvantage compared to conventional banks. If the Islamic banks develop new investment instruments. Conventional banks are not prevented from adapting their practice if they judge it profitable. By contrast, Islamic banks cannot adopt the instruments available to conventional banks'.

From these interviews it became obvious that A.I.B.L. faces a perplexity: while A.I.B.L. is trying not to make any deal which confronts Islamic law, which is causing it to lose a lot of investment opportunities, at the same time it is trying to match the conventional banks in terms of profit. This was confirmed in an interview with one of the A.I.B.L. executives when he was asked, how do you determine your profit on the investments you enter into. He said 'we put into our consideration the current rate of interest and we work in a parallel to it'.

5 Fund utilization

A.I.B.L. concentrates overwhelmingly on *morabaha* as a financial instrument for short-term use of funds, i.e. purchasing a commodity for the client on a predetermined mark-up or profit basis. In the early stages of its existence A.I.B.L. dealt on a profit-and-loss-sharing (P.L.S.) basis but it no longer does so. There appears to have been a conscious decision to stop dealing in P.L.S. contracts after a failure to achieve profit on this kind of contract (the chief executive and the credit officer admitted this). Before 1990 the P.L.S. contracts represented around 5% of the total business of the bank. In 1991 there was a decision to stop dealing in P.L.S. because the bank could not ensure that the entrepreneur would not deceive the bank. Also, there was the problem of a conflict between English law and Islamic law concerning P.L.S. In English law both capital owner and entrepreneur are liable for each other's debts for an unlimited amount, whereas in Islamic law it depends on the agreement alone. Dr Hassan Kamel, Al-Baraka's Chief Executive, explained the effective rejection of P.L.S. in an interview as follows:

'Our depositors want an Islamic deal without risk. They like, at least, to guarantee their capital. The problem with P.L.S. is that they [the Islamic economists] assume the scenario of the entrepreneur being a good Muslim. In this scenario there is no problem, everything would be fine. But is it a realistic hypothesis to find an honest person, most of the time? We are among a lot of dishonest people. It is very difficult these days to find trustworthy people. As a result, we have to concentrate on the mark-up contract more than anything else. Bearing in mind that *morabaha* does not fulfil the idea behind Islamic banks we should concentrate on finding a way to promote P.L.S. transactions to be viable contracts'.

The placement of A.I.B.L. funds in short-term investments with the Islamic departments in conventional banks indicates that it is not able to expand its investment activities in the UK market

because most investment opportunities in the UK are interest-based (said an executive conventional banker who used to be an executive in A.I.B.L.).

As a consequences of the above we can perhaps discern the gap between the theory of Islamic banking and A.I.B.L. practice: while the Islamic banking theory considers P.L.S. to be the core of Islamic banking transactions (Siddiqui, 1988b), the reality is different and A.I.B.L. has totally stopped dealing with P.L.S. for the reasons mentioned before.

6 A.I.B.L. performance

a) *Management*

The main body which manages and supervises A.I.B.L. is its Board of Directors. The characteristics of the Board of Directors are similar to any conventional bank. It is worth mentioning that the Bank of England attaches considerable importance to the role of non-executive directors, placing particular value on their ability to bring an 'outsider', independent perspective to the running of the business and to question the approach of the executive directors and other management. The Bank of England considers that non-executive directors have a particularly important role to play as members of an institution's audit committee (Penn, 1989). A.I.B.L. has responded to this criterion positively and appointed two non-executive directors from outside the Al-Baraka Group in the financial year 1991.³ The Bank of England also requires the institution to conduct its business in 'a prudent manner'. The prudent manner criterion rests with the banks to determine: the bank is responsible for setting the standard most relevant to the interests of

³ Lord Denman: Director of Close Brothers Group Plc (Merchant Bank) Former Director of Saudi British Bank and British Bank of the Middle East and Owen H. Raut: Chairman of Mercantile Group Plc and Starmin Plc. Former Executive Director (U.K.) operation of Barclays Bank Plc and Former Chairman of Barclays Financial Services Limited.

depositors. This criterion is in essence a basic assessment of whether the institution's directors, controllers and managers are fit and proper people to hold their respective positions (Penn, 1989).

When asked about the major obstacles facing A.I.B.L. in London the former and the current chief-executives pointed out the following:

- i) the insufficient number of believers willing to deal with Islamic banks;
- ii) the constraints of *sharī'a* itself: there are not enough investment products that are Islamically acceptable and profitable enough to allow A.I.B.L. to invest all the funds under their management. So they have virtually a cash surplus problem. (When asked what are the advantages of being an Islamic bank operating in London the answer was there are no advantages at all!);
- iii) the tough restrictions of the Bank of England, especially since the Bank of Credit and Commerce International scandal;
- iv) the lack of availability of experienced bankers within Islamic banking;
- v) the size of the bank's capital which is too small to compete with in London: 'the capital of the Lloyds Branch next to us is bigger than the capital of the A.I.B.L.', the chief executive said (The fact that in point ii the complaint is a cash surplus and in point v it is the insufficiency of capital is an indication of the confused way in which the management of the bank handles and analyses its problems);
- vi) the great competition from non-Islamic financial institutions. When this point was raised, I asked how A.I.B.L. competes with conventional banks in London. The answer was that A.I.B.L. does not compete with anyone. Apparently 'they' are competing with A.I.B.L. by opening Islamic investment units within their conventional operations.

When I asked whether A.I.B.L.'s banking operations and activities take more time than the same operations in conventional banks, the answer given was 'no, on the whole'. However, the top management's view (executives) was that A.I.B.L. did take longer for the following reasons:

- i) lack of efficiency;
- ii) the instruments that have been developed so far are not flexible;
- iii) A.I.B.L. does not have enough products;
- iv) A.I.B.L. until now has not had a standard form for its operations and transactions. There are no fixed investment criteria. *Each transaction is studied separately. This is time-consuming and therefore could be added to the cost of the decision making.*

Also senior managers were asked whether there are any extra costs or operational expenses that the Islamic banks have to pay because they are Islamic? The answer was 'yes', in what they called bank placements, especially with bank-to-bank business. When Al-Baraka Islamic Bank makes short-term deposits in another conventional bank it has to ensure that the investment is Islamically acceptable. A senior banker in Citibank said: 'There is an extra cost to this which is borne by the Islamic bank. In the simpler bank-guaranteed placements through conventional banks, trading goods and merchandise is more expensive than placing them (conventionally) in the interbank deposit market.' When I asked the senior manager of one of the Islamic departments in a conventional bank why A.I.B.L. does not make its own investments, he said because A.I.B.L. is not interested to take the high risk which is involved in the investments, he was then asked again: Does that mean that your bank does not care about the risk? He said, 'Of course it cares, but we have better techniques and more qualified staff to evaluate the risk of whether it is acceptable or not', and when two executives of A.I.B.L. were asked why do you ask other banks to do investments on your behalf, their answer was 'there is not enough opportunity, so we are forced to ask others to do our investments on our behalf'. Finally when I asked five managers of A.I.B.L. whether A.I.B.L. employees get any special training when working in an Islamic bank, they said

that they had not been given any sort of training, either about Islamic banking or even about banking in general.

b) *Marketing and client services*

A.I.B.L. suffers great difficulties and disadvantages from being in London. London, as the most important international banking capital in the world, is an extremely sophisticated and advanced banking institution in terms of capital size, assets, technology, network, etc. So for a small-sized bank like A.I.B.L. to work within this environment it has to offer something that no other bank could offer in order to be able to attract more depositors.

To the question, 'what are the advantages of being an Islamic bank working in London?', the Chief Executive answered, as has been observed above, that there were no advantages at all; in fact there were a tremendous number of disadvantages and the evidence for this so far is that over the last few years A.I.B.L. has been a complete failure in financial terms.

In an interview with one of the executives in A.I.B.L. I asked what they had been doing to attract more clients. The answer was by advertising the bank more and more.

But this was not enough: advertising alone did not work. Drucker (1988) stated that advertising could only succeed if two vital ingredients were added to marketing techniques:

- i) the product or service had to give satisfaction to the clients as well as providing profits for the A.I.B.L.;
- ii) the product had to be offered in a place which was convenient to the clients.

The absence of these two vital ingredients is illustrated below:

- In terms of service, there was no cheque books available for three months for the clients, and the reason was that the officer responsible just forgot to order cheque books from the printing house.

- In terms of point (ii) above, A.I.B.L. has only four branches, three of them in London and the other in Birmingham, and this does not cover the Muslim community in Britain.

We see that A.I.B.L. has neither of the vital ingredients. The services within A.I.B.L. are not competitive in terms of variety or in terms of the way they are offered to the public.

When I interviewed ten clients of Al-Baraka, London, I asked them why they deposited their money at A.I.B.L. The reasons they gave were as follows:

- i) because it is Islamic: 8 out of 10 gave this as the main reason;
- ii) because it is Islamic: 2 out of 10 gave this as one of the advantages;
- iii) because it is an Arab bank: 2 out of 10 gave this as one of the reasons;
- iv) because it has a large widespread network: 4 out of 10 gave this as one of the reasons;
- v) because a friend introduced me: 2 out of 10, one gave it as a reason and the other gave this as the main reason;
- vi) because it is close to home (convenient): 3 out of 10, one of them as the main reason.

All the clients whom I interviewed were disappointed with the services and the treatment they got from A.I.B.L.

A.I.B.L. appears to have between 11,000 to 12,000 depositors' accounts, distributed between only four branches, one in Birmingham and the rest in London. The choice of location for the bank's branches is largely dependent on the potential number within the Muslim community as well as the economic activity in the area, as the Marketing Director said. A great number of the depositors are Gulf Arabs, in London for the summer period. The number of depositors is small, and the reason for this poor showing is one or both of the following:

- i) The Muslims in this country do not believe that Al-Baraka is a proper Islamic bank. There is some justification for this, given the way that most of the employees conduct themselves, and given that A.I.B.L. does not fulfil its promises to its clients as stated in its leaflet.
- ii) The marketing is inefficient. To date the evidence suggests that the management of A.I.B.L. are keen to achieve quick profits in order to prove to shareholders that they are qualified to deal with other banks. As a result they neglect the basic thing in the banking industry, the mainstay of it, namely the clients. They try to make big deals with other banks and with big traders and neglect individual clients and small customers. Any visitor to the Edgware Road branch would be shocked by the uncaring attitude of the staff and the long wait the clients have before they are served.

As to the question 'what is A.I.B.L.'s policy of profit distribution?' the answer was as follows:

- At the Al-Baraka Annual Conference, the Chairman said to his Chief Executives, and he was talking mainly about A.I.B.L., that from this year (1992) the Al-Baraka Group will no longer cover the bank's loss for their depositors. He was saying this in order to urge the management of the bank to work harder to achieve at least a break-even point. The assumption was that A.I.B.L.'s policy of profit distribution for their depositors was not to let them suffer any loss. And the loss, totally and entirely, was transferred to the shareholders, in order to motivate and encourage the depositors to stay with A.I.B.L.

c) *The financial performance*

As confirmed by all senior managers and decision-makers in A.I.B.L., the bank aims to maximize its return on invested capital in the same way as any other profit-making enterprise.

The following analysis will include a comparison between Al-Baraka International Bank Limited (A.I.B.L.) and Habibson Bank. As is well known, the primary source of the conventional bank is from lending and investing deposits and stockholders' equity. As an Islamic bank A.I.B.L. cannot earn any profit through interest: and therefore its funds must be invested in non-interest bearing instruments so the earnings are *ḥalāl*. In order to be able to evaluate the financial performance of A.I.B.L. in a fair way we have to compare A.I.B.L.'s performance over the last five years with a conventional bank working in the same economic and social environment and established in the early eighties. For this purpose we will compare A.I.B.L. with a London-based bank called Habibson Bank Limited.

TABLE 2
A PROFILE OF A.I.B.L.'S FINANCIAL PERFORMANCE

	Capital	Assets	Deposits	Capital Assets%	Pre-tax Profits	Return on Capital	Return on Assets
1986	10,258,755	47,597,423	32,159,053	21.5%	355,954	3.46%	0.74%
1987	10,225,601	64,309,195	46,075,478	15.9%	(28,341)	(0.27%)	(0.04%)
1988	30,668,049	109,650,557	58,731,248	27.9%	1,135,180	3.7%	1.03%
1989	31,316,484	136,136,657	87,321,663	23%	1,148,105	3.66%	0.84%
1990	40,207,567	182,878,000	139,541,387	21.9%	(7,016,000)	(17.4%)	(3.83%)

Sources: **Al-Baraka International Bank Limited Annual Reports and Accounts for 1986, 1987, 1989 and 1990.**

TABLE 3
A PROFILE OF HABIBSON'S FINANCIAL PERFORMANCE

	Capital	Assets	Deposits	Capital Assets%	Pre-tax Profits	Return on Capital	Return on Assets
1986	5,131,031	35,557,522	30,006,356	14.4%	305,485	5.95%	0.85%
1987	5,325,638	37,867,504	32,077,870	14.06%	315,442	5.92%	0.83%
1988	5,513,883	48,907,556	42,634,332	11.27%	313,245	5.68%	0.64%
1989	6,718,678	66,649,544	58,825,578	10.08%	635,795	9.46%	0.95%
1990	7,001,052	90,824,679	81,319,325	7.7%	752,374	10.74%	0.82%

Sources: Habibsons Bank Limited Annual Reports and Accounts for 1986, 1987, 1988, 1989 and 1990.

If we take year 1990 as an example we will find that Habibson Bank achieved 10.74% in pre-tax profits return on capital while A.I.B.L. suffered 17.4% loss.

In terms of the deposits it is recognized that during the period 1986-1990 A.I.B.L.'s growth was more than Habibson's. It has not however been possible to analyse the trends in the growth of the various deposit accounts. The question is, how much money have Al-Baraka Group and companies overseas contributed to the increase of deposits in A.I.B.L.? It is important to mention here that in the banking industry generally deposits can be classified as retail or wholesale. The latter are raised in large amounts from other banks and companies, enabling a bank to finance a sudden rise in investment opportunities. The former are raised from depositors through a branch network. This has the advantage of ensuring a high level of stability to the deposits' base so that the bank is not at the mercy of a few large depositors (Close, 1988).

A number of sources mentioned to the researcher that more than two-thirds of the total deposits of A.I.B.L. came from the companies and banks belonging to Al-Baraka Group. What does this mean? It means that the “impressive” growth of the A.I.B.L. deposits was the result, not of successful management in attracting more money and clients, but of the increase from the shareholders’ money either directly or indirectly through their companies’ deposits.

In comparing 1985 with 1991 results in A.I.B.L. only in terms of:

- i) ratio deposits to assets;
- ii) ratio of capital to deposits;
- iii) ratio of investment revenue to total of deposit and capital, we will find the following:

TABLE 4
AL-BARAKA INTERNATIONAL BANK LIMITED (A.I.B.L):
A COMPARISON BETWEEN 1985 AND 1991

	1985	1991
Total Assets	37,374,339	191,422,000
Total Deposit	23,106,850	153,750,000
Capital	10,000,000	49,976,000
Total Investments	33,000,000	183,000,000
Profit before Tax	141,889	(6,851,000)

Resources: The A.I.B.L. Annual Reports and Accounts for 1985 and 1991

TABLE 5
AL-BARAKA INTERNATIONAL BANK LIMITED (A.I.B.L.):
A RATIO'S COMPARISON BETWEEN 1985 AND 1991

	1985	1991
Ratio of Deposit to Assets	61%	80%
Ratio of Capital to Deposits	43%	29%
Ratio of Investment Revenue to Total Deposit and Capital	0.4%	-3.7%

From the above it may be seen that the ratio of deposit to asset (the proportion of deposits placed in investment assets) has increased from 1985 to 1991 by 19%, whereas the ratio of capital to deposit has decreased by 14%. And the ratio of investment revenue to total deposit and capital has decreased by 4.1%. Therefore in comparing these ratios we find that the increase in deposits and capital looks more like a burden and a disadvantage rather than an advantage. When questioned about the reasons for losses in 1990 and how this bad result could be explained, the Chief Executive said:

- i) A.I.B.L. is a pioneering experiment in the London market;
- ii) costs are very high in London;
- iii) great competition;
- iv) lack of qualified management;
- v) inability to invest more funds in medium-term projects highlights the general difficulty A.I.B.L. has in finding projects to suit its criteria.

Finally this study of a pioneering experiment in Islamic banking in London suggests that there are major difficulties in operating Islamically in the context of a non-Muslim society's financial system. The key difficulties appear to be:

- i) the major revenue in the City involves the payment of interest, for example interest on loans, future markets, etc., all of which and A.I.B.L. is unable to use to generate profit;
- ii) the sophistication and the strength of competition of the conventional banks arise from more than three hundred years of existence which makes it difficult for A.I.B.L. to compete in terms of the services it offers. The only thing which can distinguish A.I.B.L. is that it can offer its clients *ḥalāl* profit. Therefore future growth must come principally from new ways of generating *ḥalāl* profit;
- iii) A.I.B.L. has failed to win the confidence of the Muslim community in England as they have only 11,000 depositors;
- iv) A.I.B.L. is facing tough supervision from the Bank of England, and because of this is at a disadvantage. The fact that the Bank of England has not recognized the special nature of A.I.B.L. as an Islamic bank and has not issued a special law for it, and the memory of the B.C.C.I. scandal, are both contributing factors which put A.I.B.L. under very tough restrictions;
- v) the fact that A.I.B.L. does invest most of its short-term funds via the merchant banks raises the question about the quality of its staff.

Chapter 6

**“The Jordan Islamic Bank for Finance and Investment” (J.I.B.):
The Experience of an Islamic Bank in Jordan**

1 Introduction

This chapter examines the phenomenon of Islamic banking in the context of an Islamic country, Jordan, through taking the Jordan Islamic Bank as a case study and discussing a profile of the bank, the supervision, the function, and the extent to which the Islamic values determine the bank's priorities, the fund utilization and its performance.

