ISLAMIC BANKING AND DEVELOPMENT
AN ALTERNATIVE BANKING CONCEPT?

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CONTENTS

I. INTRODUCTION

Religion, more often than not, and to varying degrees, has something to say about economic behavior. The word "Religion" itself, its Arabic counterpart "Din" and the essence of the message of all religions imply and indicate setting norms and standards for human behavior which, by definition, extend to the economic arena. Hence, it is not surprising that religion and economics are related. Separation and divorce between them would be unusual.

The objective of this presentation is to give an overview of the nature and characteristics of Islamic banking as a concept and how it is implemented by this new generation of institutions called Islamic banks.

I will begin with a quick review of the basic points of the Islamic economic system and move on to the essential foundations of Islamic banking and its underlying philosophy. I will then give a glimpse of the rise and growth of Islamic banks followed by a short description of their operations in mobilization and utilization of funds, throwing some light along the way on the Islamic modes of financing.

While looking into the developmental characteristics of Islamic banking, we will see how they are inter-linked with transactions in the physical goods market. This will be followed by a review of the social and moral commitment of Islamic banks, and a glance at the activities of the Islamic Development

Bank. I will then conclude by a call to consider the possibility of adopting the concept of Islamic financing as part of the ongoing cultural inter-changes, especially, that its applicability is not restricted to any specific religion, culture or to the Muslim societies alone.

II. ISLAM AND ECONOMICS

All monotheistic religions have their own sets of Divine values and norms with regard to human behavior at large, the economic behavior being a part of it. They all call on human beings to observe and implement religious guidance both individually and collectively. Islam, in this respect, like other revealed religions, has its own values and norms which are supposed to be reflected in all human actions.

Yet, Islam addresses all aspects of human behavior at once with the purpose of integrating morality and spirituality in all spheres of human life and by all means of social organization. This message is directed to man, whether singularly as a person for whose upliftment, purification and delivery all religions aim; or socially as groups, nations and communities of nations. Consequently, Islam is usually said to be a total way of life or a wholistic system for women, men and societies, and we Muslims believe that. This means Islam extends its realm to organize all aspects of human life: politically, socially, spiritually, morally and of course economically around the basic pillar of faith, that is the absolute oneness of God.

The economic teachings of Islam echo one unifying theme, that is: the Almighty God is the only and ultimate Owner of the worlds and the final Law Giver. While man is entrusted by God to benefit from his property, he is responsible for developing and improving it as he will be judged accordingly. In economic life, there are four broad principles that provide the essential guidance and framework of the Islamic economic system:

1. God created the whole universe and made it subject and available to men and women to use and benefit from. ***"It is He Who has made the earth submittant to you, so traverse Ye through its tracts and enjoy of the Sustenance which He furnishes: but unto Him is the Resurrection." (67:15), and "say: Travel through the earth and see how Allah did originate creation: so will Allah produce a later creation:" (29:20), and "Do they not travel through the land, so that their hearts (and minds) may thus learn and their ears may thus hear?" (22:46)***

   The Prophet Muhammad (*pbuh*) said: ***"a believer will never be satisfied of doing good until he finally reaches Heaven."***
   In Islam, women and men are urged to go through the worlds and extract their goods in order to improve the quality of life and reconstruct the environment in such a way that makes them most comfortable and most beautiful, as the Qur'an commands.

   "It is He Who has created you from the earth and ordained you to construct it".(11:61)".

2. Ethical and moral values are integrated in and inter-woven with the recommended patterns of personal behavior as well as inter-personal transactions. The values of being righteous and good doer, benevolent, punctual, truthful, honest, trustworthy, etc., are not just pure ideal morals, but they are spread throughout the legal system as they make the landmarks for economic and financial transactions. In the Islamic system, moral values are also the guiding forces for collective work and social organization. Many verses in the Qur'an emphasize being good to others as means for doing good to one's own self.

   The sayings of the Prophet Muhammad (*pbuh*) are abundant in the area of denouncing cheating, dishonesty, lack of punctuality as characteristic of hypocrisy that deprives a person from being a true believer.

   The Prophet (*pbuh*) says: ***"he who cheats is not one of us"*** and, ***"the signs of a hypocrite are three: he lies when he speaks, he betrays when is trusted and he does not fulfill when he promises."***

   The Islamic moral system makes personal salvation dependent on doing good and kindness to others. Hence, altruism becomes a means of selfishness and giving the poor and needy becomes a way of fulfilling one's personal spiritual upliftment. In this regard, a unique aspect of the Islamic system is *zakah* which is known as the third pillar of this religion. It comes, after prayers, as the second most important worshipping ritual, and it is simply a financial religious duty on the rich for the support of the poor. Islam is the only system, and the only religion, that gives the poor a direct right in the wealth of the rich and considers denying this right equal to disbelief, not only in a metaphoric meaning, but also in a full legal sense. The Qur'an says: ***and those in whose wealth and possessions there exists a given right for the needy and the deprived.*** (70:24-25).

3. Justice, fairness and standing against oppression and exploitation are hallmarks of the Islamic socio economic order. The word justice (and its derivatives) is the third most repeated word in the Qur'an. It comes after the words "Allah" and "knowledge". This symbolizes how essential is the principle of justice in the Islamic economic system. The Qur'an reads: ***"Allah commands you to render back the trusts to those to whom they are due, and when judging between human and human that you judge with justice: Verily how excellent is the teach which He gives you! For Allah is He Who hears and sees all things."*** (4:58)

   "O Ye who believe! Stand out for justice as witness to Allah, even against yourselves, or your parents, or your kin. Whether it be rich or poor, for Allah can best protect both. Follow not the lusts (of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily Allah is well acquainted with all that ye do. (4:135)

   Along with justice comes moderation, balance, selecting a middle path and avoidance of extremes.

"Oh Children of 'Adam! Beautify yourself for every act of worship and eat and drink but do not waste. Verily, He does not love the wasteful." (7:31)

"And those who whenever they spend, are neither wasteful nor niggardly, but hold a just balance between those (two extremes)." (25:67)

Islam offers a middle path between the extremes of individualism and collectivism, extravagance and miserliness, altruism and selfishness; all that with recognition of, and consistency with human nature; and while highlighting spiritual and moral aspects of human existence, it does not neglect the material and mundane side of life. Qur'an puts it:

"And Seek, with the wealth that Allah has bestowed on thee, the abode of the Hereafter; but do not forget thy share in this world. Do good to others just as Allah has done good to you. Do not aim to cause mischief on earth, for Allah does not love mischief makers."

