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Strategic Trends in the Islamic Banking and Finance Movement

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ABSTRACT

Islamic finance has proliferated beyond Islamic banks to a number of conventional banks. Both the growth of Islamic banks and the spread of Islamic finance are closely associated with newly developed working relationships between bankers and a class of *ᶜulama'* (Islamic religious scholars). The new economic-cum-political alliance between the scholars and bankers affects the invention of new modes of finance and will affect the future of Islamic finance on theoretical and practical levels. A byproduct of the new alliance is the redistribution of economic and political power in Muslim countries toward moderation and more mass involvement. The Islamic finance movement restores the banking profession to its original role in financing commodity production and exchange, with an emphasis on eliminating all kinds of non-commodity finance. Additionally, as a result of reformulating the relation between banks and their sources of funds, it brings depositors closer to the bankers' use of funds. Moreover, the new alliance is able to emphatically introduce moral or ethical standards in investment. On the other hand, it brings national bankers in Muslim countries closer to the public and bridges the gap between governments and significant segments of the Islamic movement. Islamic finance is heading more toward mainstream banking, and there is currently little or negative effort by Islamic banks to follow the international trend of integration and consolidation.

I. INTRODUCTION

Islamic banks came into existence in the second half of the twentieth century as an offshoot of the newly rediscovered Islamic economics. Writings on Islamic economics date back to the late 1940s, both in English from the South Asian subcontinent, and in Arabic from the Middle East. To understand the strategic trends of Islamic banking and finance, it is important to look at its roots in recent history. Writings on Islamic economics describe it as a market system that abides by the Islamic legal code, the *shariᶜa*.[i] In the 1950s and early 1960s writings on interest-free banking implied the prohibition of interest, and culminated in the establishment of two Islamic banks in Egypt and Malaysia. In 1974 an Islamic commercial bank was established in Dubai, and in 1976 the Islamic Development Bank (IDB) started operations, as an inter-governmental Islamic bank[ii] that presently includes 53 member countries. With a few exceptions, Islamic banks exist today in almost all Muslim countries from Indonesia to Guinea-Conakry. There are also a number of smaller financial institutions in North America that offer financing based on the Islamic modes of financing.

Two interrelated phenomena have accompanied the development of Islamic banking and finance in the last four decades: the invention of new banking techniques and the alliance between *ᶜulama'* and bankers. These phenomena are inherently related, since Islamic banking techniques were both a cause and an effect of the alliance. They also shape the future trends of this movement. This paper aims to shed light on the two phenomena, their causes, and effects on future developments in Islamic banking and finance.

In particular this paper will discuss:

- The formation of strategic alliance between *ᶜulama'* and bankers, its implicit objectives and effects on future trends in Islamic banking;
- Banking techniques produced by the alliance and introduced by Islamic banks;
- Extrapolating present strategic elements into future developments of Islamic banks and the movement of Islamic banking and finance.

II. THE *ᶜULAMA'*-BANKERS STRATEGIC ALLIANCE

The first Pakistani writing on Islamic banking came from a banking economist (Uzair) while the first Arabic writing came from a *shariᶜa* scholar (al-Sadr). It is interesting to note that the first two projects in Islamic banking, in Egypt and Malaysia, kept their distance from *shariᶜa* scholars. It was therefore expected that the first two

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commercial Islamic banks, Dubai Islamic Bank (IB) and the IDB, would not pay much attention to establishing their own *shari^{c}a* boards.[iii]

Between 1950 and 1970 there were several important works on the possibility of creating interest-free banks, creating awareness among Muslims, especially in South Asia and the Middle East, of the need for Islamic finance. When full-scale Islamic banks, like Dubai Islamic Bank and the IDB, were established they did not have any models of operation to follow. Undoubtedly because of differences in scope and their management perspective, the IDB took the direction of professional public-sector banking/administration, while the Dubai Islamic Bank took a business-trading direction, without any formal or systemic contact with *shari^{c}a* scholars.[iv]

A. An Alliance is Born

The formal contact between bankers and *shari^{c}a* scholars came during the almost concurrent preparations for the establishment of Islamic banks in Egypt and Jordan, during the second half of the 1970s. Both banks required special exemptions from banking laws, and relied on the Islamic Affairs Divisions of the government for support. This new political alliance was solidified when the *shari^{c}a* members of preparatory committees became *shari^{c}a* councils/boards of the newly founded banks. Both Faisal Islamic Bank of Egypt (1976) and the Jordan Islamic Bank (1978) have their own formal *shari^{c}a* advisers. This tradition continued with the establishment of the Sudanese Faisal Islamic Bank (1978), the Kuwaiti House of Finance (1979), and with other Islamic banks throughout the Arab countries, Turkey, Bangladesh, Indonesia and more recently, the private sector Islamic banks in Pakistan.

During the 1980s, countries such as Pakistan, Iran and later Sudan underwent a government-spurred transformation of the whole banking sector. In most Arab countries, West Africa, Malaysia, Indonesia, Turkey and Bangladesh, however, the move toward Islamic banking came as a result of the private initiatives of a few visionary individuals, such as Mohammad al-Faisal and Saleh Kamel of Saudi Arabia, Ahmed al-Yasin of Kuwait, Sa^{c}id Lutah of the UAE, Sami Hamoud of Jordan and Abd al-Halim Isma^{c}il of Malaysia. These private initiatives were influenced by intellectuals of the caliber of Ahmed al-Najjar and Issa Abdu Ibrahim, both from Egypt. Their true allies, however, were the *shari^{c}a* scholars rather than the Islamic intellectuals.

When Prince Muhammad al-Faisal embarked upon the idea of Islamic banking he was able to give it a momentum that has carried his name since 1976, with the Faisal Islamic Bank represented from Pakistan in South Asia to Guinea in West Africa. He remained in close association with Ahmed al-Najjar until 1986, when the collapse of Faisal Islamic Bank of Cyprus separated them forever. The Prince knew that his relation with al-Najjar would not buy him prospective clients, nor the government blessings that he needed for his bank in Egypt. At the same time he could not associate himself with the Muslim Brotherhood, and such an association would, moreover not bring him closer to the business sector in Egypt or other Arab countries. The former Grand Mufti of Egypt made a perfect ally who could deliver acceptance and legitimacy without negative effects on relations with the government and the prospects of the issuance of a special law that the Prince needed President Sadat to implement, in order to permit the establishment and operation of the first (Faisal) Islamic Bank in the world.

At about the same time, discussions were underway for the establishment of the Islamic Bank of Jordan, with venture capital, the Ministry of Islamic Affairs and Awqaf, Sami Hamoud who needed Islamic legitimacy, and financiers spearheaded by Saleh Kamel. *Shari^{c}a* legitimacy was sought in the ranks of the Ministry of Awqaf and the General Office of Fatwa, and a former Grand Mufti of Jordan was recruited. A new strategic alliance started to emerge between *^{c}ulama'* and businessmen-turned-bankers. This alliance has continued to prosper and grow till today.