As Presley and Wilson (1991) stated, the Jordan Islamic Bank is one of the most successful Islamic commercial banks at the retail level. It operates within a Muslim society, has support from the monetary authority and has prudent management: all of these factors and others helped it to be the third among the Jordanian banks in terms of deposits and assets. Perhaps the largest obstacle facing the banks is excess liquidity and lack of investment opportunities which are Islamically acceptable and profitable. Finally the evidence leads to the suggestion that Islamic banking in Jordan has the opportunity to grow and to be one of the major players in the Jordanian banking system.

2 Banking in Jordan

Jordan is among the middle-ranking economies in the Arab world. It had a nominal G.D.P. of \$4.58 billion in 1988 (*The Economist*, 1990). It has a population of about three million. With limited natural resources Jordan relies heavily on aid from fellow Arab countries and remittances from around 325,000 migrant workers to cover its chronic trade deficit. Jordan is not an oil-producing country; the oil boom in the Gulf helped Jordan by increasing employment for Jordanians in these countries, and it also increased aid from those countries.

In the early 1970s Jordan's banking and financial sector consisted of only a few commercial banks and state-controlled specialist financial institutions. Now it comprises at least 36 institutions. Such a rapid enlargement of this sector took place during the oil boom in the neighbouring Gulf countries when the volume of money to be handled ballooned due to increased aid and remittances. The first Islamic bank to be established in Jordan was the Jordan Islamic Bank which was set up in October 1978 in the form of a shareholding company.

Evidence (Wilson, n.d.) suggests that: Until last year Jordan's economy was reliant upon external financial assistance. However, notwithstanding this or Jordan's moderate size, it is one of the most advanced and progressive Islamic nations. The population of Jordan is certainly one of the best educated and best qualified of the whole Islamic world, especially with regard to banking, with the main body of the population using the banks. With the foundation of the Jordan Islamic Bank for Finance and Investment in 1978, the Islamic method of banking became firmly entrenched in the Jordanian financial sector. However, there is still fierce competition within the financial sectors, especially from the dominant interest-based banking spheres, which can be seen as a combined result of the lenient banking laws. In consequence of such fierce opposition the Jordan Islamic Bank is the only one of its kind in Jordan at the present time; another Islamic investment house which was set up in Amman went bankrupt due to overwhelming internal and external pressures.

3 A profile of the Jordan Islamic Bank

3.1 The establishment of J.I.B.

The Jordan Islamic bank is an associate member of the Dallah-Al-Baraka Group (the group shareholding is 40%) it tends mainly to invest within Jordan (Wilson, 1984). In Jordan there are plural systems which can accommodate both *ribā* and *ḥalāl* financial transactions from an Islamic

banking point of view. The Islamic banks are the only type permissible under *sharī'a* religious law number 13 of 1978 which was published in draft form in the official Gazette number 2733 on 1st April, 1978. It was this law which provided for the establishment of the Jordan Islamic Bank for Finance and Investment. J.I.B. was founded in 1978 and has been operating since September 1979.

3.2 The objectives of J.I.B.

As laid down in the Jordan Islamic Bank for Finance and Investment law of 1985 the bank's aims are to meet the economic and social needs in the field of banking services and investment operations on a non-usurious basis. In particular these objectives shall include (J.I.B., 1985):

- a) Expanding the extent of dealings within the banking sector by offering non-usurious banking services with special emphasis on introducing services designed to revive various forms of collective social responsibility on a basis of mutual benefit.
- b) Developing means to attract funds and savings and channelling them into non-usurious banking investments.
- c) Providing the necessary financing to meet the requirements of various sectors of the economy, particularly those which are not likely to benefit from usurious banking facilities.

3.3 The supervision

In 1985 the Jordan Central Bank declared a law called the Jordan Islamic Bank for Finance and Investment Law of 1985 which determined the way the Jordan Islamic Bank could operate.

Chapter one comprised definitions and general provisions; chapter two pointed out the objectives and functions of the bank; chapter three the capital; chapter four acceptance of deposits and issue of *al-muqaradah* bonds; chapter five rules governing the activities of the bank; chapter six management of the bank and general meetings; chapter nine final accounts, balance sheet and profit-and-loss accounts; chapter ten liability to income tax. From this document we can understand that the Central Bank recognized Islamic banking as a new movement in Jordan, and believed that it needed a special law, so it issued this one. The law tries to cover the most important issues and expresses them in detail in a way intended to help the Islamic banking movement. But, as mentioned, Jordan still has only one Islamic bank. There used to be an Islamic finance house which collapsed due to management corruption and not for any reason connected with Islamic banking. At present the Jordanian authorities do not contemplate issuing a licence to establish another Islamic bank (the General Manager of the J.I.B. mentioned this in an interview), and the Monetary Authority does not allow the conventional banks in Jordan to open an Islamic banking counter (interviews with the Governor of the Central Bank of Jordan). The conventional banks have formally complained to the Central Bank about this. The complaint was lodged after a major account was shifted from one of the conventional banks to the Jordan Islamic Bank (Liwa, 1980). Shallah (1990) in his paper mentioned that the J.I.B. is constrained by the Central Bank's regulations including the prescribed reserve requirements, liquidity ratios and other constraints related to credit control in the country. It is worth mentioning, however, that the J.I.B. is deprived of a number of facilities given to other banks: for example, the J.I.B. does not benefit from facilities provided by the Central Bank as the lender in the last resort, to support banks which experience a need for prompt liquidity. Unlike the commercial banks, the J.I.B. is also deprived of facilities (given to conventional banks) to encourage exports at a discounted rate.

Wilson believes that the Jordan Central Bank has responded positively to the establishment of Islamic banks in Jordan and recognized that many believers were unhappy with the kind of banking facilities offered by the *ribā* commercial banks, and this statement was supported by the

Governor of the Central Bank of Jordan. He stated in an interview that the Central Bank is giving all of its support to the Islamic banking movement and he believes that the Jordan Islamic Bank fills a gap which none of the conventional banks in Jordan could fill. When the Head of the Research Department in the Central Bank of Jordan was asked about what sort of support the Central Bank could offer the J.I.B, he said:

- a) By establishing a special law to organize its own operations, and that means we recognize such a movement;
- b) We did not allow the conventional bank to practise the Islamic banking operations. So we offered J.I.B. protection from the conventional banking competition.

The General Manager of J.I.B. believes that the attitude of the Central Bank is not positive, but rather it puts obstacles in the way of J.I.B. He said:

'Even if there is a special law for the Jordan Islamic Bank there is still a deficiency in some of the regulations. For example J.I.B. has been forced into loading approximately 16% extra costs onto its clients when they ask J.I.B. to finance property'.

3.4 J.I.B's business relationship with other financial institutions

Unlike Al-Baraka International Bank in London, J.I.B. has an extensive and relatively large branch network spread all over the kingdom. It has not therefore established any bilateral agreement with the Jordanian conventional banks to manage its short-term funds. As indicated earlier, the conventional banks in Jordan consider J.I.B. to be a threat and the conventional banks are trying to put pressure on the monetary authority to allow them to open an Islamic counter within their banks. But so far the Central Bank has refused. Apart from that the relationship between the Jordan Islamic banks and the other conventional banks does not go beyond clearing each other's cheques.

3.5 Fund collection

The type of accounts which are available in J.I.B. are as follows:

a) ***Trust accounts***

Cash deposits received by the bank are not subject to any conditions for withdrawal or deposit. In other words, the bank permits deposit and withdrawal at any time without any conditions or restrictions and processes the payment and collection of cheques and money orders on behalf of clients as there are no conditions to these deposits. The bank has the right to use these deposits at its own risk and to take responsibility in respect of profit or loss.

b) ***Joint investment accounts***

These include cash deposits received by the bank from persons wishing to participate with the bank in multi-lateral and continuous investment and financing operations, whereby such deposits receive a certain percentage of the annual net profits realized, in accordance with the conditions of the account under which they are entered. They include (Shallah, 1990):

- i) ***Fixed-term or time deposit.*** The minimum amount required to open a time deposit account is JD 500 in local currency and JD 1,000 if the deposit is in a foreign currency. This money must be deposited for a period of at least one year, and share in profits is payable in the month following the date of the deposit. Return on investment is determined according to the results of investment operations and amount and the period of the deposit. Time deposits earn the highest return-90% on the declared profit.

- ii) ***Deposits subject-to-notice.*** The minimum amount required to open a notice deposit account is similar to that of the time deposit mentioned above. These deposits differ from time deposits in that depositors are not allowed to withdraw any of their funds without 90 days advance notice in writing. The share in profits is about 20% for the bank and 80% for the client of the profit declared by the management.

- iii) ***Saving accounts.*** In these deposits the client can withdraw and deposit at any time and can deposit any amount according to the conditions specified by the bank. The minimum balance that is required for investment and for a share in profits is set at JD 100. Saving deposits participate in profits realized from investments at the rate of 50% of the declared profit.

- iv) ***Specific investment account.*** Cash deposits received by the bank from persons desiring to appoint the bank as an agent for investment of these deposits in a specific project or in a specific manner on the basis that the bank will receive a part of the net profits realized, but without liability for any losses not attributable to any violation or default by the bank.

Other banking services

These include:

- i) accepting cash deposits; current and deposit accounts of various types—the bank pays and clears clients' cheques, collects bills of exchange, transfers funds within or outside the kingdom, opens documentary credits and gives notification thereof,

issues bank guarantees, personal letters of credit and credit cards¹ and provides other similar banking services.

- ii) dealing in the purchase and sale of foreign currencies on the basis of spot rates only. The J.I.B. is permitted to undertake mutual lending in various currencies without interest, as may be required.
- iii) giving fixed-term loans as a mere service without interest, either by discounting commercial short-term promissory notes or by instalment lending. The bank may not offer this service, under any circumstances, on the basis of an overdraft current account.
- iv) management of properties and other assets which can be managed by the bank on the basis of an agency fee.
- v) acting as an appointed trustee, in accordance with the *sharī'a* and the laws in force in the kingdom, in cooperation with a recognized religious body.
- vi) doing special studies on behalf of clients and giving information and consultancy services on various matters.

4 The J.I.B. function

As it is stated in chapter two of Jordan Islamic Bank for Finance and Investment Law, the

¹ This means a cash point card.

functions of the bank are to provide:

- a) Non-usurious banking operations: such as accepting deposits, opening documentary credits, personal letters of credit, etc.;
- b) Social services: the J.I.B. shall act as a trustee in organising social services designed to strengthen the ties of solidarity and co-operation among various groups and individuals, through the following activities:
 - i) Giving beneficial loans for productive purposes in various fields to enable the beneficiaries to start independent lives or to raise their incomes and standards of living;
 - ii) Establishment and administration of special funds for various worthy social purposes;
 - iii) Any other activities within the scope of these general objectives.
- c) Financing and investment activities: the bank shall carry out non-usurious financing and investment operations by the following means:
 - i) Providing the necessary financing, fully or partially, in the various cases and undertakings which have a self-supporting potentiality, including the various forms of *mudarabah* financing, participation, purchasing for others on a pre-agreed profit basis and other similar forms;

- ii) Investment of funds, the owners of which desire to invest them jointly with the other resources available to the bank on a joint *mudarabah* basis. In particular cases the bank may invest the funds in a specified manner by special agreement.

The researcher asked the General Manager of Jordan Islamic Bank and seven managers working in Jordan: What are the functions and the role of your bank? Do you see your bank as a developmental institution or profit-seeking institution or a social development institution? The answers which were given vary. Some of them believe that Islamic banks are entirely profit-seeking institutions and that there is no difference between them and conventional intermediary banks apart from the interest rate. Some others believe that an Islamic bank's second aim should be the development of the community in which the bank exists. Others believe that Islamic banks cannot be profit-seeking institutions because of their nature and because Islamic law prevents them from using the market instruments most of which depend on interest. So Islamic banks are developmental banks by nature. When those people who support this view were asked whether there is anything the Jordan Islamic Bank does that other conventional banks do not, the answer was 'yes, we are distinguished for the following reasons':

- a) We offer our clients *zakāh* services; we distribute *zakāh* on their behalf if they wish;
- b) We have a *qard ḥasan* fund to help the people who face a serious problem, especially for medical treatment, for studying and for marriages;
- c) We are trying hard to implement P.L.S. as long as the interest of the bank is not going to be in jeopardy;
- d) Lastly and most importantly we finally succeeded in overcoming the dilemma which a lot of Muslim societies have had, which was how to bank and invest money in the banking system without violating Islamic law.

When the researcher asked ten clients of the Jordan Islamic Bank what they thought the characteristics of an Islamic bank should be, all of them put working under Islamic law as the first priority; some put making profit as the second, and responsibility towards the Jordanian society as the third. Others consider social responsibility as a part which is not contradictory to Islam but they did not mention profit. When they were asked about profit, whether it was a reason or not, the answer was 'we did not bank here for this reason at all; we banked in J.I.B. for two reasons:

- a) It offers Islamic transactions for us;
- b) It offers a secure place to put our money.'

Comparing the law and the view of the Islamic banks, we can see that there is a sort of similarity between them; but it is worth noting that the *morabaha* finance has not been mentioned within the J.I.B. function which, as will be seen later, makes more than 85% of the J.I.B. transactions.

5 J.I.B. transactions and conformity to Islamic values

Section six of the Jordan Islamic Bank for Finance and Investment Law of 1985 says that the bank aims at meeting the economic and social needs in the field of banking services and financing and investment operations on a non-usurious basis.

'The Bank's aim is to meet the economic and social needs in the field of banking services, financing and investment operations on a non-usurious basis. Non-usurious banking operations have been defined on the first page of the law as any activities which the bank is able to carry out on a non-usurious basis in the field of banking services, financing and investment applying such methods as are in compliance with the principles of Muslim *shari'a* law.'

As stated in the Jordan Islamic Banks Law, chapter 8, which is entitled 'Legal Consultant on Islamic Law', section 27 deals with the selection of a specialist in the practice of Islamic law, who is to be appointed as an Islamic legal consultant, and who can only be dismissed on the approval of at least a two-thirds majority of the Board of Directors. Section 28 of the chapter requests the Board of Directors to determine the functions of the aforesaid Islamic legal consultant on the basis that the Board shall be under a duty to request the opinion of the Islamic legal consultant regarding the following matters:

- a) Studying the practical regulations and rules applied by the Bank in its dealing with others, with a view to ensuring that they do not contain any form of usurious dealings which the Bank is obligated to avoid;
- b) Studying the causes which require the Bank to bear any investment loss, with a view to finding the legal doctrinal (*fiqhi*) basis to support the resolution of the Board in this regard.

So the Board of Directors of J.I.B. appoint their *sharī'a* consultant whose remit is to study the bank's instructions and operations in all its various deals and transactions and ensure that they do not, either implicitly or explicitly, have any sort of illegal aspect, from an Islamic point of view.

Shallah (1990) states that, 'according to the bank's law, the board of directors is entitled to appoint and dismiss the *sharī'a* adviser. His remuneration is also to be fixed by the board of directors. Thus such status for the *sharī'a* adviser has been criticized by many Muslim scholars since it may threaten his independence to give the correct judgement without undermining his own position.'

The J.I.B. Board of Directors, however, did appoint one of the most highly respected *sharī'a* scholars, Sheikh Abdel-Hameed Al-Sa'ih. It appears that J.I.B.'s motive for appointing him was only to seek proper criticism from a professional scholar. In the *sharī'a* adviser's opinion a

booklet should be prepared and be available to clients (and others) to inform them of the details of *sharī'a* provisions regarding the bank's operations.

Regarding ethical banking, three executives of the Jordan Islamic Bank were asked how far Islamic values shape strategic goals and whether they can be translated into institutional forms that operate Islamically and whether or not Islamic transactions or investments can still be profitable from an economic point of view. The unanimous answer was that they will never accept any deals which could violate Islamic law, either explicitly or implicitly. Regarding whether the Islamic transactions can still be profitable from an economic point of view, the answer was 'yes we could still make profit'. While some of the interviewees expressed a view that it could be more difficult, the J.I.B. General Manager said that what actually makes his bank a profitable one is being an Islamic bank.

Two managers in J.I.B. were asked in interviews what criteria they applied when deciding whether or not to get involved in any new business. The answer, given without reluctance or hesitation, was that they ensure that the project being assessed does not contradict Islamic norms and values, and if any transaction did or might do so, they would not enter into it under any circumstances.

Regarding social responsibility in J.I.B. Shallah (1990) suggested two questions which are relevant here before judging how far the J.I.B. accepts social responsibility among its objectives: how successful is the bank in mobilizing financial resources (attracting deposits)? and are these resources successfully deployed to promote socio-economic development?

The J.I.B. (since 1987) ranks third amongst Jordanian banks in terms of deposit growth; since then it has also become the third in terms of deposit size. In other words the J.I.B. has overtaken some leading banks such as the Jordan National Bank and the Bank of Jordan, which implies that the confidence of Muslims in the J.I.B. is growing: it does not necessarily mean, as Shallah

concluded, that there is increasing confidence in Islamic business, or that the Muslims in Jordan are becoming more devoted to Islam.

The social impact of J.I.B.'s policies is primarily related to two areas of its activities:

- a) Interest free loans. This is the only kind of transaction in which an Islamic bank can give a cash loan to its clients while not expecting any profit or charging commission. Such loans are made out of social responsibility and not for any other reasons. The J.I.B. has determined that interest-free loans should only be made in cases of personal need, for example, a) marriage; b) education; c) medical needs. In these cases the bank lends the maximum amount of JD 500 repayable within 12 months.

Recently the bank has established a new, interest-free loan fund to hold the deposits of people who want to give to the needy. By the end of 1991 there were JD 38,000 in this account. The total amount of interest-free loans given by the bank (including those from this fund) was JD 1.13 million and 3,131 people benefited from them. In 1990 the total was JD 1.1 million and the number of beneficiaries was 2,664. It could be concluded from the above record that the J.I.B. is trying to practise its social responsibility through giving these interest-free loans, but these loans should be increased to release the people from hardship (J.I.B, 1991).