4. Islam enjoins that people should help each other, share the bounties of God with each other and cooperate with each other in all that is good. The Qur'an reads: ***"Help Ye one another in benevolence and piety, but help ye not one another in sin and rancour"*** (5:2). Similarly, there are many verses that call on believers to spend from their own wealth on the kith and kin, on orphans and the needy, on the wayfarer and in the general welfare of society and humanity at large. The Qur'an says:

"Believe in Allah and His apostle and spend on others out of that which He has made you trustees of; for those of you who have attained to faith and who spend (in His cause) shall have a great reward." (57:7).

"So give the kinsman his due and to the needy and to the wayfarer, that is for those who seek Allah's countenance and such are successful." (30:38).

> The Prophet Muhammad (*pbuh*) said: ***"He is not a believer who eats his fill when his neighbor is hungry".*** Hence, the economic order that could be devised in accordance with the Islamic teachings is based on justice (*'Adl*) and improvement in all directions.

III. ISLAMIC BANKING

A. FOUNDATIONS

The basic principles of Islamic banking originate in the axioms of justice and harmony with reality and the human nature.

The most genuine and plain definition of financing is that it is the provision of factors of production as well as goods and services without requiring an immediate counterpart to be paid by the receiver. For instance, a laborer finances the employer by waiting until the end of month for getting compensation for the working hours given throughout the month, and the real capital owner finances the entrepreneur by waiting until the sale of production to get a portion of the net outcome.

Islamic financing is no more than that, in its full, plain and direct sense. Islamic financing is a name for providing factors of production, goods and services for which payment is deferred. So simple and so straightforward! Real-life exchange and production processes have, as part of their components or forms, the provision of goods to consumers as well as equipment, materials and other means of production to producers. This is the essence of Islamic banking practices.

Islamic banking provides financing in the form of equipment, machinery and other producers' and consumers' goods for deferred payments. It also provides means of payments as producers' principal in projects on the basis of sharing the actual, real-life outcome of a production process.

Such forms of financing are based on the principle of justice because, in profit sharing, both parties share the real results or output of a productive project without throwing the risk burden on one side while relieving the other. When financing is done on the basis of sale principle, the financier carries the kind of risk associated with owning a good and providing it to users. In both the cases, the fair play of market forces determine the rates of distribution of profit of the operation among the financier and beneficiary.

The Islamic system assigns to private property the corner-stone of its socio-economic order. The owner has a full right to the increase, growth, benefit and profit that results from one's property. This is also consistent with human nature. If a property is entrusted to someone else (through financing), the user's efforts that contribute to growth and profit must also be recognized. That is also humanly natural. The result or actual outcome of such cooperation should fairly be distributed among the two parties and nothing else.

In lending, the lender gives real goods (be it life-time savings or any other loanable goods) to the borrower against a notional right, called **debt**. Hence, lending changes the nature of what is owned from real balances to a legal commitment, which is purely an inter-personal abstract concept. A debt is, by definition and by its nature, incapable of growing or increasing because it is purely conceptual, it is a relation between a person and another person. Please think for a moment of a debt, how can a debt grow? How can it increase? Except by arbitration, artificialities and pure contrivance!

In contrast, the same savings and/or real goods may be given on sharing bases. The owner holds to the right of ownership and the user exerts efforts for making the goods grow and increase, like a peasant who buries seeds in the soil and serves them, or like a trader who buys merchandise and finds a good market for it. Ownership remains in the hands of the finance provider and the work is given by the finance receiver. Both contributions are recognized as they participate in creating the increase or growth. Therefore, both parties deserve to share the real outcome of that exercise.

If one wants one's financing to be guaranteed, why should one then have a claim on a part of output of the project while bearing no part of its pain and risks. Fairness requires that losses should be carried in proportion to financing advanced. If a financier wants to have a claim on a part of the return of a project, then she/he must also carry a proportional share of the risks and burdens of the same. This is what we call the rule of "gains should always be linked to risk exposure".

Finance on the basis of profit/loss sharing opens the way to *direct investment*, where the utmost attention of the bank is directed to the profitability of investment. In this case, close working relations between the bank and the fund user (project manager) is required to monitor performance and to solve unexpected problems. As long as returns are commensurate with risk, direct investment would not shy away from high-risk projects, nor from financing small and micro-enterprises.

However, direct investment does not seem to be favored by traditional banks. Quoting a recent article in the World Bank Research Observer,*

> "In the absence of full information, banks tend to allocate credit to firms with reliable track records or available internal funds, even if other firms present better investment opportunities. Financial intermediaries ... can acquire information that is superior to that of outsiders by developing and

* Dimitri Vittas and Yoon Je Cho, "Credit Policies: Lessons from Japan and Korea," World Bank Research Observer, Vol.II, No.2 (August, 1996), pp. 277-98.

maintaining close long-term relationships with their customers. They can play an important role in screening projects, monitoring behavior and outcomes, and managing corporate distress. (However,) In many countries, commercial banks favor lending for low-risk activities. They are generally less willing to finance high-risk projects with long payback periods, even if these projects may yield higher overall returns. They are generally also reluctant to finance small firms that lack adequate collateral, even though such firms may be more innovative and promising than others."

B. OPERATIONS OF ISLAMIC BANKS

Contemporary Islamic banks have been founded on the banking model that existed in Europe and North America, with regard to their main layout, departmental structure and their basic functions of mobilizing financial resources and using them to finance those who are in need for investible funds. Obviously, the difference lies in the area of modes of financing that are, in the case of Islamic banks, derived from the Islamic system and structured within the Islamic legal framework.

1. Fund Mobilization

Resources are mobilized from shareholders and savings owners. Shareholders own the bank's net equities while savers participate in the ownership of the bank's investments. In other words, savings are mobilized on the basis of sharing rather than interest-based lending. In Islamic banks, depositors are in a sense a special category of shareholders. They do not share the private equity of the bank such as its building and equipment, but they do share “as owners of funds” in the profit-sharing investment operations of the bank.

In Islamic banks, deposit agreement is a contract to provide funds that will be managed by the bank, on behalf of the owner, as an appointed agent. Consequently, deposit contracts in Islamic banks are not lending contract. They are more of agency or deputation contracts in which depositors authorize the bank to invest their funds and share the return with them. In case of loss, the financial burden falls on funds’ owners and the bank would have lost its efforts (management expenses) that went without compensation.

Additionally, as in traditional banks, and as was practiced by their ancestors in the Medieval Islamic cities, Islamic banks maintain current accounts for their customers. These offer the services of checking, ATM and electronic access to banking services. Deposits in current accounts are guaranteed by the Islamic banks and they are based on an interest-free lending contract.