From the newly-turned bankers' point of view, the *shari^{c}a* scholars, unlike other Muslim intellectuals, have far closer contacts with the average Muslims who form the clientele of Islamic banks than the economics and finance professionals, academics or the activists of Islamic movements.[v] Hence, the *shari^{c}a* scholars were seen to have the capability to pave the ground for the acceptance of these newly established Islamic banks and to give them the required credibility and legitimacy. In exchange a declared commitment by the bankers to abide by the *shari^{c}a* not only in the prohibition of interest, but also the detailed *fiqh* of financial transactions related to *murabaha*, *ijara*, money exchange, debt contracts and other such rules and principles. These details are usually decreed by *shari^{c}a* scholars, while Islamic economists and finance professionals usually have little knowledge of *fiqh*.

Islamic banking and finance expansion and its market penetration have thus always been associated with the involvement of professional *shari^{c}a* scholars, the *^{c}ulama'*. When international Islamic investment funds, managed by western bankers and brokers, emerged in the mid-90s, they had to get *shari^{c}a* scholars to gain the legitimacy needed to win depositors. Since 1970s the seminars, meetings, conferences, and symposia organized globally have further strengthened this alliance between Islamic bankers and *shari^{c}a* scholars and developed mutually rewarding working relationships.

The role of *shari^{c}a* scholars, essential as it is at the establishment stage and for public relations, has always been restricted to an advisory capacity.[vi] *Shari^{c}a* boards did not participate in decision-making. The management of these institutions have, at times, passed decisions without consulting their *shari^{c}a* advisers, and have subjected the latter's opinions to tactics of delay and further review without risking the loss of public confidence. In such circumstances the boards of directors realize that the alliance with *^{c}ulama'* better serves their business objectives. As such, all Islamic banks remain full-service financial intermediary institutions that abide by Islamic law as a code of transactions.[vii]

III. Banking Techniques Introduced by the Alliance

Interest-free Islamic financing is derived from two *shari^{c}a* axioms related to the *fiqh* of transactions: achieving a balance between the obligations of the two parties in exchange contracts, and a close tie to reality. Generally speaking, bank financing is redefined in terms of real commodities. For Islamic banks, financing is the provision of capital goods, inventory, and consumer durables and, to a limited extent, services against payments at a future maturity. Islamic banks are relatively less involved in activities such as project equity financing for sharing returns that are actually realized. In Islamic financing based upon sale or lease, the banker carries a risk of owning a good for a short or long time. In both cases, market forces determine the profit for the banker either directly, as a rate of markup, or as rentals. In equity financing, the revenue is based upon a ratio of profit distribution between the financier and the beneficiary's business venture. Financing on the basis of profit/loss sharing is based upon direct investment, in which the bank's attention is focused on the profitability of its investment.

A. Resource Mobilization

Since the 1950s the Islamic banking approach toward funds mobilization has been a topic of discussion. One view is that the Islamic bank receives funds on the basis of *mudaraba*, if returns are to be expected. Another view is that funds are received as loans, if the principal is to be guaranteed. This matter was settled more than a decade before the establishment of the first commercial Islamic bank, when the concept of *mudaraba,* or investment deposits, was preferred: this sacrifices an important characteristic of time deposits, namely, the guarantee of principal and fixed return. This was not an easy task for Islamic banking personnel who have been trained in conventional banks.

B. Partners, Not Depositors

Restructuring conventional time deposits in the form of investment deposits with an ex-post, de facto rate of return is an innovation in the banking industry. Since the early practices of money changers that set the pace for the European invention of banks, the relationship between depositors and bankers have been structured as loans, guaranteed and sometimes secured. A significant part of economic analysis is based on this concept of loans and lending. Interest, as a price determined at the time of the loan contract is taken for granted, and treated as a cost of money in the banking profession. Islamic banking differs from this view and changed the nature of the contractual relations between bankers and fund owners. The new relationship is based on partnership—a type of cooperation, in which cash is entrusted to bankers for investment, and the returns are shared when and if they materialize; the principals are not even guaranteed. Returns paid to fund owners are de facto and ex-post. No assumptions or presumptions are made about the rate of return on deposits. Even the share of the bank as a *mudarib* is ex-post.

At the time a deposit is made, the ratio of distribution of profit is determined. Islamic banks act as *mudarib*, i.e., authorized agents, to make investment decisions for depositors. The ratio of profit distribution is normally subject to market forces.

All types of savings deposits at Islamic banks follow this sharing principle. In 2000, a small Islamic bank collapsed, along with the funds of its shareholders and investment depositors alike, in a substantial deviation from traditional practices. Under normal governmental fraud control the sharing principle creates a performance incentive in bankers, because their ability to mobilize resources becomes dependent on their actual performance in fund utilization. In commercial banks the sharing principle makes resource mobilization a long-term function which is related to the accounting cycle. In contrast, short-term deposit mobilization is driven by interest rates. Islamic banking incentives also reduce the risk of overnight deposits withdrawal with changes in interest rates.

The principle of risk-sharing also changes the attitude of management toward doubtful debts and other potential liabilities, and losses that burden a bank's balance sheet. As shares of profit are distributed to depositors at the end of each accounting cycle, any attempt to hide or brush aside potential liabilities would have cumulative negative effects from shareholders to depositors.

Another change that affects the banking system is the monetary policy of central banks. Commercial Islamic banks can count on passing on the negative effects of such policies to their depositors, or at least, distributing it between the bank and depositors, rather than carrying the burdens alone.[viii]

Finally, it should be noted that Islamic finance has not yet received critical analysis sufficient to refine its application. For instance, there are no satisfactory studies in the area of administrative and managerial checks and balances, and the responsibilities of the bank management and depositors. There are suggestions for depositors' representation in boards of directors, and the creation of a depositors' general assembly parallel to the shareholders' general assembly, or the creation of a depositors' committee to advise the management. There are also suggestions for creating certain forms of deposits insurance by a collective action of the Islamic banks.