- b) The J.I.B. is keen to participate in financing the purchasing of equipment and furniture by educational institutions such as universities and colleges, and to do so on a profit margin not exceeding 2% (an interview with the General Manager).

6 Fund utilization

J.I.B., as stipulated in the 1985 law, carries out non-usurious financing and investment operations. In practice, it depends mostly on *morabaha* transactions of a certain pattern such as financing building materials, purchase of cars, durable goods, and the purchase of equipment by professional people such as doctors. The way to proceed with *morabaha* transactions in J.I.B. is as follows: if a client decides to buy a car, he would go to the J.I.B. and ask them to provide him with this car. J.I.B. before anything else makes sure that the client is able to repay the money. When J.I.B. is confident on this point, J.I.B. would ask the client to choose the car which is available in the market which he would like to have within a certain limit of money. Let us presume that the client found a car which costs JD 10,000 and that figure was within the limit, so he will ask the bank to provide him with the car. The bank will send a representative to buy the car under a binding agreement so that the client cannot change his mind about buying the car. When the bank has registered the car in its name, it will immediately sell it to its client at JD 10,000 plus profit: usually this profit is equal to the price of interest, or more, for the repayment period. After that the client will start to pay back the amount in monthly instalments. The theory of Islamic banking justifies the profit from the mark-up for the services that the finance owner provides, namely seeking out, locating and purchasing required goods at the best price (Khan, 1988). The practice of J.I.B. is not quite the same because J.I.B. does not locate and negotiate for the best price: its clients locate and purchase the goods at the best price and the only thing that J.I.B. does is to provide the finance. It is worth mentioning here that the client owes the bank a certain amount of money which cannot be exceeded. The J.I.B.'s policy is to take more profit on luxury commodities than on productive and necessary commodities. The evidence also suggests that it is very rare for the bank to accept any deal which depends upon profit-and-loss-sharing for the reasons which I have explained in the previous chapter on Al-Baraka, London. As the Investment Manager of J.I.B. said during an interview: 'We now work mostly on *morabaha* because we like to concentrate on safe investments.' This is supported by what Shallah (1990) concluded in his

comment about the bank's investment policy of emphasizing short-term trade finance: 'it seems that the bank has adopted a "risk aversion" approach which is in contrast to the ideology of Islamic banking based on "risk-taking".' In answer to this criticism (which points to a discrepancy between ideology and practice) the General Manager said that this is not a consequence either of ignorance or of a lack of commitment on the bank's part, nor of a lack of responsibility towards society. Rather, it is the hostile and unencouraging environment, with all its implications, indicated earlier, that makes it very risky for the bank to invest its funds in medium- and long-term projects. 'The lack of honest and responsible entrepreneurs with the required guarantee for conducting long-term business is only one example.' When the J.I.B. Investment Manager was asked how P.L.S. can be revived, he replied that it may be possible if: i) reputable people are chosen; and ii) guarantees are taken. When asked how he would assess a particular potential client as being reputable or not, he said by finding and going through the individual's record.

7 J.I.B. performance

a) *Management*

The main bodies which manage and supervise the J.I.B. are the Board of Directors and the General Assembly. The characteristics of the Board of Directors and the General Assembly are similar to any conventional bank. From the field study it appears quite clearly that the General Manager of J.I.B. is responsible for the bank's success. In an interview, he named the most important goals for J.I.B.:

- i) developing the bank's image;
- ii) satisfying clients' needs by increasing the range of services;
- iii) increasing the bank's market share;
- iv) maximizing profitability.

The J.I.B. recruited some of its senior staff from other Jordanian conventional banks. During the field study at the bank, it was discovered that despite the fact that the management has begun to give some attention to training its employees, there was a serious lack of a proper training programme for the J.I.B. employees whether they were in top management or middle management. For example the Foreign Exchange Currency Manager was asked whether he ever had a training course or seminar for the currency in the financial market capitals. The answer was 'no'. In the same interview with the Jordan Islamic Bank the General Manager set out the major obstacles which face J.I.B. as follows:

- i) J.I.B. has found itself forced, in order to make up the disadvantage of not being able to use the Central Bank as a lender of last resort, to:
 - make most of its financing operations short or medium term;
 - hold levels of cash in notes in case of emergencies.
- ii) Lack of enough financial instruments like bonds: for example, if J.I.B. could hold listed securities issued by high-quality corporations, this would do as a substitute for cash.
- iii) There is a lack of knowledge on the part of clients about Islamic banking instruments. Thus, when the J.I.B. asks its clients for a percentage of profit on *morabaha* transactions, some clients jump to the conclusion that this is a disguised interest-rate transaction. In other words, some clients who thought that J.I.B. was a charity were disappointed when they discovered the reality of the situation (i.e. that J.I.B. does not do something for nothing).

- iv) The J.I.B. has also found itself forced to take a tougher line on guarantees when it agreed to finance any project. The reason for this is that in the past some clients have tried to take advantage of the fact that the J.I.B. was not able to charge interest on late payments of bills as conventional banks can. There is no penalty for late payment under Islamic law.
- v) There is a lack of well-trained and qualified staff employed in Islamic banks.

The General Manager put the J.I.B.'s success down to:

- not contradicting *sharī'a*;
- increase of client deposits;
- increasing investments made for clients;
- giving an acceptable rate of return to shareholders, depositors and investment clients;
- promoting understanding among management and employees of the nature of the Islamic values as they relate to finance techniques;
- maintaining a good relationship between the institution and the society in which it operates.

When five managers of the Jordan Islamic Bank were asked whether J.I.B. transactions take more time or cost more, two of them answered, 'No from their own experience there is no difference at all'. The others could not give a clear answer, but one of them pointed out that you would probably find a difference if you compare J.I.B. with other international banks, but not with other fellow Jordanian banks.

b) *Marketing and client services*

The Jordan Islamic Bank does not have a department called 'Marketing'. When asked why they did not have a Marketing Department, the answer was: 'Islam is the best Marketing Department for

us'. From this we could tell that Islamic transactions are welcomed among the Jordanian society. Wilson (n.d.) comments that the Jordan Islamic Bank seems to have attracted several thousand customers who have not previously been in the banking habit. In the J.I.B. marketing is the responsibility of the General Manager and the Public Relations Manager, which means that the marketing policy is directed mainly from the Head Office.

The Jordan Islamic Bank has some 273,000 depositors in 29 branches all over Jordan. Thus it has a large network of depositors whose needs have to be met. J.I.B. recently started to computerize its procedures and transactions, but to date J.I.B. does not have an A.T.M. service.

An interview (as with A.I.B.L. in London) with ten J.I.B. clients tried to establish the main reasons for their banking with J.I.B.:

- i) All of them said they deposited their money in J.I.B. because it is an Islamic bank.
- ii) Four out of ten clients had opened their first bank account with J.I.B. This supports one of Wilson's (n.d.) observations.
- iii) Seven out of ten did not have any other account in any other bank in Jordan.
- iv) Some of them expressed their dissatisfaction in that J.I.B. takes marginal profit and costs them more than going to a conventional bank and paying interest.
- v) To the question whether, in their opinion, the J.I.B. really was working under Islamic law, some answered positively. Others equivocated, saying 'that even if it does not, Allah will punish them. We trust them to make *ḥalāl* profit and this is what they say that they will

give us. But if they do something else it is they who will be punished by Allah, not us because we have the good intentions to work within *sharī'a*.'

c) *The financial performance*

The Jordan Islamic Bank is now considered to be one of the largest financial institutions in the kingdom (see Appendix 3) as well as one of the most successful Islamic commercial banks at the retail level (Presley and Wilson, 1991).

The following analysis will include a comparison between the Jordan Islamic Bank and the Housing Bank (The Housing Bank is a suitable case for comparison. It is not as the name implies purely involved in residential real estate lending but acts as the second-largest commercial bank in Jordan, in terms of assets and deposits). The following analysis will include a comparison between the Jordan Islamic Bank and the Housing Bank in respect of return on capital and return on assets from the period 1988-1991.

TABLE 6

A PROFILE OF THE HOUSING BANK'S FINANCIAL PERFORMANCE

	Capital	Assets	Capital Assets%	Pre-tax Profits	Return on Capital	Return on Assets
1988	27,667,958	518,174,505	5.33%	3,158,043	11.41%	0.6%
1989	29,565,634	561,484,005	5.26%	3,418,622	11.56%	0.6%
1990	31,242,783	607,239,077	5.14%	3,671,492	11.75%	0.6%
1991	33,008,383	824,341,682	4%	3,805,996	11.53%	0.46%

Sources: The Housing Banks Annual Reports and Accounts, 1989, 1990, 1991.

TABLE 7

A PROFILE OF THE JORDAN ISLAMIC BANK'S FINANCIAL PERFORMANCE

	Capital	Assets	Capital Assets %	Pre-tax Profits	Return on Capital	Return on Assets
1986	9,791,314	161,661,533	6.05%	949,466	9.64%	0.58%
1987	9,935,404	197,416,645	5.03%	1,021,081	10.27%	0.51%
1988	10,260,764	222,584,341	4.6%	1,338,403	13.04%	0.60%
1989	10,694,867	242,323,408	4.41%	3,063,883	28.64%	1.26%
1990	11,947,200	244,830,709	4.87%	3,182,329	26.63%	1.29%
1991	12,819,785	356,751,185	3.59%	3,207,585	25.02%	0.89%

Sources: **The J.I.B. Annual Reports and Accounts, 1986-1987, 1988, 1989, 1990 and 1991.**

It may be seen from the above that in terms of return on capital J.I.B. achieved better results than the Housing Bank: since 1989 the return on capital for the years 1989, 1990 and 1991 was more than double that of the Housing Bank. In terms of the return on assets we find that again the J.I.B. achieved better results throughout the entire period 1988-1991.

As shown in Table 8 (overleaf) the revenue for the depositors is less than for the shareholders and so the profit distribution is in favour of the shareholders. Shallah (1990) comments on this: '... since the funds of both shareholders and depositors are employed in the same uses facing the same level of risk, such an unbalanced distribution of profits between them can be criticized as unfair.' However, Shallah forgets that the shareholders' responsibility is much greater than the depositors': while the risk to the depositors' money does not extend beyond their individual deposits, the shareholders' responsibility does extend beyond their individual share to the whole bank; thus what he considers to be unfair is, in the researcher's opinion, not only fair but justifiable.

TABLE 8. DEVELOPMENT OF THE J.B.'S PERFORMANCE OVER THE LAST TEN YEARS (1982-1991)

YEAR	TOTAL ASSETS	CASH IN THE BANK & OTHER BANKS	TOTAL DEPOSIT	TOTAL INVESTMENTS & FINANCE	INVESTMENT REVENUE BEFORE DISTRIBUTION	CAPITAL PAID & RETAINED EARNINGS	RISK INVESTMENT ACCOUNT	REVENUE FOR THE DEPOSITORS %	REVENUE FOR THE SHAREHOLDER %
1982	45,238,025	12,800,393	35,833,977	26,471,772	2,516,900	4,219,913	860,778	7.2%	8%
1983	71,483,978	25,437,099	58,565,849	37,591,249	3,073,133	4,359,283	1,475,404	5.4%	8%
1984	102,092,176	27,555,017	82,868,746	63,013,403	4,655,399	4,627,243	2,406,484	5.7%	9%
1985	126,774,045	38,855,419	102,864,396	71,013,906	5,411,864	4,891,711	2,817,358	5.48%	9%
1986	161,661,533	45,766,074	127,613,952	95,461,877	6,466,580	9,791,314	2,685,601	5.1%	9%
1987	197,416,645	65,956,075	158,503,660	108,997,214	7,721,584	9,935,404	3,416,197	5.05%	9%
1988	222,584,341	74,764,664	177,803,749	124,149,759	9,624,790	10,260,764	4,097,477	5.35%	12%
1989	242,323,408	70,037,877	187,242,091	144,078,171	13,715,673	10,694,867	5,161,520	7.25%	10%
1990	244,830,709	70,870,684	190,382,382	148,878,109	16,269,904	11,947,200	6,219,399	7.85%	12%
1991	356,751,185	135,195,264	296,976,591	193,091,736	19,309,632	12,819,785	7,473,342	7.84%	12%

TABLE 9
DISTRIBUTION OF TRANSACTIONS BY THE JORDAN ISLAMIC BANK

Year	PLS and Others	<i>Morabaha</i>	Total	<i>Morabaha % to Total</i>
1984	11764	51249	63013	81.33%
1985	14882	56132	71014	79.04%
1986	19464	75998	95462	79.6%

Reference: Musa Shehadah the General Manager, the figures are taken from 'The Experience of the Jordan Islamic Bank', a published lecture.

Table 9 above shows that the share of *morabaha* has only decreased by 1.73 between 1984-1986 where as in the discussion with the Investment Manager he pointed out that in 1992 more than 95% of J.I.B.'s transactions depended on *morabaha* financing with *mudarabah* and *musharakah* representing less than 1% of total transactions. This means that short-term trade financing is overwhelmingly the most popular transaction amongst the financial operations of the J.I.B. and therefore the share of P.L.S. has fallen from 19.67% in 1984 to 1% in 1992.

In comparing 1991 results with 1987 results in terms of sectoral distribution of the bank's investment, Table 10 (see p.119) shows that J.I.B. was keen to distribute its investments over different sectors and activities, a policy confirmed in an interview with the Investment Manager.

Shallah (1990) considers the major weakness of the bank's financing policies is the shortfall in its advances to the agricultural sector (0.6% in 1987)—the sector which has been almost entirely neglected. He concludes that this is evidence that the Jordan Islamic Bank has taken no role in

assisting farmers with funds and means of production. But Shallah plainly forgets that the bank is answerable to both shareholders and depositors and must show profitable returns on the moneys entrusted to it by them, combined with the fact that the agricultural sector in Jordan has always suffered from very low rates of return (Abdel-Haq, 1979). We should bear in mind that the reasons behind the bank's financing policies become understandable in an economic (if not necessarily a social) context.

TABLE 10. DISTRIBUTION OF ASSETS

YEAR	INDUSTRY	TRADE	PROPERTY	SMALL BUSINESSES	TRANSACTIONS	OTHERS
1987	35,940 32.9%	25,749 23.6%	17,69626 16.2%	12,695 11.6%	5,739 5.2%	11,492 10.5%
1988	32,334 26%	34,822 28%	16,711 13.4%	19,849 15.9%	5,895 4.7%	14,993 12%
1989	46,141 31.9%	32,191 22.3%	21,765 15%	23,818 16.5%	5,120 3.5%	15,580 10.8%
1990	32,916 22.1%	35,709 24%	22,514 15%	33,728 22.7%	5,873 3.9%	18,138 12.2%
1991	41,744 21.6%	50,286 26%	20,956 10.9%	52,415 27.2%	4,848 27.2%	22,842 11.8%

Chapter 7

**“Al-Baraka Turkish Finance House” (Al-Baraka Turk):
The Experience of an Islamic Bank in Turkey**

1 Introduction

This chapter examines the phenomenon of Islamic interest-free banking in the context of the secular financial system in Turkey. It also discusses the establishment, objectives, supervision, functions, the extent to which Islamic values determine the bank's priorities, fund utilization and the performance of Al-Baraka Turkish Special Finance House.

According to Turkey's most recent census (conducted in 1990), (Aksit, 1992) the country's population is nearly 57 million. The great majority of Turkish citizens are Muslims and they respond positively to the movement for Islamic banking and give the special finance houses encouragement to strengthen their presence and position in Turkey.

Despite the successes of the special finance houses in the Turkish financial markets the evidence leads to the view that Islamic banking in Turkey in the foreseeable future will remain a minority subsector.

2 Special Finance Houses in Turkey

What is legally named the special finance house is a very recent phenomenon in the Turkish financial sector. Entering the Turkish financial system only five years ago, this type of Islamic bank has, however, shown rapid growth because it has managed to attract a sizeable number of clients, with its market share of total retail deposits having reached around 2%. There are only three such institutions in the system.

The rationale behind the emergence of Islamic financial institutions in Turkey is summarized in

Buyukdeniz (1991):

‘The development of money and capital markets in developing countries is impeded by a number of factors, including underdevelopment of financial institutions, limited availability of asset choices for savers, economic instability, lack of education and information and the like. The problem becomes even more acute in countries with a predominantly Muslim population who for religious reasons prefer to abstain from being associated with the conventional banking system based on interest. As a result there occurs a leakage of savings from the financial system and savings are often placed in unproductive investments. Under these circumstances, financial institutions based on interest-free principles have emerged as a need in order to induce such funds into the national economy. This is, however, not to undermine the significance of a profit motive alongside moral and ethical factors in the process of shifting funds into Islamic banks. Perhaps the most important effect of these institutions has been on saving habits.’

The evidence tends to suggest also that the equally relevant (and more practical) rationale for the inception of Islamic banking in Turkey has much to do with three of the large Gulf-oriented Islamic banks seeing and exploiting a market opportunity with the help of local Turkish shareholders.

3 A profile of Al-Baraka Turkish Finance House

3.1 The establishment of Al-Baraka Turk

Pursuant to the Council of Ministers Decision, number 83/7506 in December 1983 (published in the official gazette 18256 dated 19 December 1983), three special finance houses have so far been established. These are Al-Baraka Turkish Finance House, Faisal Finance Institution and Kuwait Turkish Finance House. The first two institutions are Turkish-Saudi joint ventures and the later is

a Turkish-Kuwaiti joint venture. Al-Baraka Turk received its official permit to operate on 21 January 1985 and opened to the public on 18 February of that year in Istanbul. It was the first to open branches in other major cities like Ankara, Bursa and Izmir: there are 10 branches in all. In accordance with the relevant decrees and regulations governing the establishment, organization and functioning of special finance houses, they are not regarded as conventional banks and are subject to different rules in the system (the term special finance house is used as an alternative to 'Islamic' bank because the Turkish constitution does not allow any institution to call itself 'Islamic' or to have 'Islam' as a policy objective.) There are consequential differences in the role of special finance houses as regards fund collection and fund utilization as we will see later.