Hence, the Islamic bank has usually two broad categories of deposits: **(1) investment deposits** that share in the return of investment operation in proportion to the amount of deposit and on the basis of distributing the net return on a contracted ratio. Islamic banks, usually differentiate between long and short run investment deposits through this profit sharing ratio by offering higher ratio to deposits committed for longer periods. These deposits are not in fact liabilities on the Islamic banks, they are rather investments with it. And, **(2) demand deposits** which are guaranteed and represent liabilities, and they do not earn any return.

2. Fund Utilization

Islamic banks use available funds by means of three major categories of financing modes: **sharing modes, sale modes** and **leasing modes**. None of them has any interest component.

3. Sharing Modes

The principle is simple as much as it is natural. The Islamic banks provide financing to projects on the expectation of a share in the return. Obviously, if a project loses, all capital providers and financing contributors lose together and proportionately. There are two forms of applications of this principle: **full partnership** and **non-voting partnership or financing**.

In **full partnership**, the bank would be represented on the board of executive directors and would share in formulating policies and managerial decisions, while in **non-voting financing** (called in Arabic *mudaraba*), Islamic banks fully entrust managerial decision-making to the user of funds.

Both groups of sharing modes may be formulated so as to share **net income** or **gross output**. They may also be

permanent, **declining** or **timed**; that is ending at a certain future point of time.

4. Sale Modes

The idea of sale modes of financing is also simple. The bank would be asked to buy goods and give them to users (producers as well as consumers) against future repayment. Sale modes may take several forms. The simplest of them is derived from regular sale contract where the bank sells real goods, equipment and machinery to their users at an agreed upon marked-up price.

Two other forms are also practiced by Islamic banks: **construction/manufacturing contract** and **deferred delivery contract**. Construction/manufacturing is usually used to finance land development, infrastructure, manufacturing and industrial construction; while deferred delivery is generally an agricultural financing contract that provides farmers with funds needed for their operations against delivery of grain and other output at the season.

All sale based modes can end up in one lump sum deferred payment or in instalments spread throughout a certain period of time.

5. Leasing Modes

As practiced in leasing companies and recently in many traditional banks, leasing modes can have a variety of forms with fixed or variable rents, declining or fixed ownership, operational or financial, along with different conditions regarding the status of leased assets at the end of the lease period.

C. EMERGENCE AND GROWTH OF ISLAMIC BANKS

A quick reading of Islamic history tells us that practices of certain forms of banking activities go back as early as 1200 years ago in Baghdad, Damascus, Fez and Cordoba. Deposits in current accounts and use of checks were well known in these Muslim cities at that early date.* Also, inter-city money transfers were a known practice between cash depositors and practitioner "Bankers" who also used to be money exchangers at the same time.

However, the early contemporary Islamic banking institutions came in the first part of 1960s with the Pilgrims Funds (1962) in Malaysia and the Myt Ghamr Saving Bank (1963) in Egypt. Though the experiment was localized, it attracted a large number of clients and generated a lot of popular enthusiasm. In 1974 the Islamic Development Bank was formally established with a capital of 2.0 billion Islamic Dinar (=SDR); and it started operation in mid 1976. The Dubai Islamic Bank in the United Arab Emirates was established in 1974. The number of Islamic banks and financial institutions have increased to more than 180 by the end of 1996.

* In fact, the word check itself has its root in the Arabic word "cek ", which means record of transaction. It may also have come from Persian. (See: the Shorter Oxford Dic. on Historical Principles, V.I.)

On this kind of growth in the phenomenon of Islamic Banks, the Wall Street Journal comments that if its present rate of growth continues, within ten years they are expected to handle around 40 to 50 percent of total savings of the Muslim world. This, of course, does not include the Islamic windows and branches of traditional banks in several European and American banks as well as in many traditional banks in the Muslim countries. [**]

The same newspaper described Islamic banking "as an international quasi-parallel financial system" that stretched its geographical contours "from the US through Europe, Africa and the Middle East into the Indian Subcontinent to the Far East".

According to the International Association of Islamic Banks, the number of Islamic banks and financial institutions registered with it has reached 186 in late 1995 out of which statistical information is available on about 144. Looking at the geographical dispersion, we observe that 47 Islamic banks and financial institutions are established in South Asia, 30 in Africa, 24 in South East Asia, 22 in the Middle East, 17 in the GCC Countries and at least 4 in Europe and America. Insofar as the Europe/USA region is concerned, we should note that if Islamic funds managed by conventional banks are accounted for, the region's share of Islamic financing would be dramatically higher. Growthwise, over the ten-year period of 1985-1995, the number of Islamic banks and financial institutions have gone up 6 and a half times.

[**] Special supplement on Islamic banking, Wall Street Journal, 9 April 1996.

The financial indicators in table 1 show that in 1995, the total capital of the 144 banks is slightly above US$ 6 billion, total assets reached US$ 166 billion, total deposits surpassed the amount of US$ 77 billion, reserves are around US$ 3 billion and net profits reached nearly US$ one and a quarter billion.

Table 1 : Islamic Banking and Financial Institutions : Summary of Financial Highlights, 1995

US$ ‘000’ S

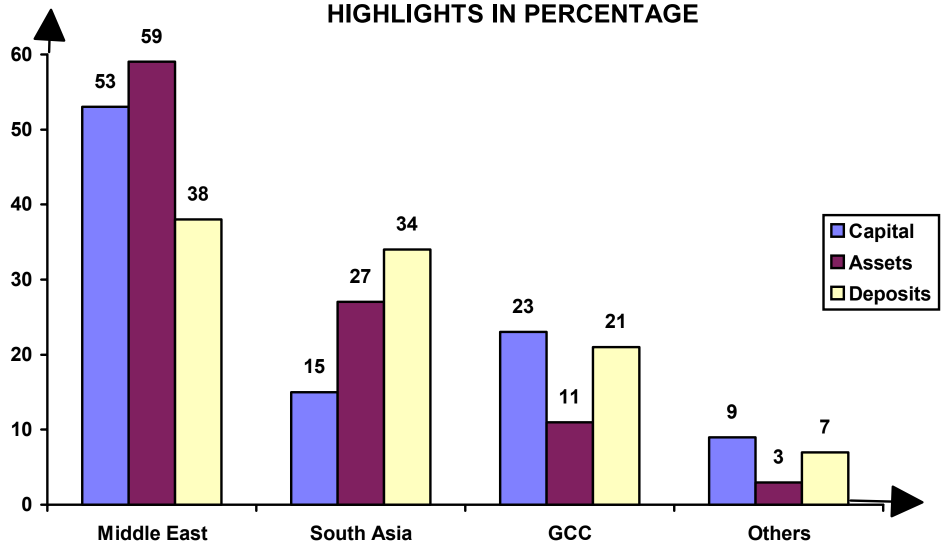
R E G I O N	No.of		CAPITAL		TOTAL ASSETS		DEPOSITS		RESERVES		NET PROFIT	
	banks*	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
South Asia	47	32	951,194	15	45,269,061	27	26,413,855	34	1, 012,689	34	365,301	29
Africa	30	21	257,476	4	3,794,394	2	2,112,960	3	112,149	4	32,517	3
South East Asia	24	17	121,919	2	1,736,361	1	1,342,604	2	101,957	4	20,570	1
Middle East	22	15	3,310,506	53	97,209,926	59	29,693,917	38	596,476	20	149,798	12
G.C.C.	17	12	1,464,846	23	17,648,197	11	16,571,459	21	1,050,278	36	655,367	53
Europe & America	4	3	201,875	3	395,219	0	1,381,037	2	65,446	2	21,940	2
TOTAL	*144*	*100*	*6,307,816*	*100*	*166,053,158*	*100*	*77,515,832*	*100*	*2,938,995*	*100*	*1,245,493*	*100*