With regard to current accounts, the alliance with the *ᶜulama'* strengthens the bankers' position, which is similar to those of conventional banks. Current accounts balances are considered loans on the bank in spite of the fact that a certain percentage is actually invested. The return on this investment is reaped by the shareholders of the Islamic banks. This is legitimized on the ground that current accounts' balances are guaranteed, and therefore have no right to any share in the profit.[ix] Keeping in mind that shareholders' equity usually makes a small proportion of the bank's funds, this practice disproportionately boosts their return. This approval from the *shariᶜa* boards can easily be refuted on the grounds that the percentage of shareholders' equities to the Islamic banks' assets is so small as to render useless any guarantee of such liabilities in case of a default.[x] Additionally, current accounts' holders' preferences indicate that they value withdrawal facilities more than return on their balances. If the Islamic banks ease restrictions on withdrawal from investment deposits, current accounts holders would be inclined to move their balances to *mudaraba*-based deposits.[xi]

The use of *mudaraba* as a foundation of the relationship between the Islamic banks and their sources of funds created a theoretical confusion within Islamic economic and banking analysis. On the basis of the pioneering Egyptian experiment of the 1960s, and in an attempt to keep away from debt-producing finance, Islamic banking is understood to depend on profit-sharing for funds utilization and mobilization. This approach to Islamic banking would give little attention to current accounts as a main source of monetary resources. Two versions are considered in early writings. A two-tier *mudaraba* version sees an Islamic bank as a simple financial intermediary, whose only role is to channel venture capital from fund providers to businesses, and does not have room for demand deposits. The second version accommodates demand deposits on a 100% reserve basis. It sees the Islamic bank as a two-compartment organization, whereby deposits in current accounts are managed in one compartment under a 100% reserve condition, with the second compartment working side by side to manage the *mudaraba* deposits that are to be directed to businesses. From this point of view commercial Islamic banks have actually failed, as they do not to maintain a majority of *mudaraba*-based financing in their assets.[xii]

C. Funds Utilization

Thus, in reality, Islamic banks have drifted away from the basic features of the pre-conceived paradigm. The main financing mode they use is *murabaha* and not *mudaraba*. The alliance with *ᶜulama'* was in a sense the savior of Islamic banks from the perception that dominates the western-educated Islamic intelligentsia.[xiii] *ᶜUlama'* were able to provide the Islamic banks with a legitimacy umbrella. This can be considered an achievement of the alliance between the *ᶜulama'*, as *shariᶜa* board members, and the bankers. The early writing did not provide sufficient clues for funds placement. Since 1976, it was the strong argument of Sami Homoud that carried the Islamic banks' *shariᶜa* boards to new modes of financing, while the early writings as well as the experiences of Egypt and Malaysia have concentrated on direct investment under the terms of *musharaka* and *mudaraba*.[xiv]

D. Commodity Financing

Financing production and exchange of commodity is the most remarkable contribution of the banking system. The role of bankers in the economic growth of the United States, Europe and Japan is apparent. Even in developing countries, like Egypt, the initiatives of its early bankers during the second quarter of the twentieth century in financing commodity production and exchange are outstanding. Somehow bankers lost that original focus. Rescheduling debt, discounting and wholesale finance have become the essential features of the banking sector. Islamic modes bring financing back in line with commodity production and exchange. They bridge the gap between the financial and the real market.[xv] As Islamic banks restrict their financing to the three modes or principles of sale, lease and equity, it is available only to help in the creation or exchange of real goods and services, i.e., it has a one-to-one relationship with the real goods market.[xvi]

Additionally, Islamic financing differs from the conventional rule of thumb for micro-finance that "shareholders equity should be used to finance fixed assets and bank credit should finance current expenses, payroll and inventory." Except in very rare cases the Islamic banks do not finance payroll and current expenses, because the

Islamic modes require a commodity base and delivery before resale. Customers of Islamic banks can rely on bankers to finance capital goods and inventories, intermediate and final goods but cannot hope to finance labor compensation. Islamic banks finance economic activities such as the establishment of new productive projects, purchases of producer/consumer goods, and the lease of productive machinery, equipment, housing and consumer durables.

The restriction of Islamic banking and finance to commodity production and exchange is deeply rooted in the *shari^ca. Shari^ca* specifically excludes two main categories of conventional financing from its profit-seeking finance. One is general purpose financing which aims at simply supplementing government and/or corporate budgets, whether for seasonal or non-seasonal purposes. This financing is normally dependent only on the debtor's ability to repay the loan, i.e., the trustworthiness of the beneficiary. The Qur'an uses the term *riba* specifically for a loan with an increment. Second, there is rescheduling finance in all its forms, as long as a common feature of an increment in the amount of debt is associated with a change of maturity or final owners. These two categories are, under the *shari^ca*, a task of philanthropic finance only.[xvii]

The establishment of a strict tie between financing and commodity production and circulation not only upset the conventional wisdom of corporate finance but also imposed a tap on the size of financing in an economy, as it makes financing tailor-made to the size of production and exchange. This works in eliminating "parasitic" financing aimed at servicing pre-existing debts. Needless to say, the financing layers that burden the real markets in interest-based economies have to be reduced if not totally abolished if Islamic modes of financing become the backbone of mainstream banking.

E. Beyond the Elimination of Interest

While the attention of the Islamic economic and finance participants was centered on the elimination of interest, the alliance between bankers and *^culama'* was able to shape the Islamic banks not only as interest-free financial intermediaries, but also as intermediaries of ethical standards. The alliance defined an Islamic bank as one that abides by all the *shari^ca* rulings. The Islamic banks introduced a new dimension in the practice of the banking profession, requiring the inclusion of moral criteria in the process of investment screening and selection.[xviii] Good bankers are conceived as moneymakers who have a commitment only to the ethics of their profession, i.e., trustworthiness and fair play. Islamic bankers, on the other hand, must adhere to Islamic values in investment. As *shari^ca* has other prohibitions than *riba*, abiding by *shari^ca*-defined moral standards in investment becomes tantamount to being Islamic. Islamic banks do not finance any commodities or services that are condemned by *shari^ca*. Thus the financing of tobacco, gambling, drugs, alcohol, weapons, and environmentally harmful products are excluded.[xix]

F. Are Islamic Banks Bankers or Traders?

The alliance of *^culama'* and bankers failed to emphasize specialization in Islamic banking. As a result two operational approaches have characterized commercial Islamic banking since the birth of the first commercial banks in the mid-1970s: as mere financial intermediaries, in which the bank does not take any business initiatives, in buying goods for financed sale/lease and in providing venture capital, only at the requests and initiative of its customers. This approach is exemplified in the behavior of the Islamic Bank of Jordan, the Faisal Group and other banks. According to this approach, a financing transaction must always begin from the user of funds.

This approach is usually desired and promoted by central banks as it equates the Islamic banks with their conventional counterparts. It is defended on the grounds of efficiency, specialization and justice. Banks are permitted to solicit deposits from the public. This gives them financial power that other businesses cannot avail. Allowing banks to compete with other businesses gives them an edge that can be used unfairly to dominate the market, and lead to monopolistic practices.