3.2 The objectives of Al-Baraka Turk

The main objectives and activities of the Al-Baraka Turkish Finance House are as stated in the Articles of Incorporation (Al-Baraka Turk, 1991):

- a) To provide an economic and financial system based on co-operation for the welfare of society in keeping with norms of justice and benevolence.
- b) In addition to the capital of the company, to attract funds and encourage investors to participate on a non-interest basis. To finance all kinds of agricultural, industrial and commercial activities and services in joint investments. To issue letters of guarantee. To finance imports and exports. To obtain equipment related to investments and to sell the same by instalments or by leasing them.
- c) To coordinate scientific and technical expertise and knowhow and direct the same within a commercial context to serve the welfare of the society.

- d) To assist small investors/traders who have experience but lack the necessary capital, as a part of the economic development of the society.
- e) To undertake all types of trade and buy/sell commodities in money/trade markets without exploitation, provided that it is permitted under relevant Turkish law.
- f) To provide technical, economic, financial and administrative consultancy services and prepare investments and economic feasibility studies for projects intended to be established and to undertake on behalf of investors the research and evaluation of projects and identification of investment opportunities.

3.3 The supervision

The monetary authority in Turkey does not recognize anything called Islamic banks for constitutional reasons. However, as mentioned above, it instituted a decree which set out the methods and procedures for the establishment of special finance houses. The decree contains seventeen articles, of which the most important are:

- a) The Central Bank fixes the reserve and liquidity ratios which differ from those of the *ribā* commercial banks. At the present time a total of 10% of all funds collected in current accounts and 1% of funds accumulated in profit-and-loss-sharing accounts must be deposited with the Central Bank on which no interest is paid. The special finance houses themselves must keep an additional 10% of the value of their current accounts in cash.

- b) The Central Bank is responsible for the auditing of accounts and supervising the operations of the special finance houses.
- c) Permission from the authorities is required for each new branch, however to open a branch of Special Finance Houses it necessitates a minimum capital of TL 5 billion as against only TL 1 billion from Conventional banks.
- d) The monetary authorities in Turkey do not allow the special finance houses to mention the word *sharī'a* or Islam in any of their advertisements or transactions; nor are they allowed to appoint a *sharī'a* consultant or religious adviser.

3.4 Al-Baraka Turk's business relationship with other financial institutions

Competition exists between the Islamic finance houses and more than 50 *ribā*-based conventional banks. Al-Baraka Turk does deal with these conventional banks. It keeps current accounts with some of them because they have many branches. It also enters into deposit-collecting agreements with some of them and therefore allows them to collect deposits for it where it does not have branches. The conventional banks do this for Al-Baraka because Al-Baraka does not take interest for its deposits with them. Al-Baraka has a worldwide network of correspondent banks in most parts of the world. Baldwin (1990) states that Al-Baraka Turk prefers, wherever possible, to use the services of other Islamic banks rather those of conventional banks (Baldwin, 1990). In interviews with three managers of Al-Baraka Turk they were asked whether Al-Baraka Turk has any advantages from being 'Islamic' and having a worldwide network of contacts. The reply was 'No because of a lack of co-ordination with other Islamic banks and because of the competition between us'.

3.5 Fund collection

The banking services offered by Al-Baraka Turk are generally considered to be similar to conventional banks except of course that it neither accepts deposits nor grants loans on interest, or any other transactions or deals which involve interest, whether at a fixed or variable rate.

a) *Current accounts*

These are demand deposits which may be withdrawn in whole or part on request. They may be opened either in Turkish or foreign currency. Withdrawals are made in the currency in which the account is opened. Current accounts may be opened in the name of the depositor or they may be 'bearer' (i.e. anonymous) accounts. Current accounts may always be closed on demand and the holders of such accounts are paid neither interest nor profit in any form whatever. Current accounts are underwritten by Al-Baraka Turk (i.e. they are guaranteed).

b) *Participation accounts*

These accounts, which may be held in Turkish or foreign currency, are opened by signing a profit-and-loss *participation account contract*. There is no interest or fixed income for the account holder, but rather a share of the profit or loss. Participation accounts may be opened in the name of the depositor or they may be 'bearer' accounts of parties who wish to share in the Al-Baraka Turk profits (or losses) for periods of 90 days, 180 days, 360 days or longer (maximum five years).

For these accounts neither the principal nor any return is guaranteed or predetermined for the depositor. Instead, the depositor becomes a participant in the average profitability of the funds managed by the bank.

The share of Al-Baraka Turk in the profit and loss resulting from the placement of the funds in these accounts is at maximum 20% (i.e. a 'management share'). The profit or loss is calculated on a weekly basis as mentioned before.

c) *Special investment account*

Al-Baraka Turk also operates a special investment account. This offers investors with a minimum of TL 60 million a higher return. The investor receives 90% of all profit and Al-Baraka takes 10% as management expenses. Funds may be placed for 180 days, 360 days or longer. It is worth mentioning that these funds are not covered by the Saving Deposit Insurance Houses.

d) *Other services*

Al-Baraka Turk provides the following additional services to its customers:

- i) to effect inward and outward remittances;
- ii) to draw up, prepare and accept bills, promissory notes, dividend certificates, cheques, bills of lading, debentures and other instruments and to endorse the same;
- iii) to purchase and sell foreign currency on the spot market;
- iv) to open, advise and confirm letters of credit;
- v) to issue travellers' cheques;
- vi) to act as trustee and attorney, to manage stocks, profit-sharing certificates, bonds, debentures and portfolios related to these.

e) *Foreign correspondent relations*

Al-Baraka Turk has correspondent relations with over 60 foreign banks worldwide operating in 14 different currencies. In order to maintain a smooth business environment

with these banks, the management of Al-Baraka Turk make a special effort to keep in touch and exchange views with them.

f) ***Foreign Investments***

Idle foreign currency funds are invested in short-term buying and selling of commodities on the foreign markets.

4 **Al-Baraka Turk's function**

Al-Baraka Turk's aim, as one of its board members stated, is to attract the funds of Muslims, especially those who were reluctant to deposit their savings in conventional banks because of interest and who prefer to 'hide it under their mattresses', and to inject it into the Turkish economy, and, in addition, to attract outside Muslim capital. In explanation of the general role of Al-Baraka Turk, its General Manager said in an interview: 'it is to make Islamic investments with no *ribā* for two types of people: first for those who have funds but do not want to invest them in a *ḥarām* way, and cannot leave them idle because of inflation. One of the most important reasons why the special finance houses have succeeded in Turkey is because of inflation and because no one can leave his money deteriorating in value by 75% inflation per year; second for businessmen who do not want to work in a *ḥarām* way. Al-Baraka Turk's role is to provide *ḥalāl* investments, *ḥalāl* facilities and *ḥalāl* profit.'

I asked the Deputy Chairman of Al-Baraka Turk and one of the board members what are the functions of Al-Baraka Turk. Is it a developmental institution or profit-seeking institution or a social development institution? Both answered as follows: 'we consider ourselves as a profit-seeking institution, keeping within the norms of justice and benevolence. We do not have any more responsibility than the conventional banks towards the development of the society.' Ten

clients of Al-Baraka Turk were asked their opinion on what the characteristics of the special finance houses should be. All of them put working under Islamic law as the first priority; the second was to give them enough yield so that their deposits would not deteriorate by inflation; after that the services they get from the bank and the staff's attitude towards the clients was third. When I asked them whether they were satisfied with Al-Baraka Turk generally, the answers were 'yes we are'.

5 Al-Baraka Turk's priorities and conformity to Islamic values

As stated above, the Turkish authorities do not recognize any such thing as 'Islamic banking'; nor are the special finance houses allowed to include terms like Islam or *sharī'a* in their documents and advertisements, nor even to have a *sharī'a* consultant or adviser for Islamic transactions. As far as the implementation of *sharī'a* in Al-Baraka Turk is concerned, therefore, it is informal rather than formal and depends wholly on how knowledgeable its managers are in Islamic banking.

With regard to ethical banking and social responsibility Al-Baraka Turk is consciously making all its investments within the norms and values of Islam within the limits previously explained and with the emphasis that it is the first financial institution in the country not to contradict Islamic principles. As for specifically socially responsible investment, a senior manager in Al-Baraka Turk stated that, to date, the bank had done nothing in this regard.

Asked about Al-Baraka Turk's investment criteria, the General Manager said the criteria were that i) nothing in a proposed deal should contradict Islamic norms and values; ii) the choices must be made on the grounds of profitability of return for depositors and shareholders. He commented further: 'We are not a charity. We do not work only for religious beliefs. We also have to be competent. We continue to be successful and the people will continue to come to us. We have to be trusted and be knowledgeable and I should say that Islamic banks do not cover all economic

activities. Not all people prefer to use us. Therefore, we will not take over; we are a complementary agency not an alternative one.'

6 Fund utilization

a) *Trade financing*

Financing is provided to individuals or companies applying to purchase real estate, raw and semi-processed materials, machinery and equipment. This form of purchasing in cash from third parties and selling on a deferred-term basis (*morabaha*) accounts for more than 75% of all Al-Baraka Turk's transactions. It is worth asking whether under this type of financing the buyer expects the bank to find (for example) the property for him. Clearly this is not the case. So here it is obvious that there is a gap between the theory and the practice. Khan (1988), as mentioned before, justifies the profit which emerged from *morabaha* contracts as follows: 'However in theory the mark-up is not in fact in the nature of compensation for time or deferred payment, though the entire cost had to be incurred because the needy person did not have means at hand to make the purchase he wanted. The mark-up is for the services that the finance-owner provides, namely, seeking out and locating and purchasing required goods at the best price.' But in practice the bank only offers to pay, and the clients usually do all of the work, such as locating and purchasing the required goods at the best price; and then the client pays back the money under instalment agreements, which is the capital plus the profit (which is usually equal, more or less, to the interest price).

b) ***Project financing (profit-and-loss-sharing)***

Participation in profits and losses may be:

- i) in the form of a full participation in all the profits and losses arising from all the activities of fund utilization;
- ii) in the form of a participation in the profits or losses arising from a particular activity;
- iii) from the purchase and resale of a particular lot of goods. Al-Baraka Turk participates in the profits of individuals or legal parties to whom it has made funds available in the ratio specified in the contract.

c) ***Leasing***

In 1987 Al-Baraka Turk started to finance medium-term projects by means of leasing. The leasing projects involved the leasing of textile machinery, machines, buses, cars, planes etc., with repayments scheduled over a four-year period. At the end of the leasing period the client makes a final repayment and obtains ownership of the goods in question. It is important to mention that to be Islamically acceptable leasing contracts must meet certain conditions (which are mentioned in chapter 3); but especially important here, as Naseef (1988) identified, is that the price of an asset that may be sold to the lessee at the expiry of the contract cannot be pre-determined. It can be determined only at the time of the expiry of the contract. Unfortunately the information was not made available to the researcher to know how Al-Baraka Turk deals with this matter. At the present time Al-Baraka Turk takes 20% of all profits received on all profit-and-loss investment placements as expenses and the remaining 80% is credited to the accounts of the investors of Al-Baraka Turk. It also operates a Special Investment Account which offers investors with a minimum of 60 million Turkish lira a higher rate of return. The investors receive 90% of all profits and Al-Baraka Turk gets 10% as management expenses. Leasing in 1991 accounted for around 20% of all Al-Baraka Turk's transactions.

Most (75%) of Al-Baraka Turk's investments depend heavily on *morabaha* transactions and leasing accounts form about 20%, with the remaining 5% for different sorts of transactions (without interest and not profit-and-loss-sharing). It was mentioned by the manager that so far Al-Baraka Turk is believed not to have set up any profit-and-loss-sharing transactions.

In answer to the question, why has Al-Baraka Turk not made use of P.L.S, two board members and the General Manager said that this was because Islamic banking in Turkey is new. 'In consequence, the "Islamic" banks have to protect their interests and, of course, their depositors' money.' Therefore, at the beginning, P.L.S. was not a viable option, being thought too risky. The bank decided that in the early stages it should seek to be profitable within Islamic law, regardless of the type of contract used, and indeed the bank has succeeded in protecting depositors' and shareholders' interests and turning out a profit. At the next stage, the bank will consider giving more weight to P.L.S. type of contracts. The interviewee also pointed out that, to implement P.L.S., the clients would have to change their attitude, that is, to be more honest. The broad intention of the bank's strategy is: 'We will implement it gradually: 75% of our contracts are *morabaha* and 20% leasing.'

7 Al-Baraka Turk's performance

a) *The management*

Al-Baraka Turk is governed by a board of directors comprising the main shareholders. The General Manager is responsible for the running of the bank's operations. Al-Baraka Turk now has ten branches in Turkey. In an interview the General Manager pointed out that one of the distinguishing features of Al-Baraka Turk's experience of Islamic banking in Turkey is that 'Islamic banks' not only compete in the market with conventional banks but also with other Islamic

banks. He considers this a healthy situation because i) if there are more 'Islamic banks' more people will know about 'Islamic banking', and ii) it forces each bank to give better services.

The stability and homogeneity in the management personnel at Al-Baraka Turk were given as two of the most important reasons for its success. These two reasons were given by the Deputy Chairman and the General Managers. Through the fieldwork study it was observed that the Al-Baraka Turk employees are very enthusiastic about their work. As for the major obstacles facing Al-Baraka Turk, the Chairman and General Manager indicated the following:

- i) finding suitable staff to work in 'Islamic banking' who have knowledge of *sharī'a* and banking;
- ii) the fact that the clients' attitude is still one of suspicion;
- iii) the attitude of the successive governments. The finance houses face the additional obstacle of how to operate in a secular state. (When asked to explain further, they said: 'We do not want protection. All that we want from the Central Bank is to let us be equal in the advantages (e.g. tax advantages, unlimited number of branches). Any conventional bank needs one billion Turkish lira to open a branch, we need five billion. A conventional bank's depositors are protected by the government, ours are not. Our responsibility is a very heavy one.');
- iv) the impermissibility (under *sharī'a* law) of giving cash credit;
- v) the burden of inflation. Al-Baraka Turk does not enter into any deals of a term longer than one year because of inflation. Al-Baraka deals with a high rate of inflation usually by distributing profit at least above the rate of inflation;
- vi) cash surplus. There are not enough investment opportunities to match the liquidity which Al-Baraka Turk enjoys. Further, it cannot deposit this money, for example as an overnight deposit in another conventional bank and get interest, so this is a problem.

While being interviewed one executive and four managers were asked whether the transactions in Al-Baraka Turk took more time or cost more. The answers were as follows:

- i) the executive and one manager said it was almost the same they were are looking to make it less time and less cost;
- ii) two managers said the time and cost were the same;
- iii) one manager said they were already in a better situation because of less time and less costs.

b) *Marketing and client services*

Al-Baraka Turk does have a marketing department which is trying to encourage people to deposit with Al-Baraka Turk on the grounds that it applies certain 'Islamic' principles and at the same time distributes good profit. The content of all advertisements is strictly regulated and monitored by the Under Secretary of the Treasury and Foreign Trade who issues detailed rules for the special finance houses regarding their publicity and advertisements: all media advertisements must avoid the use of the words Islam or *sharī'a*.

Al-Baraka Turk publishes the revalued profit figure of its Turkish lira and foreign currency accounts every Tuesday in one of the main Turkish newspapers.

As of April 1992, Al-Baraka Turk had 66,000 depositors holding leasing and participation accounts, and 17,774 depositors holding current accounts.

In interviews, ten clients of Al-Baraka Turk were asked what had led them to deposit their money with Al-Baraka. The majority gave the reason as 'Islam' (six out of ten); a significant minority said the reason was that A.B.T. offered a good service.

Baldwin (1990) stated that: “Despite the fact that the market share is captured by the Finance Houses which is steadily increasing it appears that this is a result of these institutions offering financial products which appeal to believers and not as a result of direct competition with *ribā* banks”. From the above results with the clients the evidence tends to suggest that Islam played a major role in attracting deposits and in the success of these special finance houses. But the quality of services they offered their clients also attracted more depositors.

c) *Financial performance*

The following is a comparative analysis for the results of the Al-Baraka Turkish Finance House and the Arab Turkish Bank in respect of return on capital and return on assets in the years 1989 and 1990.¹ The Arab Turkish Bank is a relevant bank for comparison because it is an Arab-Turkish joint venture bank, the same as Al-Baraka Turk.

TABLE 11

A PROFILE OF THE ARAB-TURKISH BANK'S FINANCIAL PERFORMANCE

T.L. Million

	Capital	Assets	Capital Assets %	Pre-tax Profits	Return on Capital	Return on Assets
1989	40,375	1,923,500	2%	(21,678)	-53.6%	-1.12%
1990	66,616	1,721,059	3.8%	(27,620)	-41.4%	-1.6%

Source: The Arab-Turkish Finance House Annual Report and Accounts for 1989 and 1990.

¹ The reason why only 1989 and 1990 figures are shown is because the other annual reports were not available to the researcher.

TABLE 12
A PROFILE OF AL-BARAKA TURKISH FINANCE HOUSE'S
FINANCIAL PERFORMANCE

T.L. Million

	Capital	Assets	Capital Assets %	Pre-tax Profits	Return on Capital	Return on Assets
1986	5,166,470	48,421,923	10.66%	4,629,548	92.5%	9.5%
1987	10,885,691	98,562,937	11.04%	5,847,730	58.4%	5.9%
1988	12,708,870	312,230,144	4.07%	4,227,250	42.2%	1.35%
1989	16,815,854	687,527,974	2.44%	12,489,450	12.4%	1.8%
1990	26,351,969	1,106,084,876	2.38%	24,397,136	16.2%	2.2%

Source: The Arab-Turkish Finance House Annual Reports and Accounts for 1986, 1987, 1988, 1989 and 1990.

If we compare the return on capital and the return on assets for the period 1989-1990, we find a tremendous difference between Al-Baraka Turk and the Arab-Turkish Bank. While Al-Baraka achieved 12.4% and 16.2% on return on capital the Arab-Turkish bank suffered a negative return on capital of -53.6% and -41.4% and we find the same result for the return on assets. In-depth analysis of the causes of poor performance of Arab-Turkish Bank was not possible but it is important to mention here that the Arab-Turkish Bank does not represent the Turkish conventional banking sector in terms of performance but it was chosen for the reason mentioned earlier. So from the above comparison it appears that Al-Baraka Turk is a more efficient and more profitable bank.