Source : International Association of Islamic Banks

* IDB is not included.

From the same table above, we notice also that the financial significance of the respective regions in terms of capital, assets and deposits is respectively 53%, 59% and 38% for the Middle Eastern region, 15%, 27% and 34% for South Asia and finally 23%, 11% and 21% for the G.C.C. region. The three other regions represent the rest which respectively sums up to 9%, 3% and 7%, as depicted by the Graph below:

Figure 1: 1995 REGIONAL DISTRIBUTION OF FINANCIAL HIGHLIGHTS IN PERCENTAGE



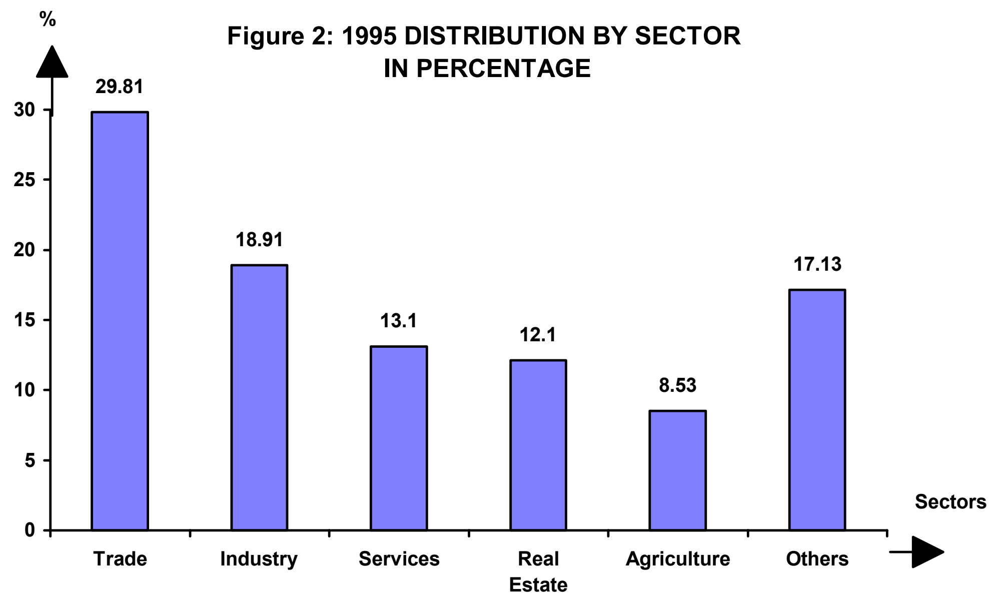
The sectorial financing table (table 2) shows how much these banks are involved in the economic activities of the different sectors of their respective regions.

Table 2 : Islamic Banks and Financial Institutions Financing by Sectors/Regions- (1995)

Percent

Region	Trade	Agricul.	Industry	Services	Rl. Estate	Others
Eur./America	42.85	1.00	1.70	21.17	18.50	14.75
Africa	20.70	23.57	18.34	9.81	4.21	21.28
S.E. Asia	42.61	5.70	8.81	26.97	4.61	11.72
S. Asia	14.06	9.30	50.26	10.04	1.58	14.37
M. East	18.68	11.22	24.92	7.12	22.30	15.33
G.C.C.	39.95	0.38	9.42	3.50	21.32	25.31
Average	**29.81**	**8.53**	**18.91**	**13.10**	**12.10**	**17.13**

On the average, about 30% of the funds were allocated to trade, 19% to industry, 13% to the services, 12% to real estate and 9% to the agriculture as illustrated by the histogram below:



Across regions, we observe that the trading sector received the highest share of financing in the three regions : Europe-America, S.E. Asia and G.C.C. countries. While in the Middle East and South Asia the industrial sector came with the largest financing share, the agricultural sector received the most financing in Africa. This diversity in sectorial financing seems to be significant in terms of the dominance of a specific economic activity within each region and the development and application of Islamic financing instruments compatible with the economic needs of the region.

In terms of modes of financing and according to the 1995 figures of the International Association of Islamic Banks given in Table 3 below, the murabaha mode (sale-based) comes first with 45% of the total Dollar value of operations, while 15% and 9% of financing were respectively carried out in the form of musharaka and mudaraba (both sharing-based), and 10% in the form of Ijara (leasing).

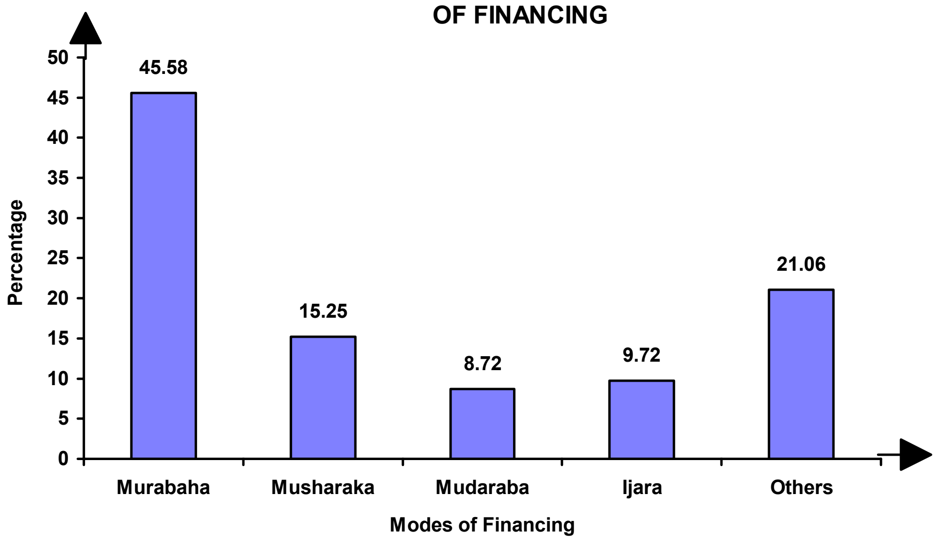
Table 3 : Islamic Banks and Financial Institutions
Financing by Modes/Regions