Alternatively, the Kuwait Finance House promotes a business approach. In addition to financial intermediation this approach allows Islamic banks to open showrooms, maintain warehouses and buy goods that the banks offer to customers on a markup (*murabaha*) basis. This approach is equally supported by most *^culama',* who call on Islamic banks to compete in the goods market. Inadvertently the special laws and decrees that established Islamic banks in Kuwait, Egypt, Sudan, Jordan and other countries seem to permit them to practice trade, i.e., to buy and sell goods without restricting them only to an intermediary financing role. This approach has caused annoyance to both central banks and the Muslim economic and finance members. This unease became apparent especially when the Kuwait central bank started exercising a formal control and supervision of the Kuwait Finance House and resulted in stalling the proposed act of Islamic banking in the Kuwaiti parliament because of the strong opposition from the supporters of the Kuwait Finance House.

IV. Strategic Trends of the New Alliance

The alliance between the *^{c}ulama'* and Islamic bankers will remain with us for the time to come. The reason is clear: both parties derive benefits from their togetherness. The strategic alliance creates a new power structure in the sociopolitical arena in the Muslim countries that affects both the short-term struggle for economic and political influence and the long-term Islamic finance and banking movement.

A. The Benefits of the Strategic Alliance

Several factors contribute to bringing the *^{c}ulama'* and some rich Muslims into alliance. The Muslim bourgeoisie and bankers enjoy several benefits. First, it provides a good means of reaching out to Muslim populations, to convince them to deal with the new banks. This is especially important if we keep in mind the history of suspicion and apprehension toward the banking sector from foreign, national and even central banking authorities; as well as to the often secularist media where the new Islamic banks advertise, and more generally, toward their own governments which license such banks. Secondly, the new alliance helps create a clientele among those who did not use the banking system at all, because it relies on interest. The alliance also helps in competing with conventional banks and in attracting their customers. A study conducted in the mid-90s by the Department of Islamic Financing Services of the National Commercial Bank of Saudi Arabia indicates that more that a third of the clients of a conventional branch would be willing to shift to Islamic financial services, if convinced the latter is "truly Islamic."[xx] The alliance helps in public relations: something new bankers need, to assert their stand and arguments against governments, the media, and the central banks and their conventional competition.[xxi] It also creates a kind of buffer that is used to support the main shareholders and professional managers of Islamic banks, who are usually drawn from conventional banks, in their dialogue with depositors, dormant shareholders and users of finance. Further, *shari^{c}a* boards are also used by bankers to bail them out vis-à-vis the depositors and shareholders as can be seen from the *shari^{c}a* board report of 1998 of Bank al Taqwa.[xxii]

The *^{c}ulama'* benefit, as this alliance brings them back to the forefront of the political scene at a time when most were marginalized by the rising political Islamic movement.[xxiii] It gives the *^{c}ulama'* a new image and allows them to implement the *fiqh* they have taught all their lives. This alliance also gives them a new source of income and a new lifestyle, which includes air travel, sometimes in private jets, staying in five-star hotels, media attention, advisory positions to people of high social and economic rank, and commissioned *fiqh* research. In some Islamic banks *shari^{c}a* scholars have reached positions as high as vice-president, and a *shari^{c}a* scholar even served as deputy governor of the central bank.[xxiv]

B. Trends in Islamic Finance and Banking

This new power alliance resulted in creating new strategic trends that affect not only the Islamic banking industry and the *^{c}ulama'*, but Muslim society as a whole. Additionally the expansion of Islamic banks and their modes of financing played an important icebreaking role that points to important future trends in finance and banking. It proves that it can be done and encourages a pro-active attitude. It is no surprise that Islamic banks were able to maintain a growth rate of more than ten percent over three decades.

The alliance of *^{c}ulama'* and bankers enhances the engineering of new financing modes. Initially there was only one financing mode, *mudaraba*. The introduction of *murabaha* enabled Islamic banks to finance imports and domestic trade. *Murabaha* actually gave momentum for the establishment of commercial Islamic banks. *Ijara* was also invented by the *^{c}ulama'*/bankers alliance. *Salam* and parallel *salam* were added to be used in financing agriculture and light industries. Even the conservative Islamic Development Bank, that restricted its financing to *musharaka* and *murabaha* for many years, added *ijara* to the purchase order, and later developed its own financial contract of a three parties' *istisna^c*-and-parallel-*istisna^c* to become the main contract for financing development projects.

The development of new financing contracts never ends, and the coalition between *^{c}ulama'* and bankers continues to introduce new modes of financing, including: swap sale of a bundle of investments consisting of debts and real assets as a form of secondary market financing contract, combination of deferred-payment sale with cash sale to provide liquidity financing and to substitute interest-based debts. The cooperation extends to the public debt market, and is attempting to develop short-term and long-term public financing instruments in Sudan and Iran, with the help of the IMF. Most of the new modes of Islamic finance have gained acceptance world-wide.

The expansion of Islamic banks led many profit-seekers to enter this new market. The *^{c}ulama'* have provided public acceptance, and Islamic banking is known to the public in most Muslim countries. Islamic banks have grown by expanding their equities, deposits, assets and investment and adding new banks along the way. Between 1990 to 1997 the assets of twelve major Islamic banks grew at a rate of 8.2%, their deposits grew at 7.9%

and their equities at 9.0%, in contrast with 5.6%, 4.9% and 5.6%, respectively, for twelve conventional banks of similar size from the same countries. Moreover the total investment of these twelve Islamic banks grew at 9.6%, compared with a 3.3% growth rate for conventional banks during the same period.[xxv] Moreover, several new Islamic banks were created and/or converted from the conventional banking practices, especially in Indonesia, Bangladesh, Saudi Arabia, Bahrain and Qatar. Hence it is safe to assume 10% as a conservative rate of growth of the Islamic banking industry, which has been sustained since its inception in the mid 1970s.[xxvi]

Islamic banks have a stake in promoting financial research, and thus the alliance has enhanced *shari^c^a* research. According to the late Mustafa al-Zarka, *fiqh* research preceded other areas of Islamic studies in its revival from the beginning of the 20th century. A reasonable claim can be made that the last thirty years have seen more *fiqh* research in the financial and economic areas than in any other field. Although there are no statistical data to substantiate this trend at the level of scholarly publications, a look at the activities of the OIC Fiqh Academy in its first thirteen years (1985-1997) is enlightening. Fifty-one of its ninety-seven resolutions relate to financial and economic issues:[xxvii] this proportion is representative of *fiqh* research in the last quarter of the twentieth century, especially when the specialized seminars and workshops conducted by the finance industry are taken into account.