Table 13 below shows figures which compare Al-Baraka Turk's position vis-à-vis other special finance houses, and Tables 14, 15 and 16 show the special finance houses as a category in comparison with conventional banks in Turkey:

TABLE 13
INTEREST-FREE BANKING SECTOR IN TURKEY:
AN INTRA-SECTORAL COMPARISON, 1991

Million Turkish lira

	ABAT	KUWAIT EVKAR	FAISAL	TOTAL
Funds Collected	1,378,525	403,670	811,762	2,593,959
Funds Utilized	1,383,924	308,438	700,164	2,392,526
Paid-in Capital	30,000	30,000	25,000	85,000
Profit	43,829	20,434	14,948	79,211

Table 13 shows the position of Al-Baraka Turk compared to other special finance houses in terms of the funds collected, funds utilized and profits gained. As it is first in all areas, it seems only right to observe that in this case Al-Baraka Turk has achieved the greatest absolute level of profit, while Kuwait Evkar achieved the best return on assets compared to the others. When a comparison is made among the special finance houses, 'Islam', as a reason for dealing with Al-Baraka, must be excluded because all of these special finance houses have the same criteria in that they invest in an Islamic way. Competition between the special finance houses therefore exists on a purely commercial level.

TABLE 14 (A)
THE SHARE OF SPECIAL FINANCE HOUSES (SFH)
IN THE TURKISH ECONOMY

FUNDS COLLECTED (DEPOSITS) MILLION TL

Year	I Commercial Bank Deposits	II SFH Deposits	II/I x 100 Percentage
1985	7,998,900	28,893	0.36
1986	11,533,800	75,823	0.66
1987	16,440,800	148,688	0.96
1988	25,238,900	327,033	1.30
1989	40,926,000	688,000	1.68
1990	59,928,000	1,312,751	2.19
1991	92,026,000	2,593,959	2.82

TABLE 14 (B)
NUMBER OF BRANCHES IN 1991

	No. of Branches
Commercial Banks	6,727
Special Finance Houses (S.F.H's)	21

Table 14 (A) shows the S.F.Hs' growth in the deposit share market development in Turkey. In 1985 the S.F.H. share of deposit collected stood at 0.36%; by 1991 it had grown to 2.82%. This becomes clearer if we link it with table 14 (B), which shows the number of branches of S.F.Hs'

against conventional banks in 1991. While the conventional banks have 6,727 branches and 92,026,000 million TL in deposits, the S.F.Hs' have 21 branches and TL 2,593,959 million in deposits. If the S.F.Hs' in the 1991 deposit base were in line with the number of their branches, they should have only TL 287,281 million; but in reality they have nine times more than this, but in practice in 1991 they collected TL 2,593,959 million.

TABLE 15
A COMPARISON BETWEEN CONVENTIONAL BANKS AND
SPECIAL FINANCE HOUSES IN TERMS OF FUNDS UTILIZED

Year	Commercial Bank Credits	SFH Funds Utilized	Percentage
1985	5,604.600	27,086	0.48
1986	7,683,700	71,854	0.93
1987	12,312,400	123,724	1.00
1988	15,806,000	275,669	1.74
1989	25,864,000	682,000	2.63
1990	47,828,000	1,212,592	2.50
1991	72,563,000	2,392,526	3.30

Table 15 shows the improvement in the S.F.Hs' market share vis-à-vis the conventional banks' credits (i.e. the S.F.Hs' relative growth in investment as set). The figures in both tables suggest the S.F.Hs' are strong, and have made impressive increases in their deposit market share and funds utilized market share: within the seven years from 1985 to 1991, the former had jumped from 0.36% to 2.82%, the latter from 0.48% to 3.30% in fund utilization. The growth is all the more striking, in view of the number of branches conventional banks have (6,727 in 1991) as against the number for the special finance houses (21).

TABLE 16
A COMPARISON BETWEEN CONVENTIONAL BANKS AND
SPECIAL FINANCE HOUSES IN TERMS OF RATES OF RETURN

Year	Interest payable on bank deposits %	Profit Share distributed by SFH to depositors %
1985	10.05	11.37
1986	8.05	11.38-10.60
1987	7.82	9.37-10.62
1988 ¹	10.05	12.03-12.98
1989 ²	12.40	11.58-13.69
1990	10.06 ³	10.02 ³
1991	13.467 ³	14.075 ³

¹ Between February and October.

² Weighted average of the banks.

³ First six months.

Table 16 shows a comparison between the rate of interest paid since 1985 by conventional banks, and the rate of return of the profit share paid by the special finance houses. Profit shares since 1985, when the special finance houses were established, were notably higher than the rates of interest paid locally.

It may be noted that within the present climate of banking in Turkey, despite the fact that the government is not enthusiastic towards this movement, there is plenty of opportunity for the Islamic banking movement or special finance houses to flourish. This is due to the fact that this

experiment offers two major things for its client: the first being *ḥalāl* investments and the second profitable investments.

So it appears more than likely that Al-Baraka Turk will continue its rapid growth within the Turkish financial market. But despite the successes of the special finance houses in the Turkish financial market, the evidence tends to suggest that Islamic banking in Turkey, for the foreseeable future, will remain a minority subsector.

Part Three

The Results

Chapter 8

Three Case Studies: A Comparative Analysis

1 The Islamic banks' goals

As stated in Wilson (1991), the most important goals of Islamic banking are both financial and social:

'Broad-based economic well-being with full employment and optimum rate of economic growth, socio-economic justice and equitable distribution of wealth and income, stability in the value of money to enable the medium of exchange to be a reliable unit of account, a just standard of different payments and a stable store of value, mobilization and investment of saving for economic development in an equitable manner such that a just return is ensured to all parties concerned, and an effective rendering of all services normally expected from the banking system'.

In the banks which have been studied, their goals were far more modest than what Wilson (1991) stated their primary goals in actual fact were like any other financial intermediary, maximization of their profit. However they differed in that they made profits without violating Islamic law. All three case studies which have been covered in this thesis have not gone so far in their goals as to think that they could influence the economy of the countries in which they operate. The evidence tends to suggest that the majority of Islamic bankers believe that Islamic banks are profit seeking organisations, a few others mentioned that they put development into their consideration but put *ḥalāl* profit first (this second opinion only existed in Jordan).

2 Profit-and-loss-sharing transactions

The evidence in this dissertation disputes the conclusion of Siddiqui (1987), that '*Shirkah* and *mudarabah* could provide the basis for a system of banking without interest', and also that of Siddiqui (1988b), that 'Banking institutions could operate without difficulty if the principle of

profit-sharing is substituted for the practice of fixed interest payments', and Wohlers-Scharft (1983), that 'for Islamic economists, the economic rationale for profit-sharing is not only distributive justice but efficiency, economic stability and growth'. The evidence supported Nienhaus (1984) when he stated that the qualities that make a P.L.S. partnership so attractive to Islamic economists and entrepreneurs is the one that makes it so unattractive to Islamic banks. In addition the three banks tried to adopt P.L.S. but it was not possible to implement it, irrespective of the banking environment in which they operate. None of the banks studied looked at it as the contract that should dominate their transactions, because it was perceived to be too risky to be adopted and it had too many loopholes from the commercial point of view. The result of this was that P.L.S. could not bring either distributive justice or economic stability and growth because it was difficult to control it from the accounting point of view.

Morabaha was the main type of transaction which all three banks adopted widely. The percentage of *morabaha* contracts varied between the three banks: in A.I.B.L. it was more than 95%, in J.I.B. at around 90% and in Al-Baraka Turk at around 75%.

3 Islamic banks operating in different contexts

While the experience of the individual banks in different countries is similar in respect of philosophy and principles, the range of services offered and techniques implemented and the degree of success are by no means identical. The differences arise on two levels:

- a) the macro-level, such as the monetary policy environment, the level of competition and whether the society is Muslim or not;
- b) the micro-level, such as the quality of management and the level of staff training.

The following are the results of the three case studies:

3.1 The environment

As Naughton and Shanmugam (1990) concluded, Islamic banks require an Islamic constitution as a prerequisite in order to flourish and to succeed. This was supported by interviews with six conventional bankers who were asked: What is the way forward for the Islamic banks? How do you see further development in the future for them? The answers were as follows:

- a) An Islamic bank can only operate effectively within an Islamic banking system. The problem that all Islamic banks face is that they operate in a non-Islamic banking system. Consequently it is almost impossible for them to compete effectively while Conventional investment bankers are busy inventing a better mousetrap. Islamic bankers are arguing whether or not they should recognize the mousetrap's existence. This colossal obstacle will only get bigger with time.
- b) The major obstacle facing Islamic banks is to develop meaningful business opportunities which do not depend on 'sham' transactions. These 'sham' transactions will inevitably lead to trouble since absence of commercial reality will never generate an effective commercial return.

The evidence collected challenges the views expressed above. While in A.I.B.L.'s case it supports their view, in the cases of the J.I.B. and Al-Baraka Turk it does not apply. Both of these banks are successful and operate without an Islamic banking system. The evidence has suggested that the success of the Jordan Islamic Bank may be partly attributable to the support of the Central Bank of Jordan which has recognized, by law, the special nature of this organisation; it could also be valid

to assume the same for Al-Baraka Turk, despite some restrictions from the government, in that Al-Baraka Turk has been recognized by the authorities in Turkey through declaration of a special law for them. While the A.I.B.L. is the one which gets the least support and most supervision from its central bank, the bank's supervision as a whole is much tougher in the UK, especially since the collapse of B.C.C.I. (Bank of Credit and Commerce International).

3.2 Obstacles

In terms of the obstacles it was found that they were the same more or less and could be summarized as follows:

- a) lack of short, medium and long-term investments because of the constraints of *sharī'a*;
- b) surplus deposit;
- c) no operational manual;
- d) lack of qualified staff;
- e) competition with the conventional system.

3.3 Investment criteria

In terms of the investment criteria all three cases adopted the following criteria:

- a) no deals should contradict Islamic law;
- b) maximizing profit;
- c) minimizing perceived risk.

3.4 Profit

While both Al-Baraka Turk and J.I.B. have been profitable (so that they have not distributed any loss to their clients) it was found that A.I.B.L. had suffered losses but did not pass on this loss onto its clients but transferred the loss to its shareholders.

3.5 Clients

In the three banks the clients main reasons for banking with them was the religious factor there were still other differences, in the case of Turkey clients were satisfied from the quality of the services they were offered. This was not the case in either J.I.B. or A.I.B.L. However J.I.B. through a widespread network of branches offered the services to the whole of the Jordanian society, while A.I.B.L. have only four branches.

4 **Conformity to Islamic values**

We have attempted to determine how far Islamic values shape strategic goals and select priorities among these case studies and to determine whether Islamic values can be translated into institutional forms that operate Islamically.

It appeared from the fieldwork that they were not involved in any deals or transactions which would contradict or violate Islamic law. Regardless of the environment and profit taken, it would be fair to say that these three banks have succeeded in translating Islamic values into an institutional

form and that this supported what Lynch (1991) stated: ‘...what we witness in the growth of Islamic banks is the growth of a type of banking which explicitly asserts its ethical values.’

5 The performance

Managing an Islamic bank has proved to be more difficult than a conventional bank for the reason that there is a lack of investment instruments which are both profitable financially and acceptable Islamically. As in conventional banks, an Islamic bank’s success or failure depends mostly on the prudent management of the bank and whether the society in which the bank operates is Muslim or not. This statement can be supported by the results of the fieldwork study. While the evidence suggests that the stability of the management in both J.I.B. and Al-Baraka-Turk and the Muslim societies was reflected in the financial performance of these two banks, this was not the case of A.I.B.L which has no stability in its management team. Over the past five years there have been four chief executives and this instability of the management has led to the bad performance of A.I.B.L. As mentioned before, for A.I.B.L. to improve its position and performance it has to make more effort to attract better-qualified staff and to train the staff which it already employs in Islamic financial techniques and behaviour. With regard to client services, ironically A.I.B.L., which is supposed to be the best in this sense because it is based in London (the international banking capital), is the worst of all three cases (for example: for three months, there were no cheque books). It is hard to believe the excuse which A.I.B.L. provided as a justification for the bad results it achieved—the lack of Islamically acceptable investment opportunities. If this was the case, then how have J.I.B and Al-Baraka Turk achieved good results when in both cases the financial system is not Islamic, especially when it is obvious that A.I.B.L. does not suffer from a lack of deposits? Thus the problem in A.I.B.L. appears to lie in the fund utilization, not in the fund collection.

Al-Baraka Turk will continue to grow, but for the foreseeable future it will remain a minority subsector, while J.I.B. will continue to be one of the major players in the Jordanian banking system. In the case of A.I.B.L. it is hard to envisage what future it has. If A.I.B.L. did not improve its policies, its client services and attract more qualified people, it will remain in an unpromising position.

Chapter 9

Conclusions and Recommendations

This thesis is a study designed to investigate the practice of Islamic banks within different economic, financial, social and religious environments, with a view to determining whether or not the Islamic banking theory is reflected in practice.

The general conclusions which can be derived from the study are as follows:

- a) The study shows that while P.L.S. is central to the theory of Islamic banking, it is quite peripheral in the actual practice of Islamic banks, and that this is so in each of the three contexts studied. The unavoidable implication is that the P.L.S. framework is not practised because it is not practicable. It follows that Islamic economists should try to evolve and to provide for practising Islamic bankers banking instruments which are Islamically acceptable and, at the same time, realistic and profitable. The evidence is incontrovertible that Islamic banks do not enter into P.L.S. contracts because of the perceived high risks involved. The Qur'ān does indeed require the eradication of interest and it calls for the encouragement of legitimate commerce and trade, of legitimate wealth-creation: in neither case does the Qur'ān specify any commitment to particular contracts or types of contract such as P.L.S. Thus, Islamic banks can be regarded as Islamically successful if they succeed in eradicating interest from their transactions and promote commerce and trade. Islamic banks may and should concentrate exclusively on acceptable and profitable economic activity, such as trading, for instance, in commodities, property investment, property development and asset leasing. They should solicit deposits for direct investment in those activities and trade therefore as quasi-investment banks. At the same time Islamic banks cannot, any more than can any other financial institution, ignore the realities and costs of inflation which permeate the whole international economy. They must find a solution to this problem in order to meet the need to maintain the value of their depositors' funds.

- b) Regarding the manpower in Islamic banks the following were concluded:
- i) There was a lack of clear vision about the nature of the banks' business, i.e. whether they were socially responsible organisations or they were there to make a profit. This indecision or lack of clarity was evident not only on the part of clients but also on the part of bank staff.
 - ii) a lack of adequately trained staff, properly qualified to handle financial transactions and knowledgeable about the relevant areas of Islamic law.
- c) Islamic values do shape the strategic goals and influence, even determine, the priorities of the Islamic banks. This means that Islamic banks do not violate Islamic law, even for guaranteed profitable deals. In principle, the three criteria by which Islamic bankers assess a possible financial project are: i) that it does not violate Islamic law; ii) that it should maximize the bank's profit; iii) minimizing perceived risk.
- d) Whether the Islamic banks are operating in an Islamically constituted legal environment is not a decisive factor in their success or survival. What is decisive is that the peculiar nature of Islamic banks should be legally recognized and secured—as in the case of Jordan where Islamic banks are protected by specific legislation. Most important of all is that the central bank provides guarantees for the operations of the Islamic banks and protects them against conventional banks. The central bank thus has a vital role in ensuring the survival and vitality of Islamic banks. That said, Islamic banks are more likely to succeed as retail banks in a predominantly Muslim society. Islamic banks in non-Muslim societies face very tough challenges indeed.

- e) The survival and vitality of Islamic banks ultimately depend on the quality of the services they offer to clients. Failure to provide the full range and right quality of services will inevitably mean that clients will switch to the 'Islamic counters' of conventional banks. The Islamic banks should therefore learn from the techniques and experience of conventional banking whatever will assist them to improve their marketing techniques, define and deliver services to clients, etc. which confirms Abdul-Jabir (1987) when he said that 'conventional economics is not irrelevant to either the theory or the implementation of Islamic economic policy and may in some ways be of greater service'. Secondly, the Islamic banks must institute a formal, structured staff-training programme: there was no such programme in any of the Al-Baraka banks studied. In contrast as the Chief Executive said: conventional banks nowadays spend what would once have been considered outrageous sums of money on staff training—nor is the training budget trimmed abruptly with every dip in profit. As pointed out above, Islamic banks' staff would need training in the relevant areas of Islamic law, as well as in conventional financing techniques.
- f) By eliminating interest from their transactions and by proving that profit-and-loss-sharing is not a practical contract to be adopted, as a result a gap has appeared in the theory which has not been filled. Islamic economists should find a realistic alternative which is not only Islamically acceptable but commercially profitable and genuinely different from interest.

Further Research

Further research should be carried out to find and create new investment instruments which are Islamically acceptable as well as commercially profitable, especially to finance long-term investments. In addition a solution for Islamic banks needs to be found that would meet the finance of the consumption needs of their clients.

Chapter 10

The Future of Islamic Banks

Over the last ten years, Islamic banks have gained a considerable quantitative importance in a number of countries, in the light of the discussions through this thesis it might be justifiable to raise the following questions:

Do Islamic banks enjoy a degree of success or not? Is Islamic banking a temporary phenomenon or one likely to survive? What is the way forward?

As stated previously Islamic banks have successfully negotiated two steps. The first step was whether it would be possible to establish another system of banking and some scholars started to lay the theoretical groundwork and background and justified it to Muslims. The second step was the actual establishment of Islamic banks. The theory became real: people were willing to put their money in such institutions either as shareholders or as depositors, and business started. Some early Islamic banks failed and shut down, but others flourished and achieved unexpected results, still others barely stayed in business without either distinguished or bad performance. The question needs to be asked—‘Is this enough?’