Percent

Region	Murabaha	Musharaka	Mudaraba	Ijara	Others
Eur./America	65.90	10.00	11.85	5.00	7.25
Africa	50.89	28.37	6.05	3.48	11.10
S.E. Asia	29.05	8.33	18.30	12.63	31.64
S. Asia	33.44	6.47	2.60	13.97	43.29
M. East	42.93	32.25	6.93	8.60	10.23
G.C.C.	51.27	6.12	6.60	14.65	22.87
Average	**45.58**	**15.25**	**8.72**	**9.72**	**21.06**

The histogram below illustrates this distribution by modes of financing:

Figure 3: 1995 DISTRIBUTION BY MODES OF FINANCING



IV. ISLAMIC BANKING AND DEVELOPMENT

A. DEVELOPMENTAL CHARACTERISTICS OF ISLAMIC MODES OF FINANCING

I am confident that by now all of you must have realized that the essential characteristic of Islamic modes of financing is their direct and undetachable link to real or physical transactions. Sharing modes are only possible for productive enterprises that involve real-life businesses that increase quantity or improve quality or enhance usability of real goods and services; and by doing that, such businesses generate a return that can be distributed between the entrepreneur and the financier.

Sale-based modes are those that involve actual, physical exchange of commodities from one hand to another whereby financing is measured only by the real sale of commodities and can only be provided to the extent of the real value of goods exchanged. The same thing also applies to leasing where leased assets are the pivotal thing around which financing is built.

In other words, Islamic financing is purely a real-life, real-goods financing. No financing can find its way to the Islamic system without passing through the production and/or exchange of real goods and services.

In contrast with traditional methods, Islamic financing is not centered only around creditworthiness and ability to repay loans and their return. The key word in Islamic financing is the worthiness and profitability of a project and the exchange of goods and merchandise, while ability to recover the financing principal becomes a result of profitability and worthiness of the project itself.

Consequently, the nature of Islamic financing makes it exclusively restricted to the construction, establishment and expansion of productive projects and to the exchange and trade of commodities. In other words, Islamic financing is intrinsically integrated with the goods and commodities market and it is limited by the volume of finance required by actual transactions that take place in this market. Whether it is done by means of sharing, sale or lease contracts, Islamic financing is bound by the extent of transactions in the goods market. The Islamic modes of financing, by virtue of their very nature, are incompatible and inapplicable for debt rescheduling, debt swap, financing of speculative cash balances, inter-bank liquidity speculative transfers and other purely monetary activities that make a substantial part of contemporary activities of traditional bank.

B. SOCIAL COMMITMENT OF ISLAMIC BANKING

The religious ideas on which Islamic banks are based are so integrated with ethical and moral values to the extent that these new institutions that are called Islamic banks cannot detach themselves from socio-moral considerations even if they try, especially, that their own environment, including both staff and clientele, expects from them such socio-moral commitment and always measure them to those moral values from whose grounds they derive their raison d'etre.

There are different forms in which the socio-moral commitment of Islamic banks is manifested. For instance, many Islamic banks have established a practice of providing goodly (interest-free) loans to their clientele in cases of dire need or unexpected circumstances.

Many Islamic banks also establish social funds especially designed for relieving economic hardship of the poor and needy. This fund is usually financed by the yearly zakah dues on shareholders' equities as well as many investment depositors who give their consent to the bank's management for the deduction and distribution of zakah annually.

Regarding their own employees, many Islamic banks have also established a practice of health insurance coverage that includes not only the immediate family members of the employee (spouse and children) but also parents and unmarried/divorced daughters without any age limit. Such practices are motivated by the Islamic concepts of extended family and financial responsibilities of the income earner for parents and all adult females in the family. Furthermore, many Islamic banks also provide interest-free loans to their employees.

Moreover, many Islamic banks contribute to research and community development and assign sometimes substantial amounts for these objectives.

Additionally, many Islamic banks usually work within a traditional banking environment, and have working relationships with traditional banks. Therefore, they often accumulate interest balances in their accounts with traditional banks. According to the Islamic Shari'ah's, earned interest cannot be considered an income and it is to be disposed of to the poor in a way that does not directly benefit the bank. Hence, those Islamic banks that happen to earn interests, spend them on benevolent social activities.

In other words, while profit maximization is equally essential to Islamic banks as other businesses, the underlying philosophy of these institutions is conducive toward social commitment and activities that usually cannot be interpreted by the motive of profit maximization.

C. DEVELOPMENTAL ACTIVITIES OF THE ISLAMIC DEVELOPMENT BANK (IsDB)

Please allow me to say that we, in the Islamic Development Bank, consider all our activities developmental. We have two broad areas of financing; **project construction and expansion** and **trade operations**. Project financing includes transport and communications, gas, electricity, water and other public utilities, agriculture and agro-industries, industrial and mining projects, social services and other development projects in addition to technical assistance provided for the purpose of projects' preparation, inception and feasibility studies. Trade financing covers both inter-member countries trade and imports of member countries from the rest of the world.

The total amount of approved financing of IDB over the past 21 years since the beginning of its operations reached US$ 14.6 billion, of which US$ 4.2 billion went to project financing and of the rest, US$ 9.9 billion went to trade financing and US$ 441 million were grants in the form of special assistance operations, Table 4.

Table 4 : Financing Approved up to the end of 1996*

(US$ Million)

Type of Operation	1992		1993		1994**		1995**		1996**		1976-1996	
	Amount	**%**	**Amount**	**%**	**Amoun t**	**%**	**Amou nt**	**%**	**Amou nt**	**%**	**Amount**	**%**
a) Project Financing	157	23	300	37	283	36	497	47	592	46	4,067	28
b) Tech. Assistance	9	1	8	1	5	1	4	-	3	-	91	1
I. Ordinary Operations (a+b)	**166**	**24**	**308**	**38**	**288**	**37**	**501**	**47**	**595**	**46**	**4,158**	**29**
II. Trade Financing + IBP	628	70	706	59	690	62	772	53	881	53	11,174	68
Sub-total	**794**	**94**	**1,014**	**97**	**978**	**99**	**1,273**	**100**	**1,476**	**99**	**15,332**	**97**
III. Special Assistance	41	6	23	3	9	1	5	-	18	1	441	3
Total	**835**	**100**	**1,037**	**100**	**987**	**100**	**1,484**	**100**	**1,667**	**100**	**16,533**	**100**

* All figures are reported net of cancelled operations.
** Including loan from Special LDMC Account.