The alliance helps modernize *fiqh* opinions and rulings, and addresses contemporary transactions from a *shari^c^a* point of view. The *^c^ulama'* have always contended that to be Islamic, a bank must submit all its contracts, transactions, and manuals to *shari^c^a* boards for scrutiny and clearance, which requires that *fuqaha'* sit with bankers, financiers and economists to learn the details of every single transaction and become acquainted with new terminology, procedures, and methods. Expansion in *fiqh* has come a long way from the letters of credit, guarantee and acceptance to foreign exchange hedging, syndicated financing, investment swaps and timesharing. An ever-expanding list of issues is daily explored by *shari^c^a* boards and subjected to scrutiny in seminars, workshops and conferences.

The alliance contributes to increasing social and economic coherence in Muslim societies, through schemes that end with the finance beneficiaries becoming owners of their productive assets. Such financing programs address small craftsmen, taxi drivers, house financing schemes and micro-financing programs. The *^c^ulama'* normally encourage and support such programs. In Sudan, for instance, the Islamic Bank of Sudan-West initiated a successful program for small farmers and craftsmen financing. This was followed by a similar program to finance micro-industries by the Sudanese Faisal Islamic Bank.[xxviii] In Jordan, the Islamic Jordan Bank takes pride in a successful scheme to help taxi drivers become owners on a declining *musharaka* mode of finance. The Arafah Islamic Bank and the Islamic Bank of Bangladesh have their own micro-financing programs that, though far smaller than Grameen Bank, have a much lower effective financing charge than the 22% plus per annum interest charged by the latter.[xxix]

In my studies of Islamic banking and finance I did not come across any statistical analysis of finance beneficiaries classified on the basis of the amount provided and the business size of recipients; such a study would be very useful. But from repeated visits to many Islamic banks, reading their reports, discussions with officers and from the general information about the size and distribution of the credit markets and the share of Islamic banks in various country markets, it seems clear that most financing is channeled to medium and small entrepreneurs. Observation and discussions with professionals have shown me that in five of the six Islamic banks established in Sudan before the "Salvation Coup" of 1989, financing has been instrumental in creating a new and rising class of non-traditional businessmen.[xxx]

This new alliance also brought Islamic banking and finance closer to the rich upper strata in Muslim societies: bankers, owners of big businesses, the middle-class, lawyers, economists, bureaucrats, and small entrepreneurs who use a lot of the banks' financing and even the poor[xxxi] who benefit from the fringe activities of many Islamic banks, especially the distribution of *zakat*.[xxxii] The social and political impact of this rapprochement is yet to be fully studied. However, it has become normal for many poor and middle-class people to defend and befriend Islamic bankers and their activities, even in very poor countries like Yemen.

The alliance creates an atmosphere of fresh political rapprochement between the Islamic movement and governments, especially in Arab countries. Keeping in mind that the governments in most Muslim countries are non-democratic, Islamic banks have been sensitive in selecting *^c^ulama'* acceptable to both the state and the people. They were particular to avoid extremists on either side: neither the so-called government-cheering *^c^ulama'*, nor those known as spokesmen of or deeply allied with Islamic movements. Since the establishment of the first Islamic bank in Dubai, Islamic bankers relied on a working relationship with the governments. All other Islamic banks followed suit, in either entering into a partnership with their governments, or keeping friendly contact with the authorities while avoiding any relations that may annoy the ruling class, on the employment as well as the business level. Depending on the type of government, the policy of selecting members of the Boards of Directors and important officers varies from strictly professional technocrats, to hiring persons of known lack of commitment to Islamic teaching.[xxxiii] At the same time Islamic bankers did not shy from utilizing the services of "moderate" Islamic activists, as long as the latter do not disturb the banks' relationships with governments. Hence, many moderate activists have found peaceful havens in the Islamic banks, especially in countries like Egypt, Jordan, Bangladesh, and Indonesia.

The rise of Islamic banking actually helps creates non-hostile relationships between the moderate Islamic movement, mainly professional technocrats and progressive *ᶜulama'* on one hand, and their governments on the other. This comes at a time when elements within the Arab Islamic movements are calling for a revision of the movement's position on relations with governments and on strategies of political change. This is especially important, since many of the reconciliatory reformists, who abandoned Sayyid Qutb's decades-old move to "Take Islam all together or leave it," for a gradual implementation of the *shariᶜa* without a radical political change, are absorbed in Islamic banks. With the exception of Sudan, Turkey, Pakistan, and Iran, Islamic banks help change the map of sociopolitical power, and are creating a nascent power center that consists of the *ᶜulama'* involved in Islamic financial research and application. There is a new and rising class of rich bankers, entrepreneurs, executives, non-antagonistic (to the Islamists) members of the secularist intelligentsia who are associated as professionals and bureaucrats.[xxxiv]

C. The Future of Islamic Banking and Finance

Islamic banking is a movement of development and renovation in the banking profession and practice. By its very existence, the Islamic banks exemplify a potential and empirical success of the idea of a banking system that is morally sound, responsive to depositors, and yet in touch with market realities. The movement is simply a new step in the advancement of banking theory and practice; it comes with a new vision and approach; it has tested new ideas and practices and has proved their applicability. In other words, Islamic banking ideals fit nicely within the theoretical framework of growth and development of mainstream banking rather than as an "alien" paradigm.

The real challenges to Islamic banking arise from the liberalization, deregulation, and globalization of financial services consequent with the expansion of the World Trade Organization. This will open the economies of the Muslim countries to large, robust and efficient financial institutions. On purely theoretical grounds, functional liberalization serves the interest of Islamic banks, since deregulation allows more flexibility to accommodate new relationships in fund mobilization and utilization. While functional liberation accommodates the new "Islamic" modes of financing, it gives conventional banks the opportunity to compete for "Islamic" business, as deposits as well as placement opportunities.

While the banking industry is witnessing a strong trend of integration, Islamic banks continue to be small and fragmented, and rest on a presumed captive clientele. In spite of a rate of growth of equity that reached 10% over the past decade, the average capital of an Islamic bank is still less than $50 million and the average total assets are less than $900 million.[xxxv] In the last five years, two more Islamic banks were created in Bahrain, Bangladesh and United Arab Emirates, respectively. There was one conversion from conventional to Islamic banking in Saudi Arabia, and a merger of two small Islamic banks and an Islamic investment company in Bahrain. At the same time the HSBC, a conventional bank, is expanding its Islamic finance operations, and several American banks are considering going into the "Islamic market" within and out of the U.S. We must also remember that Islamic banks have an edge over conventional banks that offer Islamic financing as they can share their losses with their depositors at times of hardship. Because of their small size, however, Islamic banks cannot enjoy the advantages of economies of scale. They also lack or have limited access to efficient technology, and suffer from other technical, organizational and managerial problems, such as a lack of standardization of *shariᶜa* opinions; low know-how on the part of management and staff; inadequate or dysfunctional supervisory standards, both internally and externally by the central banks; uncreative marketing; and inadequate sensitivity to customer satisfaction.