Recently in some countries (e.g. the U.K.) the central banks have allowed conventional banks to have an Islamic Investment Department or Islamic Banking Counter within the bank in order to satisfy their clients who want a *ḥalāl* investment. Then why all this fuss about Islamic banks? If the Islamic banks think the only reason for their success and survival is that they offer a *ḥalāl* investment, then it is hard to see Islamic banking continuing and surviving: sooner or later the conventional banks will put pressure on their central banks if the Islamic banks start to flourish to allow them to open ‘Islamic’ sections within their own non-Islamic banks. The Muslim client who is interested in following the Islamic code of investment, in making *ḥalāl* profit, may go to an Islamic bank to help him do so. But when this client learns that the Islamic bank in fact invests its deposit surplus in Islamic deals with conventional banks, why should the client not, as it were, skip the middle man, save himself or herself the middle man’s fee, and go straight to the *ḥalāl*

profit counter of a conventional bank? What Islamic banks are doing now in relying on Islamic Investment Departments within conventional banks could be seen as self-destructive. What Islamic banks should do, presuming that they have a surplus fund, is to invest their funds in the Islamic Development Bank's Investment Deposit Scheme rather than to invest them in an Islamic Banking Department in a conventional bank; at least this would be more justifiable to their clients and would keep the exclusivity of Islamic banking within Islamic banks

The future of Islamic banks hinges by and large on their ability to find a proper way of investment. They should be able to create their own investment opportunities by surveying the market both internally and externally. It is vital for Islamic banks to have the most highly qualified management teams, committed to the success of Islamic banking:

- a) There needs to be an already established, successful banker who can start to put together a good team. That good team will only be around to be picked if Islamic banks recognize that proper training is vital if they are to achieve their goals. Training should not be seen as a luxury, an 'extra', marketing could improve the banks' image with the public, not least by promoting the fact that they train their employees in banking and in Islamic law.
- b) As long as Islamic banks do not prove their usefulness to their societies from the point of view of socially responsible investments, there will always be a question-mark over the real difference between them and conventional banks. It is important for people to see that Islamic banks have given a tangible form to their religious ideology. The challenge facing Islamic banks is to prove that it is possible to be both economically productive and compassionate, to seek both economic self-interest and the interest of others, and that there is no contradiction between ethics and professionalism, competence in one's field and a permanent commitment to good work in that field.

- c) Last, but not least, the success of Islamic banks depends heavily on their ability to find a viable alternative to interest for financing all types of loans, especially consumption loans. They should acknowledge that their success in abolishing interest has been, at the least, partial, and that they still have a long way to go in their search for a satisfactory alternative. Part of that way will surely be more quickly travelled if, as we said (point 1 above), they improve their managerial capabilities by training their personnel in project appraisal, monitoring, evaluation and performance auditing. Their future depends also on their ability to develop, and put into practice, accounting standards that provide timely and reliable information for profit-sharing, rent-sharing or for cost-plus financing transactions. Such standards are far from adequate at present. Until they are, it is difficult work for Islamic banks to persuade clients not already persuaded to believe that they (the banks) have a sufficient and reliable information base from which to conduct and expand their business.

Finally, it is important to remember that the Islamic banking movement has only been around for twenty years and it is unfair to compare its results with the conventional banks which have been established almost three hundred years. Islamic banking is still an on-going phenomenon, still in the making. The challenge for Islamic banks is whether and how to go on surviving, then to succeed and so become an established, permanent phenomenon.

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APPENDIX 1

QUESTIONNAIRES

CLIENTS QUESTIONNAIRE

- 1 Why do you have an account in this bank?
- 2 What do you think the characteristics of an Islamic bank should be? Can you rank them in order of importance?
- 3 What would encourage you to put your money into an Islamic bank?
- 4 What facilities do you get from depositing your money in an Islamic bank?
- 5 What do you think are the advantages created by an Islamic bank?

EXECUTIVES QUESTIONNAIRE

(Questions should require precise answers. If they require a lot of writing or long speeches you will not get objective answers)

- 1 What are the functions of an Islamic bank?
- 2 What is the role of an Islamic bank, is it a developmental institution, a profit seeking institution, a social development institution or all of them? Please give examples, how and why?
- 3 What are the key objectives of an Islamic bank?
- 4 What do you think are the advantages of an Islamic bank? And which of them is more important, and why?
- 5 Do you perceive yourself to be a channel between people who have money and would like to deposit it and people who don't have money and would like to invest?
- 6 What criteria do you use for your investment policy?
- 7 The basis of Islamic banking should be P.L.S. Do you think it is sufficient and reliable enough to be able to understand the nature of the Islamic banking system (Funding Infrastructure Developments).
- 8 How do the banks determine their own risk profile?
- 9 How do Islamic banks compete with the different banking systems?
- 10 What are the differences between Islamic banks and conventional banks?
- 11 How do Islamic banks deal with conventional banks?
- 12 How do you see further development in the next 5-10 years in this particular area?
- 13 What are the obstacles facing Islamic banks?

- 14 What do you do to encourage people to deposit money in your bank?
- 15 What are the key events which have determined the development of Al-Baraka?
- 16 From reading about Al-Baraka I believe it to be a very successful group. Please identify the key issues and factors which in your opinion determine its success and identify them to be addressed later (i.e. Oil boom, profit ratio, social justice, Islamic values)?
- 17 What are the underlying values which determine the bank's decisions and how they decide on priorities.

MANAGERS QUESTIONNAIRE

- 1 The basis of Islamic banking should be P.L.S. Do you think it is sufficient and reliable enough to be able to understand the nature of the Islamic banking system (Funding Infrastructure Developments).
- 2 Siddiqi states that a profit-and-loss sharing system should be the Islamic banks alternative. Do you think it is enough?
- 3 Do Islamic banks have a surplus deposit (liquidity) problem in the short-term? Does this mean that there is a lack of short-term investment instruments.
- 4 Do banks give interest-free loans (*Qard Hasan*)? If yes, for what purposes?
- 5 Do banks charge any service charge on *Qard Hasan*? If yes, how are the charges determined. Actual cost, estimated cost, opportunity cost.
- 6 Do banks guarantee depositors the following: The principal, minimum profit or a percentage of profit?
- 7 Do Islamic banking operations and activities take more or less time or the same as conventional banks? And does this mean that this one has a more effective system or not? Why?
- 8 Are there any extra costs and extra operational expenses that the Islamic bank has to pay because it is Islamic?
- 9 What is the basis of the profit split to the depositor's profit distribution.
- 10 Has the Central bank granted specific concessions to Islamic banks? If yes, please specify?
- 11 What are the other problems which are facing Islamic banks?
- 12 How do Islamic banks manage?

- 13 Do banks have a *sharī'a* board? If yes, has the *sharī'a* board the authority to screen and withhold any transactions.
- 14 What is the difference between an Islamic bank and a Conventional bank?
- 15 How do you see Islamic banks competing with different banking systems? Do you believe that they need some kind of protection. Why?
- 16 Do banks have accounts with interest based banks? If yes and interest is paid on those accounts then do:
- a) Banks forget the interest;
 - b) Banks consider it as revenue;
 - c) Banks use it for charitable causes.
- 17 How is your bank structured and how do clients assess this?
- 18 From my M.A. thesis I found that more than 75% of I.D.B.'s operations depend on the *morabaha* contract. What is the situation in your bank? How could you justify this?
- 19 Can you explain to me how your bank determines the rate of return? What is the process for this and to what extent does the rate of interest affect the determination of the rate of return? Which parties are involved with this and why? (Secondary market...).
- 20 Do banks have an investment risk reserve (risk reserve fund) which can be used to avoid the fluctuation on profit distributed to depositors?
- 21 Does National Law permit deposits to be exposed to risk?
- 22 What do you do to encourage people to deposit in your bank?
- 23 What is the promotional criteria?
- 24 An economist said: 'Islamic economics in theory is fine but in practice it is impossible'. What are your comments about this?

- 25 What are the key events which have determined the development of Al-Baraka?
- 26 From my reading about Al-Baraka I believe it to be a very successful group, please identify the key issues and factors which in your opinion determine its success and identify them to be addressed later (i.e. Oil boom, Profit Ratio, Social Justice, Islamic Values)? Talk about the structure!

APPENDIX 2

THE NAMES' OF THE INTERVIEWEES

Interviewees

Abdul-Haq, Kayed Ibrahim, Assistant to the President of the Islamic Development Bank, Jeddah, Kingdom of Saudi Arabia.

Abolfateh, Abdulla, General Manager, AlBaraka Islamic Investment Bank, Manama, Bahrain.

Aboobaker, Aijaz M., Internal Audit Officer, Al Baraka Investment Company, London.

Afifi, Jamal H., Director General, Industry, Dallah Albaraka, Jeddah, Kingdom of Saudi Arabia.

Ahmed, Zia, Professor of Islamic Economics, Islamic Foundation, Leicester.

Al-Awadi, Yousef A., Managing Director & Chief Executive, Al Baraka Investment Company, London.

Al-Falaij, Abdul Wahab Ali, Chief Representative, Shanghai Representative Office, AlBaraka Investment & Development Co., Shanghai, China.

Al-Ish, Hisham A. Q., Manager, Information and Public Relation Department, Jordan Islamic Bank, Amman, Jordan.

Al-Mizyen, Amal S., Regional Manager, Regional Office for North West Africa, Dallah Group & AlBaraka, Casablaca - Maroc.

Alavi, A. Waheed, Director, Al Baraka Investment Bank Limited, Lahore, Pakistan.

Allahrakha, Arif M., Chief Executive, Al Baraka Investment Bank Ltd, Lahore, Pakistan.

Altamini, Younes, Deputy Director General, Al Baraka Investment & Development Co., Jeddah, Kingdom of Saudi Arabia.

Ando, Yoshinori, Chief Representative for the Middle East, The Sanwa Bank Limited, Bahrain Representative Office, Manama, Bahrain.

Ansouqah, Kaid I., General Director, Al-Baraka Kashakstan Bank, Al-Mata, Khazakistan.

Ardah, Faisal S., Head Office, Investment Department, Jordan Islamic Bank, Amman, Jordan.

Berooglu, Hakan., Assistant Expert, Foreign Affairs Department, Al Baraka Türk, Istanbul, Turkey.

Bhaimia, Khalid M., Managing Director, AlBaraka International Bank Limited, London.

Büyükdeniz, Adnan, Foreign Department Manager, Al Baraka Türk, Istanbul, Turkey.

Büyükyüksel, Ahmet, Assistant Manager, Foreign Affairs Department, Al Baraka Turkish Finance House, Istanbul, Turkey.

Campbell, John, Vice President, Middle East Division, Citibank, London.

Cheikh-Rouhou, Moncef, Deputy Chairman and General Manager, B.E.S.T. Bank, Tunis, Tunisia.

Clarke, J. Brian, Company Secretary, Habibsons Bank Limited, London.

Daredia, Ikbal., Manager, AlBaraka International Bank Limited, London.

Demirtas, Haluk, Al-Baraka Türk, Istanbul, Turkey.

Ertürk, Ahmet, Al-Baraka Türk, Istanbul, Turkey.

Hafiz, Omar Zohair, General Manager, Arab Islamic Bank, Bahrain.

Hamouda, M. Kamal., Assistant Manager, Marketing & Customer Services, AlBaraka International Bank Limited, London.

Hassan, Vaseehar, Chief Executive, Dallah Albaraka (Malaysia) Holdings SDN. BHD. Kuala Lumpur, Malaysia.

Heath, Jan., Middle East and Financial Institutions Group, Barclays Bank Plc, London.

Hightower, David F., Vice President, Citibank, Citicorp Investment Bank Limited, London.

Houssami, Hani S., Managing Director & Chief Executive, AlBaraka International Bank Limited, London.

Jack, Christopher J., Manager, Trade Investments, Saudi International Bank, London.

Kamel, Abdul Aziz A., Director General, Urban Development Est., Jeddah, Kingdom of Saudi Arabia.

Kamel, Hassan A., Chief Executive, Al Baraka Investment & Development Co., Jeddah, Kingdom of Saudi Arabia.

Kamel, Saleh. The President and the Chairman of Al-Baraka Group.

Kemirtas, Haluk, Al Baraka Türk, Istanbul, Turkey.

Khan, Muhammed Fahim, Professor of Islamic Economics, Islamic Development Bank, Jeddah, Kingdom of Saudi Arabia.

Khan, Tariq, Assistant Manager, Albaraka International Bank Limited, London.

Kiaer, Stanley A., Director, IBE (Institute of Business Ethics), London.

McCorkell, David, Financial Controller, Daiwa Bank (Capital Management) Ltd, London.

Morris, Nigel, Senior Manager, Middle East and Financial Institutions Groups, Barclays Bank PLC, London.

Mott, Melvyn F., Senior Manager, AlBaraka International Bank Limited, London.

Mudawi, Al Bagkir Y., Director and Chairman, Board Committee, Faisal Islamic Bank, Khartoum, Sudan.

Muhassiloğlu, Ahmet, Al Baraka Türk, Istanbul, Turkey.

Nabulsi, M. S., The Governor, The Central Bank of Jordan, Amman, Jordan.

Nahri, Jamal., The Director of the International Association of Islamic Banks, Cairo, Egypt.

Nasseef, Dr Abdullah Omar, Secretary-General, Muslim World League, Makkah Al-Mukarramah, Kingdom of Saudi Arabia.

Nassief, Nabil A., Managing Director, Faysal Islamic Bank of Bahrain, Jeddah, Kingdom of Saudi Arabia.

Nassur, Bruhan, Assistant Expert, Foreign Affairs Department, Al Baraka Türk, Istanbul, Turkey.

Oomer, R. S., Managing Director, Al Baraka Finance House Limited, Bombay, India.

Öner, Yalçın, General Manager, Al Baraka Turkish Finance House, Mecidiyeköy, Istanbul, Turkey.

Pasternak, Michael, Portfolio Manager, Saudi International Bank, London.

Robinson, Bruce W., Ex-Head of Corporate Finance, Al Baraka Investment Company, London and currently Director, Aitken Hume Bank PLC, London.

Salah, Jamal M., Head of Research Department, The Central Bank of Jordan, Amman, Jordan.

Saleem, Ahmed, Manager Advertising & Promotion, Dallah Albaraka, Jeddah, Kingdom of Saudi Arabia.

Saud, Mahmoud Abu, Panama City, Florida, USA.

Shair, Khaled, Regional Managing Director, Al Baraka Bancorp (Chicago), Inc., Illinois, USA.

Shaltout, Khalil., Senior Manager, AlBaraka International Bank Limited, London.

Shihadeh, Musa A., General Manager, Jordan Islamic Bank, Amman, Jordan.

Siddiqi, Adeel Y., Company Secretary, Albaraka International Bank Limited, London.

Smith, Duncan, The United Bank of Kuwait, London

Taha, Adil Khalil, Acting Manager, IQRAA Charitable Society, Jeddah, Kingdom of Saudi Arabia.

Topbas, Mustafa L., Vice-Chairman, Al Baraka Turkish Finance House, Istanbul, Turkey.

Touloumbadjian, Paul, Vice President, Citibank, Citicorp Investment Bank Limited, London.

Unakitan, Kemal, Board Member, Al Baraka Turkish Finance House, Mecidiyeköy, Istanbul, Turkey.

Vogt, Carl J., Senior Advisor, Financial Market Department, Norges Bank, Oslo, Norway.

Yamani, Mohammad Abdo, Dar Al-Qiblah For Islamic Literature & Iqraa Charitable Society, Jeddah, Saudi Arabia.

Yavuz, Ömer Faruk, Chief, Current Accounts, Al Baraka Türk, Istanbul, Turkey.

Yilmaz, Ziya, Training and Organisation Development Division, Al Baraka Türk, Istanbul, Turkey.

Zananiri, J. Antoine, Adviser, Swiss Bank Corporation, London.

Zarqa, Anas, Professor of Islamic Economics, King Abdul Aziz University, Saudi Arabia.