A. Sectorial Distribution

The largest allocation of approved project financing and technical assistance over the 21 year period was for the development of infrastructure projects, which accounted for about 42 percent, of which 24 percent was for the benefit of public utilities and 18 percent for transport and communication projects. The next largest beneficiaries were the social sector (health and education) and agriculture and agro-industry, which received financing approvals of about 17 percent and 19 percent respectively. Industrial projects accounted for 15 percent and the remainder 8 percent was channeled to Islamic financial institutions and lines of financing extended to National Development Financing Institutions. Table 5 provides the detailed data.

The focus of infrastructure projects approved has mainly been on projects that covered power generation to meet the expanding demand, to increase critically needed power-transmission capabilities and to improve electric power supplies by integrating load centres. The other projects included water supply projects aimed at the production and distribution of safe drinking water for the benefit of rural population.

Projects in the transport and communication sector accounted for about 18 percent of total approvals over the past 21 years. They cover telecommunications, port development, feeder roads and air traffic control simulators, etc.

Table 5 : Sectorial Distribution of Ordinary Operations (1972-present)*

(US$ Million)

Sector	1992		1993		1994		1995		1996		1976-1996	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Infrastructure	**58**	**33**	**129**	**42**	**110**	**38**	**289**	**55**	**262**	**44**	**1,730**	**42**
Transport and & Comm.	40	23	65	21	8	3	87	17	101	17	746	18
Public Utilities	18	10	64	21	102	35	202	38	161	27	984	24
Other Sectors	**122**	**67**	**179**	**58**	**179**	**62**	**236**	**45**	**333**	**56**	**2,428**	**58**
Agr. & Agro-Industries	31	17	44	14	60	21	80	15	140	24	774	19
Industry & Mining	18	10	36	12	36	13	66	13	35	6	644	15
Social Services	53	29	81	26	47	16	76	14	156	26	709	17
Miscellaneous**	20	11	18	6	36	12	14	3	2	-	91	2
Lines to NDFI***	-	-	-	-	-	-	-	-	-	-	210	5
Total	**180**	**100**	**308**	**100**	**289**	**100**	**525**	**100**	**595**	**100**	**4,158**	**100**

* Project Financing and Technical Assistance Only (figures exclude cancelled operations).
** Refers to Islamic Banks, Financial Institutions and others.
*** Lines to NDFI are distributed on sectors in the annual figures but come as an identified item in the total. They are: lines of equity, lines of leasing and lines of instalment sale.

Projects aimed at enhancing the development of human resources, primarily through the financing of education and health operations, account for 17 percent of the total amount approved for projects and technical assistance. They include the provision of basic education and training aimed to reach universal primary education, and to increase the skill and productivity levels of the labor force. Many projects were for the benefit of poor children in rural areas and deprived regions. Other education projects for the support of universities and other specialized higher learning centres were approved for the benefit of some of the more developed member countries. As for health care, there were projects focusing on delivery of basic health services in poor regions, improving the quality of health services and making them more accessible for the rural poor. Countries benefiting from these projects include some of the least developed member countries. The Bank also participated in financing university hospital projects in the member countries.

Agriculture and agro-industries projects accounted for 19 percent. Those were for Grain Silos, Flour Mills, rural integrated development projects, irrigation and dairy processing projects.

The industrial sector has received approvals for projects amounting to 15 percent of the total approvals over the life time of IDB. Those approvals include expansion and modernization of tyre production, cement, basic industries, manufacturing and other industries.

B. Distribution by Modes of Financing

Projects are financed from ordinary capital resources through loans, leasing, instalment sale and equity participation. Recently, the IDB introduced a new mode which we call Istisna' (construction/manufacturing contract). In addition, technical assistance is provided for facilitating project preparation and implementation, particularly in the least developed member countries by way of grants (from the Special Assistance Account) or through a loan and grant combination.

Over the 21 year period ending in 1996, a total of US$ 4,158 million was approved for project financing and technical assistance. That included US$ 1,186 million for direct leasing, US$ 286 million for direct instalment sale, US$ 988 million for loan, US$ 286 million for equity, US$ 60 million for profit-sharing, and a sum of US$ 91 million for technical assistance operations. Table 6 gives the relevant details.

The figures show that goodly loans remained the most significant mode of financing with 34 percent of total approvals over the 21 year ending in 1996. Instalment sale represented 24 percent (up from 22 percent in 1995), leasing 29 percent, equity and profit sharing 4 percent.

Table 6 : Distribution of IDB Project Financing by Mode of Financing (1976-1996)

(US$ Million)

Project Financing	1992		1993		1994		1995		1996		1976-1996	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Loans	81	49	141	46	65	23	106	21	172	31	1,415	34
Leasing	10	6	70	23	120	41	265	53	234	39	1,186	29
Instalment Sale	54	32	69	23	52	18	112	22	148	25	988	24
Equity	12	7	9	3	17	6	3	1	2	-	286	7
Profit Sharing	-	-	-	-	11	4	-	-	36	5	60	1
Sub-total	**157**	**94**	**289**	**95**	**265**	**92**	**486**	**97**	**592**	**100**	**3,935**	**95**
Lines of Financing	-	-	11	3	18	6	11	2	-	-	132	3
Sub-total	**157**	**94**	**300**	**98**	**283**	**98**	**497**	**99**	**592**	**100**	**4,067**	**98**
Tech. Assistance	9	6	8	2	5	2	4	1	3	-	91	2
Total	**166**	**100**	**308**	**100**	**288**	**100**	**501**	**100**	**595**	**100**	**4,158**	**100**

Notes: Figures include loans approved from the LDMC program, exclude cancelled operations.

1. Loan Financing

Table 6 shows an important implication of the socio-moral commitment of Islamic banking as more than one third (34%) of total financing is provided on the basis of goodly (interest-free) loans.