It is critical that Islamic banks merge, integrate and increase their capital and efficiency performance. Merger is not merely desirable; it is a must. Small banks are at a disadvantage in a world of large banks, where they no longer have a monopoly on clients. If Islamic banks want to reach international markets they must have adequate size, capital, and reasonable reach for deposits and assets-creating power. Potential resources are already viewing alternative channels in Islamic investment funds, and many Islamic banking operations, windows and branches, run outside the Islamic banks, both internationally, and in the centers of Islamic finance.

Since the opinions on many financial transactions are not yet codified, the advice *shariᶜa* boards offer often varies greatly,[xxxvi] particularly when it comes to new banking products.[xxxvii] There is a strong need for standardization at all levels, starting with the very raison d'être of Islamic banks, i.e., the *shariᶜa* codification of banking transactions. This can be achieved by forming a common platform of *shariᶜa*-accepted regulations instead of having independent *shariᶜa* boards with varying opinions. There is also a need to standardize reports, balance-sheets and other financial statements, as well as manuals and definitions of transactions, and accounting methods. For the latter, the Board of Accounting and Auditing of Islamic Financial Institutions, established in Bahrain in the late 1980s, needs to work harder and faster, and to increase its acceptability to cover all Islamic banks. Standardizing transactions will improve public understanding of these institutions, and also help spread Islamic banking practices both geographically and functionally.

Another technical problem that the institutions suffer from arises from inadequate training resulting from the rapid establishment of Islamic banks. Islamic banks draw their employees from conventional banks without sufficient retraining. This causes problems in understanding *shari^{c}a* rulings, and their accidental contravention, and in advising customers on the types of financing and deposit contracts available. The personnel problem also exacerbates the problem of the lack of creativity. Although Islamic banks have grown at over 10% annually over the past three decades,[xxxviii] this growth has not been accompanied by innovations in banking services and public outreach.

Islamic banks are generally unable to exercise creative efforts to mobilize resources and direct them toward new investments. Customer satisfaction does not usually have high priority, as the banks do not have competition,[xxxix] and rely on their own "committed" clientele.[xl] The effect of monopolistic practices may be traced in the substantial difference between the rate of return on investment deposits and the rate of return on shareholders' equity, although the difference between investment deposits and share capital is minimal in regard to responsibility toward losses.[xli]

Most Islamic banks add deposits at the beginning of the following month and funds withdrawal effective beginning of the current month. One bank does not accept investment deposits less than $265,000, forcing small depositors to use the zero-income current account system, and reaping a return of more than $6 billion in demand deposits, for the benefit of shareholders with a paid-up capital of only $400 million. The improvement of banking services with regard to investment deposit holders, current account holders and users of bank financing is a pre-requisite to increasing the ability of the existing Islamic banks to face rising competition, especially from the new branches and windows of large conventional banks.[xlii]

The lack of adequate personnel training also reflects on the Islamic banks' relations with central banks. Except for countries that Islamicized the whole banking sector, the relationships between Islamic banks and central banks have been unsatisfactory. This is partly due to the inability of the staff, themselves unfamiliar with modes of operation, to explain the special characteristics of their transactions to central bankers. Yet the main reason for unpleasant relations with central banks lies in the fact that the specially devised laws for establishing Islamic banks did not adequately address the peculiarities of supervision needed for "special banks." When governments enacted these laws the very nature of Islamic banking and finance was not clear.[xliii] At the same time, central banks could not adapt their regular tools of control and supervision to fit the specificities of Islamic banks and their transactions. Communication was thus difficult on both sides. No standard supervision criteria have been developed by any central bank,[xliv] even in countries with several Islamic banks under the authority of their central banks, such as Egypt and Qatar. Central banks still apply the same tools they use with traditional banks.[xlv]

V. CONCLUSION

The survival and advancement of Islamic modes of finance and deposits do not depend on the growth and development of Islamic banks. Islamic modes of finance have already found their way to the mainstream, although they are still offered mainly to Muslims. On the other hand, the sharing mode has not been able to penetrate the mainstream deposits market, except on a partial basis in a few conventional banks with Islamic windows, in countries like Egypt and Malaysia. Theoretically, it seems that partnership deposits make a good case in a conventional banking environment. It is apparent, however, that the use of Islamic financing and deposits modes is a viable alternative to conventional banking. To borrow al-Ghazali's terminology, we shall need a *takhliya*, removal or abolishing, in addition to the *tahliya*, addition or inclusion, to be able to reduce or eliminate the layers of monetary assets that burden the real commodity market as a result of the interest-enabled rescheduling, discounting and debts wholesale. Moreover, a country-wise transformation of the banking system is needed to accomplish the claimed macro-financial effects of Islamic banking.[xlvi]

What is at stake under deregulation and globalization is the future of Islamic banks and not Islamic finance. Improvements and actions are needed by Islamic banks themselves at the state and regulatory levels, quite as much as within the banks themselves.

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[i] The early modern writings are associated with the names of the founders of the contemporary Islamic movement: Maulana Maududi in India and Pakistan and Hassan al-Banna in Egypt, followed by Sayyid Qutb's famous book, *Social Justice in Islam*. Probably the first systemic work on the issue of interest by an economist was Anwar Qureshi 1948, followed by Muhammad Uzair 1955, and Muhammad Baqer Al Sadr 1960.

[ii] The first two Islamic banks and the IDB are all development-oriented institutions with little interest in commercial banking. The Dubai Islamic Bank was established and managed by businessmen in a country whose banking laws were still in their infancy. This bank was more involved in merchandise trading than other banking activities. Thus full-fledged commercial Islamic banking came about only with the birth of the Islamic banks in Egypt, Jordan and Sudan in the late 1970s.

[iii] As at the writing of this paper IDB still had no *shari^{c}a* board or committee. Dubai Islamic Bank got a *shari^{c}a* advisory board only after its restructuring in 1999.

[iv] It must be pointed out that both IDB and Dubai Islamic Bank have occasionally consulted *shari^{c}a* scholars when they needed advice.

[v] It should be noted that 20th century Islamic movements in almost all Muslim countries other than Turkey and Sudan have generally been on unfriendly terms with the *^{c}ulama'*. Since the time of Hasan al-Banna in Egypt and Maududi in South Asia, the real *raison d'être* of the Islamic movement has been conceived in terms of the failure of the *^{c}ulama'* in discharging their responsibility to awaken the *umma* and educate it about the importance of religion in contemporary social and political life. At the same time Islamic movements have always had fraught relations with governments. Al-Banna declared in 1938 that the true demonstration of the righteousness of the Muslim Brotherhood was expressed in the visible hostility of stooge governments and a corrupt *^{c}ulama'*; and Maududi was more than once accused of apostasy by many traditional Pakistani *^{c}ulama'*.