APPENDIX 3

ASSETS - TABLES 1-9

THE SIZE OF ASSETS BETWEEN THE JORDANIAN BANKS AND THE POSITION OF THE JORDAN ISLAMIC BANK

ASSETS (MILLION JD)	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1 ARAB BANK	215.5	371.3	444.8	536.5	601.5	665.6	735.8	853.8	981.2	1097.5
2 HOUSING BANK	202.9	223.6	292.8	342.8	382.5	427.1	473.6	515.5	573.8	607.2
3 PETRA BANK	83.3	134.1	185.0	214.1	242.7	267.1	290.6	326.7	--	--
4 KUWAITI BANK	71.6	36.5	108.8	121.9	128.4	137.0	160.6	156.9	163.1	134.5
5 ISLAMIC BANK	31.6	45.3	71.5	102.1	126.8	161.7	197.4	222.6	242.3	244.8
6 NATIONAL BANK	67.9	91.0	105.9	113.9	122.0	134.1	144.6	145.0	155.9	142.6
7 CAIRO BANK	95.5	101.3	115.1	119.2	129.3	139.5	168.5	192.3	216.3	220.7
8 ARAB INV BANK	56.4	71.5	75.0	38.3	100.1	108.3	112.5	143.7	160.6	145.9
9 BANK OF JORDAN	58.9	57.5	75.6	32.2	95.5	123.5	121.7	130.9	155.6	171.6
10 GRINDLAYS BANK	55.4	52.8	59.1	53.1	51.0	53.1	58.1	56.7	90.8	103.1
11 J-GULF BANK	60.6	70.1	75.2	76.0	96.2	109.2	120.5	135.5	--	--
12 CITIBANK	52.2	45.8	51.9	51.3	46.2	44.2	41.0	48.7	51.0	40.2
13 BRITISH BANK	31.2	37.6	42.4	52.6	61.6	71.7	78.4	89.9	104.0	100.7
14 BANK OF INTER-COMM.	30.6	33.3	37.5	48.7	56.9	60.4	71.2	80.7	100.8	74.9
15 MASHRIQ BANK	19.9	27.5	30.3	32.7	33.2	35.6	42.9	48.7	55.3	--
16 ALRAFIDEN	16.1	12.0	10.3	10.6	11.9	12.6	13.0	13.7	25.1	--
17 ARAB LAND	24.7	25.8	28.2	27.5	32.3	35.1	42.1	45.3	53.9	61.3
18 MINHNT BANK	16.6	22.1	25.4	27.7	--	--	--	--	--	--
19 BANK OF AMMAN	--	--	--	--	--	--	--	--	--	71.2
20 BANK OF BUSINESS	--	--	--	--	--	--	--	--	--	47.3
21 JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	81.7	83.1
22 ARAB BANKING CORP. BANKING SECTOR	1331	1553	1863	2136	2392	2635	2899	3251	3780	4090

THE SIZE OF DEPOSIT IN THE BANKING SECTOR

DEPOSITS (MILLION JD)	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1 ARAB BANK	250.7	318.4	383.4	459.7	516.4	579.0	630.6	722.6	835.4	934.8
2 HOUSING BANK	159.7	168.4	244.8	235.8	237.0	281.6	309.3	336.1	400.1	451.0
3 PETRA BANK	60.7	105.7	140.6	157.2	155.1	155.5	202.5	205.2	--	--
4 KUWAITI BANK	54.8	70.6	88.5	98.3	106.2	114.5	122.2	125.1	140.5	107.7
5 ISLAMIC BANK	25.3	35.3	53.6	82.9	102.9	127.6	153.3	177.3	137.2	190.4
6 NATIONAL BANK	55.6	62.1	74.0	82.5	90.6	101.3	108.0	108.0	119.7	108.7
7 CAIRO BANK	68.2	76.3	78.0	85.2	86.1	102.9	126.0	141.5	174.4	179.0
8 ARAB INV BANK	32.2	38.5	42.5	49.3	57.3	61.6	64.0	71.5	108.3	94.3
9 BANK OF JORDAN	49.6	53.7	59.3	60.5	65.5	37.3	35.0	92.7	115.9	135.6
10 GRINDLAYS BANK	49.2	49.4	44.9	44.5	44.3	48.3	44.0	50.0	79.0	37.0
11 J-GULF BANK	36.5	54.2	44.5	43.9	54.9	73.7	39.5	97.9	--	--
12 CITIBANK	35.3	25.1	30.6	34.4	32.3	32.1	23.4	35.7	36.9	28.5
13 BRITISH BANK	25.4	20.6	35.3	44.8	51.9	59.8	66.1	69.6	83.5	78.9
14 BANK OF INTER-COMM.	23.8	26.0	30.3	39.4	44.5	48.0	53.5	64.8	75.9	59.6
15 MASHRIQ BANK	15.4	20.5	23.6	24.6	24.3	24.9	29.8	33.3	37.2	--
16 ALRAFIDEN	10.2	7.3	4.9	5.2	5.9	7.0	6.7	4.6	13.9	--
17 ARAB LAND	18.2	19.7	21.5	21.3	23.4	23.6	29.8	32.0	41.6	41.7
18 MINHNT BANK	9.0	10.2	13.8	17.1	--	--	--	--	--	--
19 BANK OF AMMAN	--	--	--	--	--	--	--	--	--	16.3
20 BANK OF BUSINESS	--	--	--	--	--	--	--	--	--	27.9
21 JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	54.4	57.7
22 ARAB BANKING CORP. BANKING SECTOR	978	1169	1398	1603	1747	1946	2142	2346	2625	2643

THE FACILITIES

FACILITIES (MILLION JD)	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1 ARAB BANK	178.5	203.8	223.2	240.3	255	251	318.6	346.1	353.3	354.2
2 HOUSING BANK	123.9	155.8	198	247.1	273.2	294.0	309.7	322.4	323.4	330.5
3 PETRA BANK	47.6	63.1	94.4	110.4	125	451.8	140.4	164.2	--	--
4 KUWAITI BANK	38	50.8	62.9	73.9	76.1	30.9	89.4	94.8	80.3	77
5 ISLAMIC BANK	15.1	26.5	37.6	53	71	95.5	109	124.1	144.1	143.9
6 NATIONAL BANK	41.1	54.3	60.5	69.9	75.9	32	33.7	36.6	79	75.6
7 CAIRO BANK	57.4	67.7	71.2	76.3	77.3	36.1	97.9	108.6	91.6	38.3
8 ARAB INV BANK	13.3	27	27.2	31	31.4	30.2	39.3	49.3	33.7	39.7
9 BANK OF JORDAN	33.1	39.6	47.4	52.1	53.7	75.2	72.7	73.5	67.9	75.4
10 GRINDLAYS BANK	45.7	44.3	33.1	34.7	30	34.2	33.7	44.1	46.8	54.5
11 J-GULF BANK	35.1	42.8	45.5	43.9	53.4	61.5	63.6	73.6	--	--
12 CITIBANK	12.6	17.9	21.3	24.1	18.3	17.4	15.3	11.7	10.1	11
13 BRITISH BANK	20.4	22.1	25	33.1	38.9	43.1	47.4	55.8	58.7	57.9
14 BANK OF INTER-COMM.	16.9	19.8	21	20.6	21.3	29.5	27.5	25.7	25.6	20.5
15 MASHRIQ BANK	7.8	9.3	10.3	12.3	13.1	15	18.7	21.6	24.9	--
16 ALRAFIDEN	2.9	4.7	5	5.1	5.4	5.5	5.9	5.6	5.1	--
17 ARAB LAND	14.2	14.8	17.6	17.2	19.7	21.6	26.3	27.9	25.8	32.3
18 MINHNT BANK	8.8	13.2	14.2	15.9	--	--	--	--	--	--
19 BANK OF AMMAN	--	--	--	--	--	--	--	--	--	49.8
20 BANK OF BUSINESS	--	--	--	--	--	--	--	--	--	14.7
21 JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	19.6	22.9
22 ARAB BANKING CORP. BANKING SECTOR	721	887	1031	1185	1274	1395	1513	1634	1730	21.5 1864

THE ASSET GROWTH RATE FOR THE JORDANIAN BANKS

ASSETS	GROWTH RATE	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1	ARAB BANK		72.3	19.8	20.6	12.7	10.1	10.5	16.0	14.9	11.9
2	HOUSING BANK		12.7	28.1	17.1	11.6	11.7	10.9	3.3	11.3	5.8
3	PETRA BANK		61.0	38.6	15.2	13.4	10.1	3.8	12.4	--	--
4	KUWAITI BANK		20.8	25.8	12.0	5.3	5.7	9.9	4.2	4.0	-17.5
5	ISLAMIC BANK		43.4	57.8	42.8	24.2	27.5	22.1	12.3	3.3	1.0
6	NATIONAL BANK		34.0	16.4	7.6	7.1	9.9	7.8	0.3	7.5	-3.5
7	CAIRO BANK		6.1	13.6	3.6	3.5	7.9	20.3	14.1	12.5	2.0
8	ARAB INV BANK		7.8	4.7	17.7	13.4	3.7	3.4	27.7	11.3	-9.2
9	BANK OF JORDAN		14.6	12.0	8.7	16.3	32.3	-3.3	7.5	18.9	10.3
10	GRINDLAYS BANK		-4.0	-5.9	-10.2	-4.0	4.1	9.4	14.3	36.1	13.5
11	J-GULF BANK		15.7	7.3	1.1	26.6	13.5	10.3	12.4	--	--
12	CITIBANK		-12.3	13.3	-0.8	-10.3	-4.3	-7.2	18.8	4.7	-21.2
13	BRITISH BANK		20.5	12.8	24.1	17.1	16.4	9.3	14.7	15.7	-3.2
14	BANK OF INTER-COMM.		8.8	12.6	29.9	16.8	6.2	17.9	13.3	24.9	-25.7
15	MASHRIQ BANK		38.2	10.2	7.9	1.5	7.2	20.5	13.5	13.6	--
16	ALRAFIDEN		-25.5	-14.2	2.9	12.3	5.9	3.2	5.4	83.2	--
17	ARAB LAND		4.5	9.3	-2.5	17.5	8.7	19.9	7.6	19.0	13.7
18	MINHNT BANK		33.1	14.9	9.1	--	--	--	--	--	--
19	BANK OF AMMAN	--	--	--	--	--	--	--	--	--	--
20	BANK OF BUSINESS	--	--	--	--	--	--	--	--	--	--
21	JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	--	1.7
22	ARAB BANKING CORP. BANKING SECTOR	--	16.7	20.0	14.7	12.0	10.2	10.0	12.1	16.3	8.2

DEPOSIT GROWTH RATE FOR THE JORDANIAN BANKS

DEPOSITS	GROWTH RATE	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1	ARAB BANK		22.6	20.4	19.9	12.3	12.1	3.9	14.6	15.6	11.8
2	HOUSING BANK		5.4	25.8	11.3	0.0	18.4	9.8	3.7	19.9	12.7
3	PETRA BANK		74.1	33.0	11.8	5.7	-0.4	22.4	1.3	--	--
4	KUWAITI BANK		28.3	25.4	11.1	8.0	7.8	6.7	2.4	12.3	-23.3
5	ISLAMIC BANK		41.5	63.7	41.5	24.1	24.0	24.2	12.2	5.3	1.7
6	NATIONAL BANK		11.7	20.6	10.1	9.8	12.4	6.1	0.0	10.8	-9.2
7	CAIRO BANK		11.9	2.2	9.2	1.1	19.5	22.4	12.3	23.3	2.6
8	ARAB INV BANK		19.6	10.4	17.2	15.1	7.5	3.9	11.7	51.5	-12.9
9	BANK OF JORDAN		3.3	11.4	1.2	10.1	31.3	-2.1	7.3	25.0	17.0
10	GRINDLAYS BANK		4.0	-5.9	-10.2	-4.0	4.1	9.4	14.3	36.1	13.5
11	J-GULF BANK		48.5	-23.4	5.8	47.3	21.3	13.7	9.4	--	--
12	CITIBANK		-28.9	21.9	12.4	-6.1	-0.6	-11.5	25.7	3.4	-22.8
13	BRITISH BANK		-18.9	71.4	26.9	15.8	15.2	10.5	5.3	20.0	-5.5
14	BANK OF INTER-COMM.		9.2	16.5	30.0	12.9	7.9	11.5	21.1	17.1	-21.5
15	MASHRIQ BANK		33.1	15.1	4.2	-1.2	2.5	19.7	11.7	11.7	--
16	ALRAFIDEN		-28.4	-32.9	6.1	13.5	18.6	-4.3	-31.3	202.2	--
17	ARAB LAND		8.2	9.1	-0.9	9.9	0.9	26.3	7.4	30.0	0.2
18	MINHNT BANK		13.3	35.3	23.9	--	--	--	--	--	--
19	BANK OF AMMAN	--	--	--	--	--	--	--	--	--	--
20	BANK OF BUSINESS	--	--	--	--	--	--	--	--	--	--
21	JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	--	6.1
22	ARAB BANKING CORP. BANKING SECTOR	--	19.5	19.6	14.7	9.0	11.4	10.1	9.5	11.9	0.7

FACILITIES GROWTH RATE

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1	ARAB BANK	14.2	9.3	7.7	6.1	-1.6	26.9	3.6	2.2	0.1
2	HOUSING BANK	25.7	27.1	24.8	12.6	6.0	5.0	4.1	0.3	2.2
3	PETRA BANK	43.1	33.6	16.0	14.1	20.5	-7.5	17.0	--	--
4	KUWAITI BANK	33.7	23.3	17.5	3.0	6.3	10.5	6.0	-15.3	-4.1
5	ISLAMIC BANK	75.5	41.9	67.6	12.7	34.5	14.1	13.9	16.1	3.3
6	NATIONAL BANK	32.1	11.4	15.5	3.6	8.0	2.1	3.5	-3.3	-4.3
7	CAIRO BANK	17.9	5.2	7.2	1.3	11.4	13.7	10.9	-15.7	-3.1
8	ARAB INV BANK	103.0	0.7	14.0	4.3	-3.3	30.1	25.7	-32.3	17.3
9	BANK OF JORDAN	19.6	13.9	10.6	3.4	40.0	-3.3	4.4	-7.6	11.0
10	GRINDLAYS BANK	-8.1	-14.0	-8.9	-13.5	14.0	13.2	14.0	6.1	16.5
11	J-GULF BANK	21.9	6.3	-3.5	21.6	15.2	11.5	7.3	--	--
12	CITIBANK	42.1	19.0	13.1	-24.1	-4.9	-12.1	-23.5	-13.7	3.9
13	BRITISH BANK	8.3	13.1	32.4	17.5	10.8	10.0	17.7	5.2	-1.4
14	BANK OF INTER-COMM.	17.2	6.1	-1.9	3.4	38.5	-6.8	-6.5	-0.4	-19.9
15	MASHRIQ BANK	19.2	10.8	19.4	6.5	14.5	24.7	15.5	15.3	--
16	ALRAFIDEN	62.1	6.4	2.0	5.9	1.9	7.3	-5.1	-8.9	--
17	ARAB LAND	4.2	18.9	-2.3	14.5	9.6	21.8	6.1	-7.5	25.2
18	MINHNT BANK	50.0	7.6	12.0	--	--	--	--	--	--
19	BANK OF AMMAN	--	--	--	--	--	--	--	--	--
20	BANK OF BUSINESS	--	--	--	--	--	--	--	--	--
21	JORDAN BANK FOR INVEST.	--	--	--	--	--	--	--	--	16.8
22	ARAB BANKING CORP. BANKING SECTOR	23.0	16.2	14.9	7.5	9.5	8.5	8.0	5.9	7.7

APPENDIX 4

KEY POINTS ADDRESSING EACH HYPOTHESES

a) ***Composition of respondents***

A sample of 102 people included:

- i) Islamic economists (6 interviews);
- ii) Islamic banks working in a Western environment (Middle Management and Executives) (15 interviews);
- iii) Islamic bankers working in a secular environment (Middle Management and Executives) (20 interviews);
- iv) Islamic bankers working in a Muslim environment (Middle Management and Executives) (20 interviews);
- v) Conventional bankers working within the Islamic Investment Department of a Conventional bank (5 interviews);
- vi) Economists working in the Central banks (4 interviews);
- vii) Conventional bankers (8 interviews);
- viii) Corporate and individual clients from London, Istanbul and Amman (30 interviews).

Who were asked the questionnaires prepared for them.

b) ***Summary of key points***

The following are summaries of the key points to each question:

- i) What is the function of an Islamic bank?
 - The majority were of the opinion that the function of each of the three banks was as a financial intermediary.
 - Two interviewees expressed that Islamic law does not accept the idea of 'financial intermediaries' because it does not consider money as a commodity.

ii) What is the role of an Islamic bank?

There are three kinds of answers for this question as follows:

- Islamic banks are profit orientated institutions but without contradicting Islamic law (A.I.B.L's and A.B.A.T's view);
- Islamic banks are profit orientated institutions with a social responsibility to the society they operate in but this is not essential (J.I.B's employees point of view);
- Islamic law does not accept the idea of 'banks'.

iii) What is the mission for an Islamic bank?

There were various responses as follows:

- The mission of Islamic banks is to do banking according to Islamic law;
- You cannot have Islamic banking without an Islamic State;
- There was no response which reflected the confusion about the nature of the Islamic banks from the employees.

iv) What are the advantages of being an Islamic bank?

- Most of the answers concentrate upon the fact that the advantage of Islamic banks are only for Muslims, which offer *ḥalāl* profit. Others expressed the opinion that there could be another advantage for non-Muslims as well, which is providing them with a fair system, which depends on P.L.S.

v) What criteria do you use for your investment policy?

There was a consensus among the three banks about the investment criteria, as follows:

- It does not contradict Islamic law;
- After making sure that Islamic law is not contradicted, adapting the conventional investment criteria such as: profitability, will it generate cash flow, what security can be offered etc.

vi) Whether P.L.S. is reliable and sufficient enough to be implemented?

- In London the answers supported the point that P.L.S. has not been implemented since 1991, after trying to adapt it many times before and failing to convince the bank of its reliability;
- In Jordan it is implemented but only in a small percentage. This percentage varies between 1-5% of the entire J.I.B. transactions;
- In Turkey A.B.A.T have not tested it yet.

In all the banks it was expressed frankly that P.L.S. involved a lot of risk which makes banks reluctant to adopt it.

- On the future of P.L.S. some of them believe it could be implemented by adopting new methods to make sure that the clients are trustworthy enough and to find a proper way to control the project which is financed under P.L.S. contracts;
- Others believe that it cannot be implemented;

- Conventional bankers believe that P.L.S. depends upon how professional the bankers are, they have to be careful. Islamic banks should know how the company does its work on a daily basis in order to be able to achieve profit.

vii) How do the banks determine their own risk profile?

- In the three banks it has been admitted by the General Managers and Chief Executives that they are trying to minimise the risk involved in their transactions by implementing the mark-up as the major transaction; and in A.I.B.L. only, they even ask some Conventional banks, like Citi Bank, to do investments under mark-up on their behalf. So in practice A.I.B.L. does not have any risks involved in their investment dealing, while the others have the minimum risk. The statement used by the Chief Executives and General Managers is: 'to be an Islamic bank does not mean that we take larger risks'.

viii) What are the differences between Islamic and Conventional banks?

- The majority of the respondents agreed that the major difference is that the interest rate does not exist in Islamic banks.
- Some other respondents mentioned that Islamic banks should be sociably more responsible towards the Muslim societies in which they operate.

ix) How do Islamic banks compete with the Conventional banking system?

- Islamic banks face great competition from Conventional banks concerning service terms. The only way that Islamic banks in non-Muslim environments can compete is to offer *ḥalāl* investments for Muslims. Within Muslim societies Islamic banks have more chance to compete with conventional banks.

x) What are the obstacles and the problems facing Islamic banks?