Loan financing is mainly intended for social and economic infrastructure projects which are unlikely to be revenue generating and have a long implementation phase. This mode of financing is intended mainly to support projects in LDMCs. The type of projects that benefit from loan financing include schools, water supplies, health centres, hospitals, rural electrification, roads, ports, airports, irrigation schemes and land development. Starting in 1994, loan financing from the Bank's ordinary capital resources has been supplemented by additional resources allocated for LDMCs through LDMCs Special Account. The IDB charges a service fee to cover a part of its actual administrative expenses. The repayment period for loan is between 15-25 years (including a 5-year grace period) for ordinary loans and 25-30 years (including a 10-year grace period) for LDMC Account loans.

2. Leasing

The importance of leasing among IDB modes of financing has been rising over the last five years, and it is expected to become the leading mode in the coming few years.

This medium-term financing involves the financing agent, purchase of equipment and subsequent transfer of the right of its usage to the beneficiary for a specific period, during which the IDB retains ownership of the asset. The repayment period is between 7 to 15 years, including a 2 to 4-year grace period. The normal ceiling applied to lease operations is ID 20 million per project. Repayments carry mark-ups ranging from 6.5 to 7.5 percent as a once-for-all increment on the purchase price. These mark-ups are periodically reviewed. Application of mark-up rate is determined on the basis of sector as well as on rate of return of a project. A project is placed in one of three categories. They are: category A: industry, agro-industry, tele-communication, ports, airports, power, energy, mining and other extractive industries; category B: multi-sectorial projects (e.g. dams), roads and railways; category C: agriculture, health, education, water supply and sanitation. The application of mark-up is uniform for all member countries for each category. The mark-up rates are: category A: 7.5%, category B: 7% and category C: 6.5%. Lease financing accounted for the largest share of project financing since 1994 to present.

3. Instalment Sale

Instalment Sale is also a medium-term mode of financing which is similar to Leasing. The main operational difference between this mode and leasing is that the ownership of assets is transferred to the beneficiary on delivery in the case of instalment sale, whereas in leasing, their ownership is transferred to the lessee after the final lease payment has been made. With instalment sale, repayments are normally made over a period of 6 to 10 years with a mark-up of between 7 and 8 percent. As in the case of leasing, this mark-up is periodically reviewed and currently, there are three mark-up rates. The application of a mark-up rate is also determined on the basis of sector as well as rate of return of a project. A project is placed in one of the three categories as indicated above. The application of mark-up is uniform for all member countries for each category (Category A: 8%, B: 7.5% and C: 7%).

4. Equity Participation

The IDB participates in share capital of new or existing enterprises through direct equity or through funding lines provided to National Development Financial Institutions (NDFIs). The level of financing is determined on individual merit but in any case it does not exceed one-third of the equity of a project.

As of the end of 1996, the IDB had direct equity in fourteen Islamic Banks and 78 companies in member countries. Following the ruling of the Islamic Fiqh Academy of the OIC which prohibits equity participation in companies using interest-based financing, the Bank has taken initiatives to assist successful companies in utilizing alternative Shari'ah compatible modes of financing in close collaboration with Islamic banks. To this effect, a pilot project was approved by the IDB in September 1994 and is currently under implementation. The purpose of the pilot project is to evaluate the feasibility of replacing interest-based debts of companies by equity or other Shari'ah compatible financing instruments.

5. Lines of Financing

The Bank has been extending lines of financing to NDFIs and Islamic banks to assist the financing of small- and medium-scale enterprises in the private sectors of the member countries. Since 1993, the Bank ceased financing under the line of equity in compliance with the ruling of the Fiqh Academy; and now only lines of leasing, instalment sale or combined lines of leasing and instalment sale together are extended.

6. Technical Assistance

The Bank provides technical assistance (TA) to member countries for the identification, preparation and implementation of projects as well as for institution building. Priority for technical assistance is given to LDMCs as well as regional projects. In most cases, consultants are used to provide technical assistance for the implementation of studies, supervision of projects and other related works. In addition, the Bank finances consultancy services to assist its own staff in project preparation and follow-up. The assistance is extended in the form of a goodly loan, grant or both. Loan repayment is made over a period of 16 years with a grace period of 4 years. Other technical assistance facilities are provided through the Technical Co-operation Program and the activities of the Islamic Research and Training Institute of the IDB.

C. Relations with Islamic Banks

The IDB has established close contacts with Islamic banks in different countries in order to meet the financial and developmental needs of its members countries. In dealing with those banks, the IDB plays the role of a promoter and coordinator of activities of Islamic banking and finance. Mutual efforts and consultations between the IDB and Islamic Banks have resulted in launching institutions and preparation of studies on subjects like liquidity management and other related matters, medium and long term investments, as well as on new financial instruments.

The IDB has in collaboration with indigenous entrepreneurs set up Islamic Banks in different member countries. Apart from equity participation, the IDB provided for technical assistance and helped in development of procedures manual for the operations of these Banks. The IDB also assisted some countries in setting up special legislative framework for the establishment of Islamic Banks in collaboration with other sister Islamic institutions. Another cooperative efforts having far-reaching consequences is the pilot project to make the capital structure and financing of companies having interest-bearing debts compatible with the principles of Shari'ah. IDB is also making strenuous efforts to contribute to the capacity building of Islamic banks and to mobilize them to co-finance projects.

The IDB launched a joint effort with other Islamic Banks for establishing an international Islamic Lease Finance Company in Kuwait, known as "International Leasing Company". This holding company will create specialized leasing companies at the national level in different member countries. The IDB, in pursuance of its belief in having standardized, correct and transparent accounting procedures, has been instrumental in setting up the Auditing and Accounting Organization for Islamic Financial Institutions in Bahrain which seeks to establish accounting and auditing standards for the Islamic Banks. Conformity with prescribed standardized forms will, we hope, contribute towards making them more responsible and responsive to the demands and interests of the clients in accordance with internationally accepted norms.

Since its inception in 1990, the IDB Unit Investment Fund has maintained mutually beneficial business relations with Islamic Banks. Some of the Banks such as Kuwait Finance House, Al-Baraka and the Faisal Islamic bank of Bahrain (FIBB) are unit holders of the Unit Investment Fund. Additionally, the Fund cooperates with them in the fields of syndication, co-financing and exchange of business information. The Fund aims at developing these connections more closely in the future particularly with a view to developing more Islamic financing instruments which would be helpful in managing their liquidity and in developing efficient Islamic financial markets in the IDB member countries. As a matter of fact, the Units of IDB Investment Fund are already listed in the Bahrain Stock Exchange.

An area which IDB is particularly proud to mention is that investors can now have their investments guaranteed by the Islamic Corporation for the Insurance Investment and Export Credit (ICIEC), a 100% owned subsidiary of IDB. ICIEC will provide guarantees of investments against sovereign risks.