[vi] Some Islamic banks also charge their *shari^{c}a* board with the responsibility for arbitration in case of disputes with customers. This function is also a part of the public relations role of the *^{c}ulama'*, as it is intended to assure the public that the bank abides by *shari^{c}a* rules.

[vii] Some writers consider Islamic banks as more than finance intermediary institutions. This is not true. For instance, in a 1997 paper, Timor Kuran said, "Islamic banking defies the separation between economics and religion. It invokes religious authority in a domain that modern civilization has secularized." A close look at the difference between *shari^{c}a*-as-law and religion indicates that Islamic banks are not religious organizations. They are civic institutions that elect to abide by the rules of *shari^{c}a*. Their *shari^{c}a* boards have advisory capacity with no executive power, they act in a manner similar to legal advisors. the only executive authority exercised in Islamic banks is that of their boards of directors under the control and supervision of their respective central banks or monetary authorities.

[viii] Most Islamic banks create an investment-risk reserve fund or provision to stabilize the distributed returns to investment-deposit holders. With the help of such funds, Islamic banks were able to practically stabilize the return on deposits from year to year. Furthermore, investment-risk funds were utilized to support distributed profits in low-return times in order to maintain a competitive status vis-à-vis interest-giving banks. This reserve fund is normally financed from the share of profit distributable to investment deposits.

[ix] There are differing views by some *^{c}ulama'* that defend the owners of current accounts. For instance, Hassan Abdulla al-Amin's analysis that these accounts deserve a return was rejected by the *^{c}ulama'*. Al-Amin argues that demand deposits cannot be considered loans from the *shari^{c}a* point of view, because they lack the intention of lending, and the contractual relation calls them deposits. Accordingly, demand deposits must be considered deposits in *fiqhi* terms, i. e. *wadi^{c}a* and the rulings of *wadi^{c}a* must apply to them. He also states that these deposits are given for safeguard and convenience purposes and the bank uses them in its investment activities in violation of the *fiqhi* rules of *wadi^{c}a*. This violation has two effects: it imposes a guarantee of principal on the user, and it gives the owner all the return that resulted from the utilization of the *wadi^{c}a*. (al-Amin 1980).

[x] Kahf 1980.

[xi] Islamic banks usually impose restrictive measures on investment deposits. Faisal Islamic Bank of Egypt is the only Islamic bank that allows withdrawal from investment deposits on a 24 hour notice. As a result, its balance sheet shows low balances on its current accounts and high balances on investment accounts. This is in contrast with all other Islamic banks.

[xii] Mirakhor 1997.

[xiii] This point shall be touched upon later when I discuss the future of Islamic banking and finance.

[xiv] The early writings on Islamic banking envisioned the Islamic banks would provide funds on the basis of *muđaraba*. This turned out to be demanding on the Islamic banks' personnel, as it requires knowledge in project evaluation, market forecasting, price extrapolation techniques etc., with a horizontal spread over all commodities traded in the market; in addition to a different type of follow-up with the beneficiaries of finance. It is interesting to note that even the theoretical writings had never made any reference to *murabaħa* until Sami Hamoud's dissertation was published in 1976. *Ijara* and especially *ijara wa iqtina'* only entered the theory of Islamic banking in the 1990s. (Kahf 2000).

[xv] Notably, *murabaħa* and *ijara* can also be used as vehicles in debts rescheduling. However, *shari^{c}a* boards restrict their use in rescheduling to the substitution of interest-based loans for Islamic financing.

[xvi] It has been the practice of Islamic banks to finance less than 100% of a transaction and to leave a certain percentage to be financed by the customer under what they call "the margin of serious commitment."

[xvii] Qur'an 2:280.

[xviii] The moral commitment of Islamic banks is intrinsic because the *shari^{c}a* rulings are always morally loaded. On the other hand, during the struggle against apartheid, there were calls to boycott the oppressors, which culminated in a movement to include moral criteria in investment outside Islamic banking. While all Islamic banks are, by definition, morally committed, few other bankers apply moral standards in investment screening.

[xix] This raises the issue of financing terrorism. The history of Islamic banks and of main shareholders and management staff indicates that they cannot accommodate terrorists or terrorist financing They are committed, controlled and supervised by local monetary authorities. Unfortunately, no evidence connecting Islamic banks to financing terrorism has been provided, and the actions against some has no legal or moral grounds. Unfortunately, after the attacks of 9/11, an atmosphere of distrust has impacted Islam, the Muslim world, and American Muslims severely.

[xx] Al Murtan 1999.

[xxi] While the image of Islamic banking received a boost from the *^{c}ulama'*, the so-called "Islamic investment companies" found it unnecessary to hire *shari^{c}a* advisers. These companies draw their clientele from two categories: people who can be reached directly and indirectly through word of mouth and personal contacts, and those who have are willing to take high risks for a quick windfall profit. The earliest of such companies emerged in Saudi Arabia in the mid-70s and wiped out the savings of many people, while its owner/founder landed in a Mecca prison. The same experience was repeated in Egypt, and on a smaller scale in Syria, in the late 1980s. Several "Islamic investment companies" were established in Egypt, taking advantages of loopholes in the law. They collected huge savings from the public, and their main practice was to distribute a high rate of return, actually taken from new deposits. They mainly counted on the pyramidal cumulative effect of new deposits, with very little actual investment. Though Islamic banks and *^{c}ulama'* and most Islamic economists and financiers took strong stands against these companies, a few outspoken Egyptian Islamic activists allied with them, strongly defended them and attacked what they called "the government conspiracy against the Islamic investment companies." The support of Islamic activists did not compensate for the lack of support from the *^{c}ulama'* did not lend these "Islamic" investment companies public acceptance.

[xxii] The bank management flopped in 1998. The bank's report at the end of the year showed a loss of over 23% of the principal to both *muđaraba* depositors and shareholders. The *shari^{c}a* board reported that "the management did not violate the *shari^{c}a* rules," and went so far as to state that the board of directors and the management did their best with sound banking and investment decisions, and that the loss was a result of the South-East Asian crisis, as the management claimed. In 2000, a letter from the management revealed the truth, indirectly indicating that in a breach of established principles of sound banking and common standards of financial wisdom, the bank management actually took high exposures, as it invested more than 60% of the bank's assets in a single project.