- Non-Co-operation of the authorities in the respective countries (fear that the Islamic banking movement will convert to a political movement);
- Non-Islamic environment;
- Being pushed to determine certain levels of profitability by using the interest rate as a guideline;
- Restrictions on investment, i.e. lack of short, medium and long term investments due to the need to find an instrument Islamically permissible and profitable at the same time;
- Competing with non-Islamic institutions;
- Problems in the asset built up and the kinds of assets in Islamic banks is very limited;
- Islamic banks cannot provide the same possibilities as Conventional banks because of constraints of *sharī'a*, such as a lack of overdraft instruments;
- Clients are still suspicious about whether we actually work under *sharī'a*.
- Islamic banks do not have any set operations manual;
- Lack of experienced bankers in Islamic banking;
- Surplus deposit;

- Lack of short-term investment instruments.

xi) What are the underlying values which determine the Islamic banks decisions?

- There is a strong consensus that Islamic values underlie and determine the Islamic banks decisions regardless of the environment which they operate in.

xii) Is it true that Islamic banks always attract second class projects?

- Not necessarily, it depends upon the market circumstances.

xiii) What do you think about Al-Baraka?

There were two points of view:

- If you look at the Chairman you will see that he has built his fortune in a very short time - it is a very successful Company;
- If we compare it with other financial groups we find that it is far behind. Management is not very good - managed like a small supermarket;

What could be done?

- Create a professional and strong headquarters;
- Create a controlled system to oversee every single issue in our banks worldwide;
- Create a proper balance sheet. We do not have a consolidated balance sheet to reflect the strength of the group.

APPENDIX 5

REPLIES AND COMMENTS OF THE INTERVIEWEES

LONDON

The following are summaries of the key points addressing each hypothesis:

- 1) Islamic banks are profit seeking organisations within the framework of a social developmental role based upon Islamic law regardless of the environments in which they operate.
 - The commercial Islamic banks aims are firstly, profit, secondly development (the goals).
 - You can achieve just distribution through Islamic banks if they operate under an Islamic state.
 - The role of an Islamic bank is rendering services to the client on an Islamic basis, but this does not mean charity. We do care about profit.
 - The role of A.I.B.L. is a profit oriented institution first, but the nature of our transactions here is to play a developmental role, however we are neither long-term developmental banks nor charitable institutions.
 - We exist only for profit.
 - The mission of Islamic banks for Muslims is *ḥalāl* profit. For non-Muslims a fairer system which depends on P.L.S.

- The role of an Islamic bank is making profit and having some sort of development abroad - but it is not essential.

2) Profit-and-loss sharing i.e. *mudarabah* and *musharakah* is the concept which underlies Islamic banking and practice.

- P.L.S. cannot work under the current circumstances.
- P.L.S. is very difficult to implement because of dishonest clients.
- P.L.S. takes more time because each case is different.
- P.L.S. is not really used anymore because the Islamic banks do not like to take risks, they try to minimise the risk as much as possible, therefore they deal with mark-up which is lending at a pre-agreed rate but is one which is Islamically permissible.
- Mark-up is the same, from an economic point of view, as an interest loan.
- P.L.S. is not implemented in England.
- P.L.S. is not reliable, there is a conflict between UK law and Islamic law concerning P.L.S. In the UK both capital owner and entrepreneur are liable for each others costs upto an unlimited amount. But in Islamic law it depends upon the agreement only.

- P.L.S. was less than 1% in 1991 and now no longer exists. Mark-up is the dominant transaction (95% mark-up).
- Implementing Islamic banking is not impossible but will take time.
- It is not true that our clients are all good Muslims. We have had a lot of bad experiences with many people so we cannot implement P.L.S.
- P.L.S. could be implemented through creating a good system.
- A conventional banker said: P.L.S. depends upon how professional the bankers are, they have to be careful. Islamic banks should know how the company does its work on a daily basis in order to be able to achieve profit in case of P.L.S.
- It has not been tested yet (P.L.S.).

3) The operations and performance of Islamic banks differ in accordance with the economic, financial, social, legal and religious environments in which they operate.

- The advantages of Islamic banks are: i) being able to invest funds in a *ḥalāl* manner; ii) being able to enter into direct investments like P.L.S. It is an advantage to use P.L.S. because an owner should not be a lender; iii) eliminating fraud.
- The investment criteria for Islamic banks are: i) does not contradict Islamic law; ii) is self financed; iii) is it going to generate cash flow; iv) understanding the deal itself; v) what security can be offered.

- Investment criteria policy is: i) the same as other Conventional banks; ii) risk, type of risk, tender, yield and also cash project has its own position; iii) prudent risk balance sheet; iv) historical performance.
- Investment policy criteria: i) to be Islamically acceptable; ii) profitable; iii) legally permissible. We have two laws we should follow - Islamic law and the UK law.
- Problems: i) surplus deposit; ii) lack of short-term investment instruments.
- Obstacles: i) non-co-operation of the authorities in the respective countries (fear that the Islamic banking movement will convert to a political movement; ii) non-Islamic environment; iii) being pushed to determine certain levels of profitability by using the interest rate as a guide line.
- Obstacles: i) restrictions of investment, i.e. lack of short, medium and long term investments, because we are looking to find an instrument which is Islamically permissible and profitable at the same time; ii) problem in the asset build-up and the kinds of assets in Islamic banks is very limited; iii) competing with non-Islamic institutions; iv) Islamic banks cannot provide the same possibilities as Conventional banks because of constraints of *sharī'a* such as; the fact that clients are still suspicious about whether we work under *sharī'a*.
- Islamic banks need some kind of protection from the Central banks, the authorities should recognise the nature of our business (like taking risks).
- Islamic banks will succeed only if society has Islamic faith.

- It is very rare to have interest-free loans, we are not a charity like some people think.
- Advantages: i) one million Muslims in England want *ḥalāl* investments.
- People deposit with us because we are *ḥalāl* not because we are the better.
- We cannot compete with Conventional banks in their services.
- The Bank of England does not have formal regulations for Islamic banks so therefore it is the duty of the the Islamic banks' in England to guarantee the principle, therefore A.I.B.L. guarantee the principle but do not guarantee any return.
- A.I.B.L. does not have an operations manual.
- There is a lack of experienced bankers in Islamic banking
- Islamic banks do not attract second class projects only because Islamic banks should depend on the true believers, and because Islamic banks do not take or accept second class projects.
- Types of investment by A.I.B.L: property, trade, in line with some Conventional banks.

- A.I.B.L. encourages people to deposit money with them by: i) offering *ḥalāl* profit; ii) quality services and iii) good return.
- More attention should be given to the training of employees of Islamic banks.
- We cannot have a proper Islamic banking system in a Western environment. Even when we use *morabaha* we do not follow *sharī'a*. There is no physical activity, it is done only on paper and the contract is done between the client and the company. There is no *hiazah*.
- In reality they are interest free banks not Islamic banks.
- We use the interest rate as a guideline to determine our rate of return.
- A.I.B.L. finds it difficult to be a proper Islamic bank.
- The difference between Islamic and Conventional banks is that money is not a commodity - you cannot make money without any real investment.
- A.I.B.L. has no interest free loans policy.
- A.I.B.L. guarantees the depositors the principle only.
- There is an extra expense that the Islamic banks have to pay, because they are Islamic, especially with bank to bank business. When you deposit in another bank you have to make sure that the investment is Islamically acceptable and this costs more.

- There is no special training - but it would be very useful.
- How do banks determine their own risk profile: i) quantity limits; ii) industry limitations; iii) geographical limitations, and like any other professional, risk management level.
- How do Islamic banks compete with the different banking systems? We compete; they compete with us on our services. We face great competition concerning service terms.
- The difference between Islamic and Conventional banks is the interest rate.
- A.I.B.L. does not recognise inflation.
- Criteria for investment policy: i) feasibility studies, *risk and return, like any other* Conventional institution. To be an Islamic bank does not mean we take large risks. We should analyse everything and above all everything should be within Islamic values. No alcohol, pork or armament.
- Conventional banker: 'I believe only Muslims deposit in Islamic banks especially in London. The Islamic banks can only survive because of Muslim investors.'
- There is no advantage at all for being an Islamic bank; the last eight years have been a complete failure.

- 4) Islamic values determine the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.
- Islamic values are underlying the policies which determine the banks decision i.e. no alcoholic deals even if they are 100% profitable.
 - It is not true that *sharī'a* limits A.I.B.L.'s opportunities - but rather the opposite in that it focuses our attention on our strengths.
 - Islamic values determine our decisions.
 - Islamic values determines the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.
 - The bad result of A.I.B.L. is because of the recession of property values, nothing to do with Islamic banking.
 - You cannot implement Islamic economics in A.I.B.L. The Bank of England does not allow any 'Islamic' transactions. So A.I.B.L. is not an Islamic bank. A.I.B.L. provides certain Islamic deals but not everything. It is not their fault, but the Bank of England's restrictions.

JORDAN

- 1) Islamic banks are profit seeking organisations within the framework of a social developmental role based upon Islamic law regardless of the environments in which they operate.
 - The function of an Islamic bank isn't only as a financial intermediary it has a developmental dimension as well.
 - The aim of J.I.B. is to achieve profit without contradicting Islam.
 - The aim of J.I.B. is firstly, to develop the Muslim society in Jordan and invest its money in an Islamic way; profit comes second.
 - J.I.B. is a predominantly commercial and developmental bank, of an Islamic nature.
 - J.I.B. is a mixture of both commercial and developmental elements.
 - J.I.B. is a developmental bank of an Islamic nature.
 - J.I.B. is a socially orientated Islamic bank.
 - The most important banking goals for Islamic banks in Jordan are as follows:
 - i) developing the bank;
 - ii) satisfying customers needs;
 - iii) to increase the market share;
 - iv) to increase the range of services;
 - v) to increase the return on investment;
 - vi) maximize profitability;
 - vii) to minimize risk.

- Social responsibility should be part of the training of Islamic banks.
 - The special function of the Islamic bank is directed towards social responsibility, Islamic banks decisions and activities are closely related to the stability and growth of the society.
 - We are not a charity like some people tend to think.
- 2) Profit-and-loss-sharing i.e. *mudarabah* and *musharakah* is the concept which underlies Islamic banking theory and practice.
- The advantage of being an Islamic bank is: i) to invest funds in a *halāl* manner; ii) being able to enter into direct investment like P.L.S., the advantage of P.L.S. is to become an owner not a lender.
 - P.L.S. can work but it should have a portfolio management, (what assets should go to *modaraba* and *musharakah*).
 - P.L.S. is not a straightforward operation, P.L.S. should be implemented under certain procedures: i) know your customer; ii) past performance; iii) how long has the customer been with you?; iv) feasibility studies; v) the future implication (risk involved).
 - P.L.S. is not implemented in the J.I.B.
 - P.L.S. is less than 5% of J.I.B.'s transactions.

- 3) The operations and performance of Islamic banks differ in accordance with the economic, financial, social, legal and religious environments in which they operate.
- Obstacles: i) lack of investment instruments which are profitable and at the same time Islamically acceptable.
 - The biggest obstacle is that the number of products we offer are not enough.
 - The co-operation between the Islamic banks is weak.
 - There is no operations manual.
 - Establishing a training institution.
 - The investment criteria are: i) to be Islamically legitimate; ii) socially useful; iii) profitable.
 - The bank determines its own risk profile by understanding the deal itself through answering the following questions: i) is it sub-financed?; ii) will it generate cash flow?; iii) understanding the deal itself; iv) what security is offered?; v) what would be the bank's profit?; vi) how much risk is involved?
 - Problems: i) surplus deposit; ii) lack of short, medium and long-term investment instruments.
 - Problems: i) non-co-operation of the authorities in respective countries.

- We compete with conventional banks by offering *ḥalāl* investments and good services.

 - The difference between conventional and Islamic banks: i) not receiving or paying interest; ii) kinds of investment; iii) types of deposit; iv) sorts of financing and charging for services.
- 4) Islamic values determine the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.
- The investment should be under Islamic values.

 - Islamic values always underlie the banks decisions and priorities.

- 2) Profit-and-loss-sharing i.e. *mudarabah* and *musharakah* is the concept which underlies Islamic banking theory and practice.
- P.L.S. has not been tested yet, in A.B.A.T.
 - A.B.A.T. has not implemented P.L.S. yet as Islamic banking in Turkey is a new system, so the Islamic banks have to protect their interests and their depositors money. Therefore at the beginning it would not be prudent to use P.L.S. because it is very risky.
 - P.L.S. has not been implemented in A.B.A.T. because it is very risky.
 - In order to implement P.L.S. the clients should change their attitude towards the Islamic banking system; they should be more honest. We will implement it gradually.
- 3) The operations and performance of Islamic banks differ in accordance with the economic, financial, social, legal and religious environments in which they operate.
- The competition between Islamic banks in Turkey is considered a healthy phenomenon. When there are more banks it means more people will know about it, this is what is called a positive externality.
 - A.B.A.T. does not need protection from the Central bank. A.B.A.T. want the Central bank to treat it equally with other conventional banks; in terms of the advantages, i.e. tax advantages, unlimited number of branches. Conventional banks need only one billion Turkish Lira to open a new branch whereas A.B.A.T.

need five billion. The conventional banks depositors are protected by the government whereas A.B.A.T. clients are not. A.B.A.T.'s responsibility is heavy.

- There is no sophisticated research section in A.B.A.T.
- One of A.B.A.T.'s investment criteria is that they prefer to do business with large companies who are financially strong.
- Concerning investment criteria, A.B.A.T. has two criteria: i) nothing should contradict Islam; ii) on a financial basis A.B.A.T. acts on a strictly commercial basis.
- A.B.A.T. investment criteria are as follows: i) minimal risk; ii) companies at least should be working not less than 3 years; iii) have very strong capital; iv) qualified managers; v) market potential; vi) good financial statements; vii) profitability; viii) nothing against *sharī'a* and every project should be *ḥalāl*.
- Lack of short-term investment instruments, i.e. they cannot use overnight instruments. A.B.A.T. has not got a problem in Turkish Lira because when there is a surplus A.B.A.T. exchange it into foreign currency, but it has a surplus problem with foreign currency.
- The Islamic banking theory failed to inform A.B.A.T. how they can invest excess funds for overnight investments.
- A.B.A.T. is trying to minimize its risk as much as possible.

- A.B.A.T. cannot compete with conventional banks. It does not have branches everywhere. A.B.A.T.'s growth rate is bigger than the conventional banks but A.B.A.T. has a long way to go yet.
- A.B.A.T. can act as a trader and as a banker.
- More than 75% of A.B.A.T. transactions depend on the mark-up basis.
- A.B.A.T. has an operations manual.
- A.B.A.T. has all sorts of trade and banking activities, apart from any deals or commodity which contradicts Islamic law.
- The mark-up is determined on the market rate and is virtually the interest rate.
- The longest period for any deal is not more than one year, since *inflation is too high*.
- A.B.A.T. tried to overcome the inflation problem by spot buying and selling currencies.
- Islamic banks play a complimentary role, they are not an alternative for conventional banks.
- We should be a profitable institution under Islamic law regardless of which contract is used.

TURKEY

- 1) Islamic banks are profit seeking organisations within the framework of a social developmental role based upon Islamic law regardless of the environments in which they operate.
 - A.B.A.T. is a financial intermediary.
 - A.B.A.T. is not a charity.
 - A.B.A.T. a profit seeking institution which operates under Islamic law.
 - A.B.A.T.'s main target is to make Islamic profit.
 - A.B.A.T. does not have any developmental role, but this does not mean they will not have in the future.
 - To make an Islamic investment with no *ribā*. For the investors and the entrepreneur.
 - A.B.A.T. was not only established for religious beliefs.
 - A.B.A.T. does not have anything in the terms of social responsibility toward the society in which it operates.

- The main obstacles: i) finding suitable staff to work in Islamic banks with knowledge of both Islamic law and banking; ii) the clients attitude - they are still very suspicious about A.B.A.T; iii) the governments attitude.

- Main obstacles: i) does not give cash credit; ii) the central bank does not look to A.B.A.T. in a friendly way; iii) the Conventional banks have made a lobby against us; iv) not enough branches; v) some people believe that Islamic banks are a sort of Islamic revolution.

- Further development in the next five years in Islamic banking in Turkey is expected in terms of: i) more banks; ii) more branches; iii) more share in the market.

- A.B.A.T. deals with other conventional banks keeping current accounts with some of them because they have many branches so they can collect deposits for A.B.A.T. in the areas which A.B.A.T. has not got branches.

- What is the reason behind making A.B.A.T. the first between the Islamic banks? - We do not have any problems within our management team like Faisal Bank and this is the most important point behind our success.

- The way A.B.A.T. encourages people to deposit in the bank is through applying Islamic principles and at the same time distributing good profit.

- Concerning the clients, we usually distribute our profits at least above inflation - usually this is an average 66%.

- In Islamic banks in Turkey last year growth was 100%, 70% inflation then the actual growth is 30%.
- A.B.A.T. represents over 50% of Islamic banks shares.
- The reason behind Al-Baraka's success is that the management is very stable and there is no problem between the shareholders.
- A.B.A.T. and other Islamic banks do not cover all economic activities. Not all people prefer to bank with the Islamic banks. Therefore Islamic banks are not an alternative to conventional banks in Turkey.
- A.B.A.T. has 390 employees.
- A *sharī'a* advisor comes in one day a week on an informal basis because it is against the law.
- So far A.B.A.T. has not ever distributed loss to its clients.
- A.B.A.T. is trying to solve its surplus deposit problem by buying hard currency in the spot market.
- A.B.A.T. encourages people to deposit money through advertisements in the newspapers and magazines. Some of the advertisements are for customers and some of them for investors. Also A.B.A.T. publishes (every Tuesday) its profit for the last 3, 6 and 12 months.

- No conventional bank has an Islamic investment department in Turkey.

 - In *morabaha* the client has two choices either to pay at the end of the year the whole amount in a lump-sum or monthly payments for the maximum of twenty-four months.

 - A.B.A.T. usually distributes profit over and above the inflation rate.
- 4) Islamic values determines the selection and implementation of the strategic goals and priorities of Islamic banks and ensure that the banks operate Islamically.