V. ISLAMIC BANKING AS A NEW CHOICE

A. ISLAMIC BANKS AND BANKING COMMUNITY

Nowadays, most Muslim countries have Islamic banks operating within their banking community, under the supervision and control of their respective central banks. Some countries have only one Islamic bank which is, of course, a disadvantage because it deprives the prospective clientele from the benefits of competition. However, there are several countries, such as Qatar, Bahrain, Bangladesh and others that have more than one Islamic banks. In most Muslim countries, Islamic banks work side by side with traditional banks and there are many inter-banking and business relations between both categories. Few countries have also switched to an Islamic banking system.

In addition, many traditional banks have entered this new field of Islamic finance in several Muslim countries, very often through establishing Islamic transactions' windows, whereby a bank would establish a financially autonomous internal unit that receives investment deposits on the basis of profit sharing and offer financing to the businesses community by means of the Islamic modes as described earlier. Some banks even transformed some of their branches to Islamic banking units. Very recently Citi Bank formed a full-fledged corporation for Islamic banking activities under the name of Citi Islamic Investment Bank of Bahrain, and it actually started operations in that country.

Although the nature of Islamic banking transactions requires special attention from the central banks and monetary authorities, the relationships between them have gone reasonably smooth, effective and constructive.

Moreover, many non-Muslim countries have Islamic banking in one form or another that work in coherence and cooperation with the existing banking community. Those banks do not only serve Muslim in those countries, but they are also open to the public for deposits and financing. Islamic banks operate in some Western countries off-shore as well as on-shore. There are also a few banks in the pipeline for establishment in the Western hemisphere.

As we noticed earlier, Islamic banking's operations have their own characteristics both on the financing and the resource mobilization sides. Their application does not require bankers or customers to have a particular religion, ethnicity or language. Their success or failure depends only on managerial ability to provide competitive services.

We believe that in the small world of today and with prevailing cultural intermingling, having Islamic banking services available to every person, Muslim and non-Muslim alike, in Western countries as well as in Muslim countries, is a very important achievement to which we must all look forward, because it provides customers with expanded options of banking services that they can choose from. The whole community will certainly become better off by having Islamic financing available side-by-side with traditional banking, thanks to the wider freedom of choice. Moreover, Muslim communities, specifically in the West, need to have Islamic banking institutions, because for Muslims this represents an approach for development that is compatible with their faith and it is in this sense an essential element of their religious fulfillment.

B. ISLAMIC BANKING AS AN ALTERNATIVE APPROACH

One might wonder whether Islamic banking and finance is an alternative approach to modern banking.

In fact, the banking business is no more than a possible means to satisfy the needs of society according to the prevailing conditions and circumstances. Those needs should always govern the means, not be its subject.

The most important development in modern banking is the art of mobilizing funds for investment. It happened to be that the method of both collecting and using of funds was based in the West on interest paid and charged. In contrast, Islamic banking is a system that provides financing and attracts savings on the basis of profit/loss sharing. One may have to think positively of such a scheme. By waiving the interest factor, we find an alternative vehicle to provide financing on a different basis which should be judged on its own merit.

For Muslims, this system of profit/loss sharing coincides with their belief in the prohibition of interest, and helps in mobilizing unused funds for investment and creating new job opportunities.

As for non-Muslims, the Islamic banking system does not contradict their faith, while it provides the society with alternative ideas for venture capital and other tools of investment.

Mudaraba as a contract of participation between the provider of capital and the managing entrepreneur responds to normal human needs. An enterprising engineer living in the West, as an example, would welcome any possibility that enables him to be provided by venture capital to establish a new factory. This could be the case with many individuals of the same spirit.

The ultimate test of such alternative is whether it is successful or not. It can be safely said that the idea of Islamic banking has been successful. It is, therefore, not surprising to find several international banking institutions started the establishment of Islamic units or windows for some of their customers. Islamic banking was partially practiced by some of the Western banks and financial institutions in Switzerland, U.K. and the United States. The establishment of Citi Islamic Investment Bank in Bahrain is the latest example for the possible adoption of the Islamic banking system by traditional bankers.

Economists have proven that the wider is the freedom of choice the higher is the level of social welfare. In addition, wider choice implies greater respect of human rights. When an alternative concept such as Islamic banking is introduced, a new choice is open to the market, with obvious economic and social benefits.

Introducing Islamic banking as a new choice has also further benefits related to the advantages it provides to many fund users. Commodity and service producers would certainly appreciate equal opportunities for obtaining capital based on the merits of their businesses rather than on their personal creditworthiness alone. Those entrepreneurs who prefer to be self employed need ways to obtain financing other than borrowing. Islamic banking gives those pioneers such an opportunity on the basis of profit/loss sharing.

In general, Islamic finance places more weight on the merit of the business to be financed, rather than the wealth of the fund user. As a result under this new banking alternative, a better distribution of credit may be achieved.

Therefore, I would like to recommend strongly to the Western World that all obstacles remaining in the way of establishing Islamic banks in their countries be removed.

VI. CHALLENGES AND PROSPECTS

Last but not least, I would like to conclude with a word about the challenges facing Islamic banks and what prospects they may have.

The biggest challenge Islamic banks have faced from their very beginning is how to narrow the gap between the Islamic banking model and its application; in other words, between theory and practice. Difficulties arise in this respect come from being relatively small in a traditional banking environment, having to rely on bankers trained in traditional banking, and attempting to balance the unquenchable enthusiasm on the side of depositors, with a limited supply of investment opportunities.

Islamic banks have been trying hard to meet those challenges through several means. The first is to work for a better understanding of the concepts upon which their operations are based. This has been a success to the extent that now traditional bankers are mostly cooperative and accommodating. Central bankers have also come forward with new ideas of better methods for supervision and control, to suit the operations of Islamic banks.

Another means is to train their staff in this new form of banking and to press for more banking and financial innovations which are necessary for the new modes of finance. Fortunately, financial engineering has come in handy with bold and new ideas in finance which made the Islamic model so much more applicable. Innovations in this regard did not come exclusively from Islamic banks. Surprisingly, financial markets produced some useful innovations, perhaps indicating that Islamic banking is an idea whose time has come.

Nonetheless, many challenges still remain, not the least to the predominance of murabaha (sale mode) in the operations of some Islamic banks, as well as the relative scarcity of short-term Islamic financial instruments.

The prospects of Islamic banking and finance will depend ostensively on the ability of Islamic banks to continue facing challenges with resourcefulness and creativity, in addition to being worthy of trust and understanding. I believe that competition, if allowed and maintained, not only within Islamic banks, but also between all banks whether Islamic or traditional, would insure a promising future for the banking industry as a whole.

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