[xxiii] It is worth noting that historically the *^{c}ulama'* have played leading advisory roles, and defended the public from rulers' atrocities and outside aggression. Ibn Hanbal, Nawawi, Ibn ^{c}Abd al-Salam, and Ibn Taymiyya are only some of the most prominent examples. In the past the *awqaf* was the main source of finance for Islamic and secular education. From the days of Muhammad Ali in Egypt the control of *awqaf* was transferred to the government. The Awqaf Act of 1856 in the Ottoman Empire extended the government authority to *awqaf* and made the *^{c}ulama'* government employees, which made them lose their independent source of finance, and thus their leadership status. Gradually, they took a position on the peripheries of the political stage. Although the European invasion of much of the Muslim world caused revolutionary reactions and resistance movements often lead by *^{c}ulama'*, most remained invisible. The 20th century political Islamic movement was partly a reaction to this dormancy, but took a turn in the 1940s and 1950s when it presented

itself as a substitute for existing regimes instead of the ^{c}*ulama'*. This is in contrast with the ^{c}*ulama'* of the medieval Islamic period, who did not pose threats to their rulers.

[xxiv] Both stories come from the Sudan's Bank al Tadamun and Central Bank.

[xxv] Iqbal, 2000.

[xxvi] *Directories of Islamic Banks*, 1994-1996. Also, Al-Omar 1997.

[xxvii] The remaining 46 are distributed as follows: 20 medical, 11 administrative, 14 miscellaneous, and one on a query from the American Muslim community consisting of about 30 questions, many which are financial.

[xxviii] Babikr 1997.

[xxix] Reports for the 1998 and 1999 fiscal years, of the three banks named in the text.

[xxx] Two more Islamic banks were established in 1988-89: The Islamic Bank of Sudan-North and the Bank of Workers, but neither was very active before the coup. It should be noted, however, that some Islamic banks restrict a considerable proportion of their financing to a closed circle of main shareholders and their partners and associates. This is especially noticeable in one Sudanese and one Saudi Arabian bank.

[xxxi] Most ^{c}*ulama'* come from poor backgrounds. This is because of the structure of the educational system in Muslim countries. With the introduction of the Western educational system and its emphasis on the sciences, the financial resources of the traditional Islamic educational centers and job opportunities for their graduates became very thin. Since the beginning of the twentieth century, Islamic education became the monopoly of poor children whose parents cannot afford to send them to public or private schools, whereas most Islamic schools provide meager boarding facilities subsidized by charities and the remnants of *awqaf*.

[xxxii] Most Islamic banks take charge of distributing the *zakat* due on shareholders' equity, and some of them obtain the consent of their depositors to deduct and distribute their *zakat*. This allowed some of the Islamic banks to create sizable *zakat* distribution departments that keep relations with the needy, and with other local charities. This is evident in the Social Naser Bank and the Faisal Islamic Bank of Egypt and Kuwait Finance House.

[xxxiii] Although there are no statistical data to substantiate this claim, a close look at the lists of CEOs of Dar-al-Mal's central office and affiliated banks and Al-Baraka Group's banks especially in Tunisia, Algeria, Mauritania, and Bangladesh support it.

[xxxiv] Islamic banks follow different trends in some areas. The peculiarities of the economic and political scenes in Sudan, Turkey, Pakistan and Iran affect the alliance, especially with regards to interaction with the Islamic movement. Analysis of these special cases is outside the limits of this paper.

[xxxv] *Directory of Islamic Banks and Financial Institutions 1996.* The 1996 report was the last one published by the IAIB before it closed. It should be noted that 92 of the reported 166 Islamic banks had a capital of no more than $10 million, and only seventeen had a capital of $100 million or more. Of the latter, nine are state-owned Iranian banks. A similar trend appears for assets. Although total assets average at $826 million, only twenty-three banks have assets of more than one billion dollars. Of these ten are Iranian, which inflates numbers because of the use of official rate of exchange in converting from rials to dollars. There are 85 banks with assets under $100 million.

[xxxvi] For instance, some *shari^{c}a* boards ask the management to submit each individual contract to scrutiny, while others restrict themselves to studying standardized contracts.

[xxxvii] The closing of Al-Barakah Bank in London was partly due to its inability to form a relationship between the bank management and the *shari^{c}a* board which satisfies the Bank of England.

[xxxviii] See n. 25 above.

[xxxix] Bahrain, where three full-service and several off-shore Islamic banks compete in a small economic environment, may be an exception. Some other Muslim countries are also creating a competitive environment. Bangladesh and Bahrain have five banks each, and Malaysia, Qatar, Saudi Arabia and Indonesia have two each.

[xl] The establishment of a second Islamic bank in Jordan was not appreciated by an existing bank, which tried to draw its customers away by questioning the Islamic legitimacy of the new bank, on the grounds that it was established by traditional bankers' capital. Similar fears were raised about the Islamic branches of the National Commercial Bank in Saudi Arabia, as Sa^{c}id Martan wrote.

[xli] Prior to 1998, shareholder's rate of return in the Bahrain Faisal Islamic Bank was above 16% for several consecutive years, while investment deposits' return was only 4-5%.

[xlii] For example, Citicorp of New York established an Islamic Citibank in Bahrain (1995); the National Commercial Bank of Saudi Arabia established more than 46 Islamic branches between 1992 and 1998; and the recently established full-service Islamic bank by the Arab Bank of Jordan (1998), The Arab Investment Banking Corp in Bahrain (2000); in addition to Islamic banking services offered by many traditional banks from New York to London to Geneva to Cairo to Kuala Lumpur.

[xliii] This is an important reason for the argument in the Kuwaiti Parliament between supporters of the Kuwait Finance House and the central bank; the latter wants (rightly) to restrict the Kuwait Finance House to the role of financial intermediary, while the former holds to the authorities granted in the Princely Decree of its establishment.

[xliv] Bahrain Monetary Authority has recently published standardized criteria for supervising Islamic banking. These criteria were developed in cooperation with the Accounting and Auditing Organization of Islamic Financial Institution.

[xlv] Luca Errico and Mitra Farahbaksh suggested applying the CAMEL of the Basel Committee on Banking supervision with higher than 8% capital adequacy, which is the Basel Committee minimum level for OECD countries (Errico and Farahbaksh 1998). This suggestion may be rejected on the ground that unlike the theoretical model used by Errico and Farahbaksh, Islamic banks' assets consist mainly of debts, while most of their liabilities are investment deposits, i. e., venture capital not liability. This makes their capital needs smaller than those of conventional banks. This line of argument borrows support from the practice of the Gambia's central bank in excluding investment deposits of the Arab Gambian Islamic Bank from liquidity requirements because they are not bank liabilities.(Information from the Chairman of the Board of Directors of the AGIB).

[xlvi] It would be an interesting subject of research to study the effect of the Islamization of the banking sector in Pakistan, Iran and Sudan on the size of rescheduling, discounting and wholesale financing in those countries, and on the financing facilities for on tobacco and other "unethical" production and exchange.